INVESTMENT ASSOCIATION RESPONSE

FCA/FRC JOINT DISCUSSION PAPER: BUILDING A REGULATORY FRAMEWORK FOR EFFECTIVE STEWARDSHIP

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The Investment Association is a company limited by guarantee registered in England and Wales. Registered number 04343737. Registered office as above.

ABOUT THE INVESTMENT ASSOCIATION

The Investment Association is the trade body that represents UK investment managers, whose 250 members collectively manage over £7.7 trillion on behalf of clients.

Our purpose is to ensure investment managers are in the best possible position to:

- Build people's resilience to financial adversity
- Help people achieve their financial aspirations
- Enable people to maintain a decent standard of living as they grow older
- Contribute to economic growth through the efficient allocation of capital

The money our members manage is in a wide variety of investment vehicles including authorised investment funds, pension funds and stocks & shares ISAs.

The UK is the second largest investment management centre in the world and manages 37% of European assets.

Investment Association (IA) members hold in aggregate, one third of the value of UK publicly listed companies. We use this collective voice to influence company behaviour and hold businesses to account. More information can be viewed on our website.

EXECUTIVE SUMMARY

The joint FCA and FRC Discussion Paper provides a compelling framework for an effective market for Stewardship in an important period of stewardship reform. It also raises crucial questions about how the regulatory framework can be enhanced to better promote and assure effective stewardship across the investment chain.

The implementation of the Shareholder Rights Directive II and the revised Stewardship Code will result in significant shifts in the market for stewardship in the UK. Implemented effectively, these developments will help to ensure that there is better demand for stewardship across the investment chain and improved transparency and accountability of market participants. It is appropriate therefore to ensure that there is a robust and coherent regulatory approach to stewardship that can ensure these reforms are effectively raising standards, resulting in better outcomes for the ultimate beneficiaries, the end saver. The need for further regulatory developments should be informed by benchmarking against this framework, with clear criteria for effective stewardship.

Our members believe the *central purpose* of stewardship is to generate sustainable value for their beneficiaries, the end savers. A clearly identified purpose of stewardship plays an important role in signalling demand for stewardship across the investment chain. Improving demand at the critical juncture between asset owners and asset managers will raise standards and help to build an effective market for stewardship.

The regulatory framework for stewardship needs to support and promote this central purpose and legitimise the different approaches to stewardship that help to achieve this across different investment strategies, asset classes and across the investment chain – for asset owners, both index and active strategies, asset managers acting on behalf of both institutional and retail clients as well as service providers that support these actors stewardship activities.

Our response complements the framework for stewardship set out by this discussion paper, providing additional evidence to highlight the current shape of the market for stewardship, as well as providing clarification where appropriate. It builds on many of the arguments that we set out in our response to the FRC's recent consultation on a revised UK Stewardship Code and FCA's consultation on implementing the Shareholder Rights Directive II. While these reforms make significant steps towards creating a better market for Stewardship, in our response on the Stewardship Code in particular, we have noted a number of concerns with how these are implemented in practice. In this response, we also argue the need for:

- A joined up approach to stewardship regulation across different government departments.
- Greater regulatory clarity on the legitimacy of different stewardship activities in the context of Market Abuse Regulations.
- A definition of stewardship which respects asset owners' and asset managers' duties towards their clients and beneficiaries, recognises the role of stewardship in terms of the allocation of assets (for some actors) without neglecting the importance of active oversight of assets, and underpins the varying roles of stewardship across the investment chain.

Regulating Stewardship

We support a flexible, non-prescriptive approach to the regulation of stewardship, which sets clear minimum standards for all relevant market participants (as will be achieved through the implementation of the Shareholder Rights Directive II) and aspirational standards through the UK's Stewardship Code. Regulation should not prescribe how to conduct stewardship, but seek to ensure there is sufficient transparency and accountability for market participants' to effectively scrutinise and distinguish between different providers based on how their approach meets their investment objectives.

Role of different regulators in stewardship

At this point in time, we do not think it would be appropriate for any additional powers to be granted to regulators to better enforce stewardship until we can see how the significant reforms being introduced are working in practice. If these reforms are successful, then better demand for quality stewardship should drive up market standards independent of regulatory intervention. The relevant regulatory bodies involved in Stewardship need to have the appropriate combination of skills, expertise and regulatory authorisation to identify, monitor and review progress on these reforms with respect to their regulated entities.

The Government needs to take a joined up approach to the regulation of stewardship to ensure that the interplay of different regulations and standards results in a coherent regulatory framework that promotes best practice across the investment chain. In particular, regulatory bodies with responsibilities for different market participant should encourage and promote effective stewardship and consider their role in monitoring and assessment:

- Alongside their role in monitoring the implementation of the Shareholders Rights Directive, the FCA will need to consider their role in the regulation of stewardship given the significant reforms in this area. It will be helpful for the FCA to continue to engage with their regulated entities to understand how they are adapting to the reforms.
- The body that will replace the FRC, 'ARGA', will need to effectively promote the integrity of the UK stewardship market through the development and monitoring of the effectiveness of the new UK Stewardship Code.
- The FCA, DWP and the Pensions Regulator should monitor the effectiveness of the new regulations requiring pension fund trustees and IGCs to incorporate stewardship into their Statement of Investment principles on the quality of demand for stewardship from asset owners and the implementation of Shareholder Rights Directive.

Regulatory Clarity

The FCA can play an important role in setting out clear expectations on the legitimacy of different stewardship activities in the context of Market Abuse Regulations and inside information. There is currently insufficient clarity on these issues, which can hamper asset managers' stewardship efforts. While bodies such as the Investor Forum provide a framework for collective engagement and these can give investors more certainty in these activities, investors ought to have confidence in conducting these activities outside of this context.

Definition of stewardship

The new definition of stewardship proposed in this consultation conflicts with asset managers' and asset owners' duty towards their clients and beneficiaries; this will ultimately hinder rather than promote the development of an effective market for stewardship. We propose amending the definition to read as follows:

"Stewardship involves the responsible allocation and active oversight of assets by different actors across the investment chain to generate sustainable value for beneficiaries. Effective stewardship should lead to long-term benefits for society and the economy."

This needs to be accompanied by a clear statement that different actors in the investment chain have differing roles and responsibilities when it comes to stewardship depending on their investment approach and style – they are not all expected to play a role in both oversight and allocation. For example, asset owners should not necessarily be expected to provide active oversight of individual companies, as that role is typically delegated to their asset managers. Asset owners typically focus on allocation. Index strategies, where asset allocation is driven by the constituents of their chosen index, do not have a role in allocation in the way active managers do; their role is typically focused on oversight. While active managers do play a role in both allocation and oversight, a large proportion of active managers' stewardship activity is focused on oversight.

The IA proposed definition:

- Respects asset owners' and asset managers' duty towards their clients and beneficiaries whilst recognising the interdependence between good stewardship and benefits to society and the economy over the long term.
- Recognises the role of stewardship in terms of the allocation of assets (for some actors) without neglecting the importance of active oversight of assets, which leads to sustainable value creation.
- Underpins the varying roles of stewardship across the investment chain, including asset owners and different types of asset managers, including both index strategies and active investors.

INTRODUCTION

Asset managers help their clients – whether individuals or institutions – achieve their investment objectives. These objectives can be financial, for instance to retire with enough money to live on, and can also be non-financial, such as to invest in companies, governments or projects that have a specific social or environmental benefit. Different clients have different investment objectives according to the investment needs of their beneficiaries. Stewardship plays a central role in generating sustainable value for these beneficiaries. It can also play an important role in meeting other investment objectives as per the client mandate.

An effective market for stewardship

Our members consider an effective market for stewardship to have a number of critical features. The IA has been advocating for some time for developments in the UK stewardship market to raise standards and create a better market for stewardship[1]. Our yearly Stewardship Survey[2] outlines the stewardship activity of the IA's members. Good stewardship is underpinned by a clear objective to generate sustainable value for beneficiaries. This can be achieved by integration of stewardship across the relevant stages of the investment process:

- For index strategies, this involves oversight of the assets held to protect and enhance their performance and quality and using ownership rights such as voting to ensure that the interests of company management and beneficiaries are aligned.
- For active managers, this will also involve researching and selecting assets and making decisions to sell.

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[1] Please see:

- Our response to the FRC's consultation on a revised UK Stewardship Code.
- Recommendations relating to stewardship in our Productivity Action Plan.
- Our Response to BEIS' consultation on the Corporate Governance Code.
- Our Response to BEIS' consultation on Insolvency and Corporate Governance.

[2] https://www.theinvestmentassociation.org/investment-industry-information/research-and-publications/stewardship-survey.html

- For asset owners this ranges from identifying their investment beliefs and asset allocation strategy, to researching, identifying and selecting asset managers, to monitoring the performance and quality of those managers in terms of both financial returns and the outcomes of their stewardship activities.

Each actor in the investment chain may have different priorities and incentives that can at times cause a misalignment of interests. For example, pension savers can have very long-term horizons, while the executives at the companies they are invested in may be tempted to run the company in their own, short-term interests, rather than the long-term interests of the company and shareholders. Stewardship activities such as oversight and engagement are essential to building accountability along the investment chain to ensure that all actors are engaged and focussed on creating sustainable value over the relevant time horizon of the ultimate beneficiaries.

To generate sustainable value for beneficiaries, stewardship involves oversight and engagement on the *material* issues that will impact on the sustainable value of the asset. This can include issues like strategy and financial performance, audit and accounting, capital management and executive remuneration as well as environmental, social and governance issues such as climate change, human capital and board diversity. They engage with Environmental, Social and Governance issues because they are critical to maintaining and generating long term value. This is not a definitive list - investors will focus on the relevant and material issues for the asset under consideration. Different investors may take a different view on which issues are material and should be focused on for that particular asset. Asset managers will also decide which particular stewardship activities will be most effective for the asset under consideration and at which time. These activities may include monitoring, engagement, escalation of engagement, exercising of rights and responsibilities, and in the case of active managers, buying or selling the asset.

In a good market for stewardship, asset managers actively demonstrate the outcomes of their stewardship activities. They are transparent about the aims of these activities and held accountable by their clients, as well as the general public, in recognition of their responsibilities as market participants. There also needs to be clear demand from asset owners. This demand directs asset managers to dedicate sufficient resource to stewardship activities and ultimately drives up standards across the industry as asset managers compete to differentiate themselves from their peers. Asset owners help generate this demand by making stewardship an explicit part of their expectations of asset managers in their selection process, investment mandate and contractual arrangements.

RESPONSES TO QUESTIONS

Q1: DO YOU AGREE WITH THE DEFINITION OF STEWARDSHIP SET OUT HERE? IF NOT, WHAT ALTERNATIVE DEFINITION WOULD YOU SUGGEST?

The regulatory framework for stewardship needs to be built around a definition of stewardship that captures the *central purpose* of stewardship, which our members believe is to generate sustainable value for the beneficiaries of the investment process, the end savers.

This definition also needs to provide a framework where different approaches to stewardship across different investment strategies, asset classes and across the investment chain are accommodated – it needs to work for asset owners, both index and active strategies, as well as asset managers acting on behalf of both institutional and retail clients.

Getting this definition right will help savers and the public to understand what stewardship is and the important role it plays in creating sustainable value for beneficiaries; this will in turn help to facilitate greater demand for it. It will also help to set clear expectations in terms of what the right regulatory approach to stewardship is.

In our response to the FRC's consultation on a revised UK Stewardship Code we argued that the proposed definition of stewardship, which is also proposed by this discussion paper, conflicts with asset managers' and asset owners' duties to their clients and beneficiaries; this will ultimately hinder rather than promote the development of an effective market for stewardship.

We propose amending the definition to read as follows:

"Stewardship involves the responsible allocation and active oversight of assets by different actors across the investment chain to generate sustainable value for beneficiaries. Effective stewardship should lead to long-term benefits for society and the economy."

There needs be a clear statement accompanying the definition that different actors in the investment chain have differing roles and responsibilities when it comes to stewardship – they are not all expected to play a role in both oversight and allocation. For example, asset owners should not necessarily be expected to provide active oversight of individual companies, as that role is typically delegated to their asset managers. Asset owners typically focus on allocation but also oversight of their asset managers and other service providers. Index strategies, where asset allocation is driven by the constituents of their chosen index, do not have a role in allocation in the way active managers do; their role is typically focused on oversight, so as to protect and enhance the value of the index. While active managers do play a role in both allocation and oversight, a large proportion of active managers' stewardship activity is focused on oversight.

To clarify the kinds of activities that could be designated stewardship, it is helpful, but not essential, to add "Stewardship activities include oversight of assets and service providers, engaging issuers and holding them to account on material issues, and publicly reporting on the outcomes of these activities" as per the consultation's proposed definition.

By "sustainable value", we are referring to how the value of the assets is sustained and enhanced over the relevant time horizon – both short term and long term – and, ultimately, in line with the time horizon of the underlying beneficiaries. An assessment of "sustainable value" will take into account of material environmental, social and governance issues where these are relevant for the investment objectives of beneficiaries.

This definition builds on the existing definition of stewardship in terms of reflecting the roles and responsibilities of stewardship across the investment chain, and:

- Respects asset owners' and asset managers' duty towards their clients and beneficiaries whilst recognising the interdependence between good stewardship and benefits to society and the economy over the long term.
- Recognises the role of stewardship in terms of the allocation of assets (for some actors) without neglecting the importance of active oversight of assets, which leads to sustainable value creation.
- Underpins the varying roles of stewardship across the investment chain, including asset owners and different types of asset managers, including both index strategies and active investors.

<u>Conflict with duties towards clients and beneficiaries and contractual obligations.</u>

The definition of stewardship in the 2012 Stewardship Code assumes the primacy of beneficiaries - that is, that the ultimate purpose of stewardship is to benefit beneficiaries. The new definition however puts the benefit of society and the economy on an equal footing with the benefit of beneficiaries. This is in conflict with asset managers' responsibilities towards their clients. Whether this is consistent with other asset owners duties toward their beneficiaries will depend on their particular investment objectives. For example, some sovereign wealth funds or charities may have particular environmental and social investment objectives; pension fund trustees have a fiduciary duty to their scheme beneficiaries. Either way, the asset manager's mandate is driven by the particular investment objectives of their client, which will reflect the investment objectives of the asset owners' beneficiaries. This will be articulated in the contract between the asset owner and asset manager.

Nevertheless, to generate long-term value for beneficiaries, it is important for asset managers to have regard to the impact of their investment activities on the society, environment and economy and to factor this impact into the investment process. Asset managers may incorporate these factors into their investment processes by assessing the material Environmental, Social and Governance risks and opportunities that an asset presents. This may inform their selection of assets if they are an active manager and their approach to engagement with and oversight of these assets according to their investment strategy. This is essential to generating sustainable value for their clients and their beneficiaries. As a result, in the long term, we expect stewardship to have a positive impact on the society and the economy, regardless of whether this is a particular investment objective of beneficiaries. Our members also recognise the interdependence of these factors - over the long-term, a healthy society and economy will contribute to the financial wealth of beneficiaries. Different asset managers and asset owners will draw on this interdependence to varying degrees in their investment beliefs and objectives. Increasingly asset owners are formally reflecting in their investment beliefs on the world that beneficiaries retire into.

It is important to note that in some circumstances there may be a conflict between the investment benefits for beneficiaries and the impact on society and the economy of a particular investment. It is important to draw from the learnings of the Law Commission's investigation into this area for pension funds, when considering the implications for the definition of stewardship.

Asset managers' duties are towards their clients – they take account of material Environmental, Social and Governance issues to help generate sustainable value for beneficiaries. They cannot prioritise sustainable value for society or the economy over beneficiaries, unless their clients explicitly mandate them to. This means that where a conflict between these areas arises, the impact on client and/or beneficiaries has to take priority. This is not reflected in the proposed definition, which introduces a conflict with these duties. Careful consideration should be given to the legal ramifications of imposing additional duties on financial market participants. The FRC and FCA would need to initiate a much broader and transparent conversation to understand whether this would be appropriate or practical.

Our proposed definition avoids this conflict by maintaining the primacy of beneficiaries, whilst recognising the importance of the longer-term impact of stewardship on the economy and society and the interdependence between these factors.

The importance of active oversight

The new definition neglects the important role of the active oversight of assets by asset managers in stewardship. One of the fundamental roles of asset managers is to hold companies to account and promote their ability to create sustainable value over the long term. This often means engaging with companies to reform practices which are inherently short term. The second sentence of the proposed definition alludes to this role in terms of the kinds of activities that constitute stewardship - "Stewardship activities include monitoring assets and service providers, engaging issuers and holding them to account on material issues, and publicly reporting on the outcomes of these activities."

However, by not pointing to this important role in the first sentence, setting out what stewardship is, we are concerned that the resulting definition is misleading, implying that capital allocation is more important than oversight, when in fact both are critical to generating sustainable value for beneficiaries. It also implies that the role of stewardship is limited to those actors that are actively involved in the selection of assets – this excludes index strategies whose emphasis in stewardship is necessarily on oversight and protecting and enhancing the sustainable value of the index.

We recognise that this emphasis on allocation may have resulted from an attempt to incorporate the role of asset owners in the new definition. We agree that the existing definition should be broadened to recognise the important role of asset owners in the investment chain. However, the new definition should recognise the roles and responsibilities of both asset owners and asset managers in terms of both capital allocation and oversight.

Q2: ARE THERE ANY PARTICULAR AREAS WHICH YOU CONSIDER THAT INVESTORS' EFFECTIVE STEWARDSHIP SHOULD FOCUS ON TO HELP IMPROVE OUTCOMES FOR THE BENEFIT OF BENEFICIARIES, THE ECONOMY AND SOCIETY (E.G. ESG OUTCOMES, INNOVATIVE R&D, SUSTAINABILITY IN OPERATIONS, EXECUTIVE PAY).

Our answer to question 1 above sets the framework for our response to this question. Our focus is on prioritising the material issues that will impact on creating sustainable value for beneficiaries in terms of both risks and opportunities. These will often be material environmental, social and governance issues that also have an impact on outcomes for society, the environment and the economy. For active managers, focus on these issues may also inform their investment decisions and for index investors, focus on these issues may also inform their approach to developing an index strategy.

Material issues are wide ranging - they will depend on the investment in question and also the investment approach. Some clients may specify that they consider certain issues to be of critical importance to generating sustainable value for their beneficiaries and will agree with their asset manager to dedicate resource to monitoring and assessing them. IA members have asked us to set expectations of company behaviour in a number of areas which are considered critical to generating sustainable value. IVIS, the IA's Corporate Governance Research service, monitors and assesses companies against these expectations.

In the IA's Stewardship Survey, IA members ranked ten areas for engagement with investee companies in terms of their relative importance against the frequency with which they engage on them:

1. Strategy
2. Financial Performance
3. Capital Allocation
4. Leadership – Chair/CEO
5. Executive remuneration
6. Board composition (including diversity)
7. Culture
8. Environment including climate change
9. Audit and reporting
10. Competition
11. Human Capital
12. Social

It is important to recognise that effective stewardship cannot be boiled down to a checklist of issues to engage on – this would turn stewardship into a compliance exercise and prevent asset managers from differentiating themselves from their competitors based on their stewardship approach.

Strategy and financial performance
The IA's Stewardship Survey reveals that these are considered the two most important areas for investors to engage with companies on and the two areas that asset managers actually engage most frequently engage on as they believe they are essential to long-term success.

Governance
Investors will consider issues such as leadership, succession planning, risk management, culture, diversity and board effectiveness, in order to make sure that the board has the right skills and attributes to run the company to deliver long-term success. Many investors will also assess a company's governance alongside the requirements of the UK Corporate Governance' Code and how directors discharge their duties in line with the Companies Act. Investors want to make sure that companies have the broad range of perspectives they need to be successful in the long-term, so they will engage with companies on issues of board diversity, as well as diversity throughout the organisation.

Audit and accounting
Investors rely on the information in a company's annual report and accounts to provide them with the information they need to make investments decisions and prioritise engagement. A high quality audit is vital to ensure the markets trust and have confidence in the information companies report on. Therefore the company's approach to audit and accounting is growing area of focus. When considering audit quality, investors will consider a wide range of issues from the audit tender process – how the audit committee ensures the tender is managed and directed in the interests of the shareholders, through to the ongoing question of how the auditors challenged management on their judgements and how the Audit committee oversaw the audit to ensure there was a high quality audit.

The quality of companies audit and the role of investors in holding them to account on this has received heightened scrutiny over the last year, following the high profile collapse of several companies, where audit practices have been questioned.

Executive Pay

The issue of executive pay gains a lot of media and political attention, as an issue that resonates with the wider public. It is therefore often used as a barometer of the success of asset managers' stewardship activities. It is important to consider this in terms of the relative importance of issues identified by asset managers, compared to the relative frequency that they are used for engagement; in our experience dialogue with companies on executive remuneration can sometimes crowd out other governance conversations.

Nevertheless, a company's approach to executive remuneration can often give insights into the wider governance of the company, including the interaction between executive and non-executive directors and the dominance of the CEO. Executive Remuneration can be used as a mechanism to ensure that the incentives of executives are aligned with the time horizons of investment beneficiaries and doesn't encourage short-termism. Poorly designed incentive schemes can act as a disincentive to invest in capital expenditure and research and development. They can also incentivise short term outcomes over longer term value creation. Poor Executive pay practices can therefore be symptomatic of wider governance issues at a company - investors therefore consider this an important focus for their stewardship activities.

Long-term issues that impact on productivity

In March 2016, the IA's Productivity Action Plan identified the need for an increase in long-term investment, to help improve productivity in the UK. The Action Plan identified the need for companies to improve their long-term reporting by moving away from short term, quarterly reporting and focussing reporting on long term issues such as Productivity, Human Capital and Culture and Capital Management. These are critical areas for stewardship activities as they will determine how productive and sustainable a company is over the long-term and therefore whether they will contribute to generating sustainable value for beneficiaries.

In the IA's Long Term Reporting Guidance, we have set expectations for companies to report against them to provide quality information for asset managers to take into account in their oversight and allocation.

- **ESG Risk and Opportunities**- Environmental, Social and Governance risks and opportunities have an important impact on the short-and long-term value of assets. Our members believe that sound management of significant environmental, governance and social risks by a company's Board can have an important, positive flow-on effect on the businesses long-term ability to generate sustainable value for beneficiaries.

- **Productivity** - Improving productivity can increase wages, improve living standards, and enhance company performance. Stronger and more productive businesses can help to deliver the exceptional long term investment returns that many millions of people, whose savings and investments our members manage, both demand and deserve. In order to be able to support investments in productivity improvements, our members require clarification from companies as to what the main drivers of productivity are within the business, and how planned investments are expected to drive productivity gains over the longer term. Investments in productivity can be framed in terms of infrastructure, innovation (including innovative research and development), skills and culture. Lack of disclosures on research and development was identified by the productivity action plan in particular.

- **Human Capital and Culture** - A key driver of creating sustainable value is how a company is managing its workforce and whether it is being deployed efficiently. Our members believe a well-engaged, stable, and trained workforce is more likely to be more productive and, in turn, be more likely to drive long term business success. A healthy corporate culture is a valuable asset, a source of competitive advantage, and vital component in the creation and protection of long term value.

- **Capital Management** - Capital allocation decisions play a vital role in determining a company's long term success and are viewed by our members as some of the most important responsibilities of company management. Our members are keen to understand a company's capital position, how it manages its capital and measure the performance of its capital allocation decisions.

Systemic risks

Systemic risks such as climate change are important issues for investors to take into account. Climate change risks are wide in scope, covering physical, transition and liability risks and they also interact with other ESG risks that company's face.

There is a clear need for asset managers to understand the extent to which climate change risks are material for the particular assets within their portfolios and the impact this will have on their sustainable value. This understanding needs to be informed by accurate disclosures by issuers so that it can be used to improve the quality and value of the asset held or, where relevant, to inform investment decisions.

Long-term systemic issues can be vulnerable to a lack of attention, particularly if there aren't sufficient long-term incentives and mechanisms to overcome principle-agent problems across the investment chain. To help to overcome this is essential for asset owners to set explicit expectations of stewardship of their asset managers that reflects the relevant time horizons of their beneficiaries.

Sustainability

Increasingly asset managers are focusing on wider sustainability considerations of their assets, particularly where their clients have specifically mandated them to pursue broader sustainability objectives. Some asset managers are seeking to assess, demonstrate and review the broader impact their investment activity has on society, the environment and the economy. Consideration of these factors will become increasingly important in future years given their emphasis by the EU's Sustainable Finance Package. It will be helpful for the Government to ensure these reforms are consistent with their wider regulatory approach to Stewardship.

Q3: TO WHAT EXTENT DO THE PROPOSED KEY ATTRIBUTES CAPTURE WHAT CONSTITUTES EFFECTIVE STEWARDSHIP? WHICH ATTRIBUTES DO YOU CONSIDER TO BE MOST IMPORTANT? ARE THERE OTHER ATTRIBUTES THAT WE SHOULD CONSIDER? IF SO, PLEASE DESCRIBE.

The Discussion paper set out a compelling framework for effective stewardship – we agree that the four attributes identified are critical components of stewardship. We make some specific comments on the corresponding behaviours below.

A clear purpose

We agree that stewardship should have a clear purpose. It is essential that this purpose is reinforced by a clear definition of stewardship, which reinforces asset manager and asset owner duties towards their clients and beneficiaries, as set out in response to Question 1.

Where different actors identify a clear purpose of stewardship, this plays an important role in signalling demand for stewardship across the investment chain. As identified in the introduction, improving demand for stewardship at this the critical juncture between asset owners and asset managers will raise standards and help to build an effective market for stewardship. The explicit reference to demonstrating purpose in the revised UK Stewardship Code will support this development.

In general the activities and behaviours described in this section accurately represent the clear alignment of duty and contractual obligations throughout the investment chain. As described in response to Question 2, the material issues that asset managers focus on in stewardship are not just limited to ESG issues, but also includes other financially material issues including strategy and financial performance, audit and accounting, capital management and remuneration. These issues are not just considered in terms of risks but also in terms of opportunities. This should be reflected in the first bullet of example activities and behaviours by referring to *material issues*, including material risks and opportunities.

<u>Constructive oversight, engagement and challenge and active monitoring of assets.</u>

As described in response to Question 1, constructive oversight, engagement and challenge is an essential aspect of effective stewardship that helps to solve principle–agent problems throughout the investment chain and protect and enhance the value of the assets held. Asset owners play an important role in terms of constructive engagement, oversight and challenge with regards to the oversight of their asset managers – this role should be emphasised in the accompanying behaviours.

It would also be helpful for the following behaviour: "Where possible (and with appropriate regard to relevant conduct rules), both asset owners and asset managers cooperate with each other to enhance their influence" to emphasise collective engagement with other market participants. Effective collective engagement is not just limited to asset owners and asset managers working together, but will also involve asset managers working with other asset managers and other relevant stakeholders where appropriate. Our members consider collective engagement and escalation an important component of their stewardship activities. Our Stewardship Survey illustrated that 75% of respondents engaged with other investors mainly via direct communication or through representative bodies such as the IA or Investor Forum.

Stewardship is an invaluable tool that helps asset managers generate sustainable value for beneficiaries, irrespective of their investment strategy. Active and index strategies use stewardship at different points in the investment process. For example, while index strategies do not use stewardship to inform buy and sell decisions, as long-term holders of companies in the constructed index they use oversight, engagement and the exercise of voting rights where relevant to ensure the long-term quality and performance of the assets held. In the examples of stewardship behaviours given, the Discussion Paper appears to implicitly assume that an active management model is the only way to deliver stewardship. The emphasis on investment *decision-making* assumes an option to buy or sell. The framework should instead refer to the investment *process*, to reflect the important role that stewardship plays in generating sustainable value in different investment strategies.

<u>Culture and institutional structures that support effective stewardship</u>

We agree that the example behaviours and activities described here reflect this important attribute of effective stewardship. It would be helpful for the language in the accompanying behaviours to align with the key expectations of the Stewardship Code in terms of how stewardship activities clearly link to organisation purpose, objectives and values.

It would also be helpful for this section to reflect on asset owners and asset managers having an appropriate governance framework for effective stewardship in place alongside appropriate controls, oversight and methods for managing conflicts of interest.

<u>Disclosure and transparency of stewardship activities</u>

Improved disclosure and transparency of stewardship activities and outcomes is a key attribute of an effective stewardship market. By being more open about how they conduct stewardship, investors can help to create awareness of the value of stewardship and allow clients to identify the different approaches of different asset managers. As we stressed in our response to the Stewardship Code consultation, effective stewardship reporting should focus on stewardship outcomes, in addition to activities, so that asset managers can demonstrate how their stewardship generates sustainable value for beneficiaries and be held to account for doing so. This is the key shift in approach to the Stewardship Code recommended by the Kingman Review and that the IA has been advocating for some time. This should be reflected in the name and behaviour underpinning this key attribute by referring explicitly to stewardship outcomes.

Q4: WHAT DO YOU THINK IS THE APPROPRIATE INSTITUTIONAL, GEOGRAPHICAL, AND ASSET CLASS SCOPE OF STEWARDSHIP? HOW CAN CHALLENGES ASSOCIATED WITH ISSUES SUCH AS THE COORDINATION OF STEWARDSHIP ACTIVITIES ACROSS ASSET CLASSES, OR THE EXERCISE OF EFFECTIVE STEWARDHIP ACROSS BORDERS, BE OVERCOME?

The appropriate institutional, geographical and asset class scope of stewardship will vary according to the overall strategic objectives of the asset manager, how these relate to stewardship and should also be driven by client expectations. Asset owners should set out clear expectations of stewardship with relation to asset class, fund selection and market scope when selecting and contracting their asset managers, so that asset managers can allocate resource accordingly. Clear expectations combined with clear reporting of how this approach has been applied will result in better accountability for delivering on these expectations.

As is noted by the discussion paper, conflicts of interest can arise when coordinating stewardship across different asset classes and markets. The results of our Stewardship Survey illustrate that asset managers use a variety of techniques to manage conflicts in their stewardship activities including:

- Escalating to a senior committee within the firm or alerting the CIO and/or the legal and compliance teams.
- Following the voting recommendations of a third party or abstaining from voting on specific resolutions e.g. the re-election of a board member that is connected with the asset manager.
- Assigning the monitoring of the stewardship team's activities to independent non-executive directors.
- Placing a Chinese wall between client-facing executives and those making stewardship decisions.
- Reallocating engagement to an individual within the firm that doesn't have any personal holdings in the investee company.

Institutional Scope

Asset Managers should coordinate their approach to stewardship with the overarching objectives and governance of their firms. There are a variety of ways in which asset managers adopt stewardship across their institutions. These differing approaches should be communicated clearly to clients who may select to work with a particular manager or fund on this basis:

- Many asset managers adopt an institution-level approach to stewardship, which relates to their strategic objectives. There may however be some variation between different approaches across funds and asset classes.
- Other asset managers adopt a fund-level approach, which may or may not translate to a wider institution-level approach.
- Some institutions will segment their stewardship approach according to the type of clients they act on behalf of, for example, whether their clients are institutional investors, retail investors, or 'execution only' clients.

Asset class scope

Stewardship plays an important role in creating sustainable value across all asset classes and should not be limited to listed equities. The UK Stewardship Code originates in relation to equity, as a result of this asset class having voting rights and therefore increased opportunities to engage with investee companies and escalate any concerns. An important driver of stewardship activity for other asset classes, therefore, is the extent to which ownership of the underlying asset comes with rights and responsibilities.

Many asset managers will have holdings in a particular company through different asset classes – for example, they may own shares in the company as well as the company's bonds. In these cases it is helpful for the manager to ensure consistent messaging to companies across these different asset classes. Where conflicts of interest arise as a result of owning assets of the same company in different structures, asset managers should have an appropriate governance process in place to manage these conflicts.

Geographical scope

The investment chain in which stewardship operates is an increasingly global one: 40% of all assets managed in the UK are being managed on behalf of overseas clients a total of £3.1 trillion[3] and, as the discussion paper highlights, 56% of UK shares are owned by non-UK investors. Building a good market for stewardship in the UK therefore is contingent not just on the behaviour of domestic market participants but also on the behaviour of overseas actors from across the investment chain. This relies on building an effective global framework for stewardship.

There are a number of challenges to achieving this:

- Effective stewardship across delegated management models can be challenging according to the expectations and legal requirements in the delegated market.
- With the majority of UK equities and other asset classes owned by overseas investors, issuer discipline can be problematic where overseas investors do not hold them to the same standards of scrutiny and accountability.
- Investor's attitudes to stewardship are driven to a certain extent by cultural norms and expectations informed by the regulatory expectations of their own jurisdiction. Some investors for example, consider that the UK's robust approach to corporate governance and listing standards means they don't need to spend as much resource on stewardship activities in the UK and instead allocate their stewardship resource to higher risk markets.
- Some overseas investors are less willing to participate in collective engagement in the UK because of the regulatory approach of the country they are headquartered in. In the UK, governance and stewardship is seen as a means to enhance the long term value of the asset, whereas in other jurisdictions there can be more of a compliance driven mind-set to governance and stewardship, due to reporting or voting regulatory requirements.
- Anecdotal evidence from issuers implies that investors typically spend more resource on engaging with issuers in their local markets.
- Fragmented ownership across geographic boundaries can challenge voting influence. While coordinated engagement can go some way to addressing this issue, varying approaches and expectations of international investors, can limit global participation in these engagements.

To help to overcome these issues there is a role for the FCA and ARGA to play in terms of promoting global excellence in stewardship standards and promoting and protecting UK issuer standards.

Q5: WE WELCOME EXAMPLES OF HOW FIRMS WITH DIFFERENT OBJECTIVES AND INVESTMENT STRATEGIES APPROACH STEWARDSHIP. IN PARTICULAR, WE WELCOME INPUT ON HOW

[3] https://www.theinvestmentassociation.org//assets/files/research/2018/20180913-fullsummary.pdf.pdf

STEWARDSHIP PRACTICES DIFFER ACROSS ACTIVE AND INDEX TRACKER FUNDS, IN THE FOLLOWING AREAS:

For asset managers Stewardship involves a range of activities as described by the supplementary definition to the stewardship code: "Stewardship activities include oversight of assets and service providers, engaging issuers and holding them to account on material issues, and publicly reporting on the outcomes of these activities".

Different actors in the investment chain will prioritise and conduct their stewardship activities according to their investment strategy, objectives and the particular roles and responsibilities they have to their clients or beneficiaries.

I: HOW FIRMS PRIORITISE AND CONDUCT STEWARDSHIP ENGAGEMENTS

With many asset managers holding thousands of companies across a range of different markets, it is helpful for them to prioritise their stewardship activities in order to be effective. Evidence from our Stewardship Survey shows that firms prioritise stewardship engagements by focusing their stewardship activities on cases where they have identified significant issues. The next biggest factor for prioritisation is the size and proportion of total assets under management (AUM) that the holding represents. The Survey found that whether the holding was managed actively or as part of an index strategy was the least important consideration for prioritising engagement. Many asset managers have established their own framework for prioritising engagement, this may include prioritising according to risk profile (including the risks associated with the particular market the asset operates in), size or relative proportion of the holding, thematic engagements on particular issues, or sector based prioritisation. Some asset managers will contract external research agencies to support this prioritisation process.

In terms of how they conduct their stewardship activities, investors will engage with companies at different times throughout the financial year, both regularly and to address specific issues. Many of these engagements will take place over a extended time period, with the asset manager revisiting the issue with the company (often over many years) to facilitate change. Our Survey highlights that just over half of all recorded engagements during 2018 related to on-going relationship management, while 27% involved a one-off communication to address a specific issue. They will engage with companies directly by talking to company management and board members, including key positions such as the Chair, Chairs of the Remuneration, Audit and Nominations committees. They will also engage collectively by attending company road shows or participating in industry forums.

The following framework is an example of how asset managers conduct their stewardship activities and escalate any concerns they have with the behaviour of the companies they are invested in. Many asset managers have established their own process for prioritising and escalating engagement for effective stewardship outcomes.

- Voice - shareholders set out their expectations of investee companies through guidelines and direct engagement. If they have identified a particular concern they can voice these privately.
- Escalate – where merely voicing concern isn't effective, investors might escalate their approach for example by joining together with other investors, or making public statements or requisitioning resolutions at company AGMs.
- Vote – Investors can express disagreement or support for company decision by voting at a general meeting for listed equities.
- Exit - Where a company is facing challenges and is receptive to constructive engagement, these activities can go a long way in supporting a company to improve its prospects. However, where the Board continues to pursue strategies or governance proceedings that asset managers considers detrimental to their clients' interests, they may choose to sell their shares if this option is available to them.

It is sometimes assumed that effective stewardship can prevent all company failures. Where a company is facing challenges, which may have the potential to result in insolvency, stewardship can help a company to improve its prospects if the underlying business is viable and if the company is receptive to constructive engagement with shareholders. However, good stewardship alone cannot prevent company insolvencies where the underlying business is unviable as shareholders are not ultimately responsible for managing the company. It can play an important role in improving governance and, when done effectively, reducing the likelihood of these events. However, when a company is no longer generating sustainable value for beneficiaries, it may no longer be appropriate for asset managers to continue to own shares in the company.

II: WHAT INVESTMENTS FIRMS HAVE MADE IN STEWARDSHIP RESOURCES

Asset manager's investment in stewardship resources is driven by their approach to stewardship, their investment strategy as well as their clients' expectations. Depending on the particular stewardship activity, asset managers may employ specialist resource or leverage investment staff to conduct engagement activities. The IA's joint stewardship survey with the PLSA from 2017 gives an indication of the variety of ways in which investors structure their stewardship resources[4].

Specialist resource can include stewardship analysts, engagement specialists and corporate governance, ESG and sustainability analysts. These specialists will engage with companies and other stakeholders directly, carry out research and use dedicated stewardship resources. They may work closely with investment teams to make investment decisions regarding these companies.

Other firms focus stewardship resource on their investment team - this will involve training staff such as portfolio and fund managers. By taking this approach firms directly delegate stewardship responsibilities to investment professionals. Many firms take a combined approach.

Our survey highlighted that nine out of ten asset managers mainly use in-house capabilities to carry out engagement and voting. The 56 respondents that carry out engagement mainly in-house, employ a total of 1,859 portfolio managers and analysts, stewardship specialists and others that exercise stewardship activities in relation to UK companies. This would imply an average in-house resource of approximately 33 professionals in each firm. The majority (84%) of this resource is portfolio managers and analysts suggesting a significant degree of integration of stewardship into the investment process, as the individuals responsible for investment decisions are also active in stewardship. The degree to which stewardship is undertaken as a core part of the investment process is often under-appreciated – it is helpful for asset managers' to capture the results of this significant activity as a part of their stewardship disclosures.

Firms can also complement their in-house capabilities with outsourced stewardship resources such as using research from proxy advisory providers to inform their engagement activities and using specialised stewardship and ESG data platforms to inform the investment process. 55% of asset managers complement their in-house capabilities with proxy advisory research providers, which provide research and voting recommendations based on the investor's stewardship policies. Asset managers may or may not follow these voting recommendations; 89% of asset managers use proxy agencies for processing voting instructions.

III: HOW STEWARDSHIP ACTIVITY IS INTEGRATED WITH INVESTMENT DECISIONS.

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[4] Page 14: https://www.plsa.co.uk/Portals/0/Documents/Policy-Documents/2017/PLSA-Stewardship-report-2017.PDF?ver=2017-09-22-162024-650

The emphasis on investment decision-making assumes an option to buy or sell. Active managers use stewardship to inform their investment decisions. However, other firms, including those specialising in index strategies, will use stewardship at other points in the investment process. As such, when considering how firms integrate stewardship, it is helpful to consider how this is done throughout the investment *process* as well as for individual investment decisions.

Firms can integrate stewardship in a number of ways and at different stages of the investment process. Active managers will consider ESG research and data inputs when researching potential additions to their portfolios, and incorporate these factors into their company valuations. Learnings from stewardship engagement activities can also influence decisions on whether to sell a specific asset where engagement with the company has failed and poor governance is leading to diminished returns for beneficiaries. This can be considered an exercise of stewardship.

Once an asset has been bought, stewardship contributes to preserving and boosting the value of the asset. To do this, firms monitor their investee companies and engage with them on material issues that have been identified. Company engagement can be carried out by stewardship professionals, portfolio and fund managers, or by third-party stewardship providers. Not all engagements are company-specific: firms also carry out thematic and policy engagements to promote higher governance standards among listed companies.

Where there are long-standing corporate governance or ESG concerns, or where initial engagements have been unproductive, firms may choose to escalate their stewardship activities. Some firms choose to make their concerns public through the media, while others engage through industry groupings such as the IA or Investor Forum.

Q6: TO WHAT EXTENT DO YOU AGREE WITH THE KEY BARRIERS TO ACHIEVING EFFECTIVE STEWARDSHIP IDENTIFIED IN THIS DP? WHAT DO YOU BELIEVE ARE THE MOST SIGNIFICANT CHALLENGES IN ACHIEVING EFFECTIVE STEWARDSHIP? WE WOULD PARTICULARLY WELCOME VIEWS ON THE INVESTMENT REQUIRED TO EMBED EFFECTIVE STEWARDSHIP IN INVESTMENT DECISION-MAKING.

While the UK has one of the world's most advanced stewardship markets, we believe that there is more that can be done to develop this market and ensure it is working harder to generate sustainable value for savers. The IA has been advocating for some time for developments in the UK stewardship market to raise standards and create a better market for stewardship[5]. In particular, we have recommended that there needs to be:

- Better and more consistent public disclosure of stewardship activities by asset managers. By being more open about how they conduct stewardship, investors can help to create awareness of the value of stewardship and allow clients to identify the different approaches of different asset managers.

- A clearer shift in focus away from policies and towards activities and outcomes. The expectation that the Stewardship Code would help to facilitate this shift was set out clearly by Sir John Kingman in his independent review of the FRC.

- Clearer alignment of incentives across the investment chain to focus on long-term value creation. In particular, a more demanding and discerning client base and better inclusion

[5] Please see:

- Recommendations relating to stewardship in our Productivity Action Plan.
- Our Response to BEIS' consultation on the Corporate Governance Code.
- Our Response to BEIS' consultation on Insolvency and Corporate Governance.

of stewardship in asset owners' expectations of asset managers. This will help increase competition in the industry and drive forward best practice in stewardship.

- A clearer focus on long-termism in line with the investment horizons of beneficiaries – this will help to ensure that stewardship is focused on the issues that will impact on assets' ability to generate sustainable value over the short and long term.

By making these improvements, many of the potential barriers identified by the FCA could be addressed. The implementation of the Shareholder Rights Directive and the development of the UK Stewardship Code will contribute to this. We discuss some of the barriers identified by the Discussion Paper and how they can be overcome below.

Incentives and Costs

The cost of effective Stewardship may outweigh the benefits

As discussed in response to Question 5.III, asset managers integrate stewardship into the investment process in different ways. It is important to recognise that many investment managers are involved in the stewardship process when they engage with the companies in their portfolio, however they may not formally identify it as such. It is important therefore, when discussing the potential impact of free-riding, to distinguish between instances where asset managers do not engage in stewardship and where this is not formally disclosed.

There are three significant regulatory developments that should act to significantly dis-incentivise free-riding and encourage more stewardship coverage.

- New minimum standards of the Shareholder Rights Directive II – this will result in much greater consideration of stewardship for both asset managers and asset owners and we hope as a result would encourage more signatories to the UK Stewardship Code. This will also require greater disclosures on stewardship, which will enable the FCA and ARGA to better identify coverage.
- The new requirement for pension fund trustees to set out in their Statement of Investment Principles, their policies in relation to the stewardship of investments, including engagement with investee firms and the exercise of the voting rights associated with the investment. We believe that this will result in much greater consideration by asset owners of their roles and responsibilities in relation to stewardship and, as a result, better scrutiny of and demand for stewardship from their asset managers.
- More transparent reporting by asset owners and managers as a result of the enhanced reporting requirements of Shareholder Rights Directive and the new UK Stewardship Code. Effective 'activities and outcomes' reports should enable asset owners to better hold their asset managers to account on their stewardship functions and to differentiate excellence in stewardship.

In order for these developments to address concerns about free riding, it will be important for the FCA and the new ARGA to monitor their impact, in particular with regards to:

- The quality of disclosures meeting the requirements of the Shareholder Rights Directive – this will give an indication of alignment with the minimum regulatory requirements.
- The levels of signatories to the new Stewardship Code – this will give an indication of how extensively market participants are aspiring to stewardship standards over and above the minimum requirements set out under SRD II. In our response to the FRC's consultation on a revised Stewardship Code, we highlighted that some of the expectations of asset owners in the draft Code are too onerous and may dis-incentivise them from becoming signatories.

- It will also be important to monitor the interplay between the SRD II and the new Stewardship Code – an effective market for stewardship should encourage market participants to meet the higher standards of the UK Stewardship Code rather than defaulting to the minimum requirements under SRD II.
- Quality of activities and outcomes reporting – The accuracy and quality of these reports is critical to helping to create more transparency and accountability in stewardship.
- Additional resource being dedicated to stewardship – it will be helpful to understand how firms are prioritising their stewardship activities and how these resources are being allocated in terms of – the investment function, dedicated stewardship specialists, training and investment in data and systems that support stewardship and compliance and reporting.

It is important to recognise that the decision to sell an asset is a legitimate component of an asset managers' stewardship process and is not necessarily a hall-mark of ineffective stewardship or free-riding as is implied by paragraph 5.17 in the Discussion paper. This decision will be taken where the asset manager believes that it is no longer in their client's best interest to continue to hold the asset. Choosing to sell an asset where this is considered in the client's best interest can be evidence of stewardship working in practice. Asset owners should take a view on whether sufficient resource was dedicated to oversight and engagement prior to the decision in their oversight of their asset managers.

<u>Method and intensity of oversight, engagement and challenge is not clear from Stewardship reporting</u>

The IA recently conducted an assessment into how firms are reporting in line with our own Stewardship Reporting Framework, considering the disclosures of those members that are signatories to the Stewardship Code. This assessment revealed quality disclosures, in many instances going above and beyond the expectations of the 2012 Stewardship Code. It also indicated a degree of innovation – a number of our members are developing innovative methods of reporting, developing new ways to make these disclosures appealing and relevant to their clients.

Evidence from this assessment suggests that many firms are reporting in line with the framework, with 90% producing voting summary statistics, 70% producing engagement summary statistics and 57% of firms providing information on how they have engaged with wider stakeholders such as industry bodies or governments. We also identified a number of new areas of best practice, including:

- Identifying how investors escalate concerns, including through collective engagement;
- Evidence of approach to engaging on a number of thematic areas, including climate change, employee practices or executive pension contributions and how this leads to individual engagement with companies.
- Evidence of the effectiveness of requests for change at companies in terms of the impact of these requests.
- Information on how staff are trained in ESG issues
- Articulating the asset managers' stewardship priorities for the year.
- Disclosures on how the governance process for stewardship works within the firm.

We expect reporting on the revised Stewardship Code to further build on this best practice, and for signatories to give much more detail on the method and intensity of oversight, engagement and challenge as well a clear understanding of firms' investment in stewardship functions and degree of integration of stewardship in the investment process – enabling asset owners to differentiate firms based on quality and impact. The quality of signatories' 'Activities and Outcomes' report will be a critical test of how the revised Code shifts behaviours in this respect.

We have set out a number of suggestions as to how these reports will work best in practice in our response to the FRC's consultation on a revised Stewardship Code and are working to develop the Framework to meet heightened expectations of best practice.

Misaligned incentives

Asset manager selection is typically based on recent performance

Lack of scrutiny from Asset Owners and Investment Consultants

Clear signalling and demand from asset owners is a critical component of an effective market for stewardship. Asset owners should develop clear investment objectives and investment principles with respect to stewardship and use these to inform their manager selection process. These expectations should be clearly defined in the relationship between the asset owner and asset manager and should be underpinned by relevant contractual arrangements. The achievement of these expectations should clearly inform the asset owner's assessment of performance of their asset managers.

In the IA's Productivity Action Plan[6] we identified a concern with the manner and frequency of how performance is assessed through the contractual relationship between asset manager and asset owner and that there is insufficient signalling of the need for a long-term approach governed by strong stewardship through the Statement of Investment Principles and the investment Mandate.

The increased emphasis in the revised Stewardship Code on the responsibilities of asset owners should go some way to counter these concerns. The IA is also in the process of developing best practice guidance on incorporating a long-term approach into investment mandates including guidance on how to incorporate expectations on stewardship into the relationship between asset owners and asset managers.

Investment Consultants play a critical role in advising asset owners on how their long-term investment objectives are best achieved by providing services including:

- Development of client's investment objectives and investment policy statements
- Benchmark selection
- Asset allocation advice
- Manager selection
- Fiduciary management

Investment consultants therefore play an important role in embedding stewardship into the relationship between asset owners and asset managers. We noted in our response to the consultation on a revised UK Stewardship Code that the service provider provisions have only been developed with Proxy advisers in mind and need to be broadened out to reflect the important role of investment consultants in facilitating a good market for stewardship.

Information flow between asset owners, asset managers, service providers and issuers

Poor disclosure from issuers

The quality of the information provided by issuers is critical to supporting long term value creation. Annual reports and accounts and supplementary market announcements should provide asset managers with the relevant information to develop a real understanding of a business and its drivers, its financial strength, the quality of management and its decisions and the material risks and opportunities it is managing. This information should be appropriately audited or assured. This will enable asset managers to make more efficient

[6] https://www.theinvestmentassociation.org/assets/files/press/2016/20160322-supportingukproductivity.pdf

capital allocation decisions and to conduct quality oversight and engagement through their stewardship activities.

In our Productivity Action Plan, we identified a number of areas of company reporting that significantly impede the ability of investors to understand and support a company's long term strategy and capital investments. In particular:

- A lack of clarity on companies' management of capital shareholders are often unable to assess accurately the capital position of companies, thus hindering their ability to assess the effectiveness of capital allocation strategies. Furthermore, the measurement of return on invested capital is not clear.
- No articulation of overall capital management policy and practice – there is a lack of meaningful information concerning future expenditure plans, how these will improve the business and how they are linked to strategy.
- Acquire and internally intangible assets are disclosed together, obscuring the economics of acquisitions and other business costs.

In response to these concerns the IA developed Long Term Reporting Guidance for companies to improve issuer disclosure on issues that are material to the long term value of the company, specifically with respect to Productivity, Capital management, Human Capital and Culture and ESG Risks and Opportunities. A review of how well FTSE All Share companies are reporting in line with these expectations revealed limited progress. While some promising disclosures are being made on human capital and ESG risks and opportunities, companies need to make significant progress in order to make meaningful disclosures on Productivity and Capital Allocation.

Issuer disclosure on ESG risks and opportunities and broader sustainability factors are becoming increasingly important to investors as they seek to formally integrate these factors into their investment process. Greater comparability, quantification and assurance of issuers' disclosures on these factors would be beneficial. However, greater comparability shouldn't come at the cost of materiality given the way that different risks interact with different companies and sectors.

At present there are limitations to reliable disclosures in this area:

- A number of ratings agencies have developed models for assessing companies' ESG ratings – however there are no consistent standards resulting in different ratings for companies.
- As identified above, the quality of information from issuers is often poor.
- There is no formal requirement for assurance or audit of ESG and sustainability disclosures – resulting in possible green-washing and misleading statements that can't be reliably incorporated into investment models.

<u>Permitted activities</u>

There is currently a lack of legal clarity on the extent to which stewardship activities such as engagement with companies and collective engagement might contravene inside information and market abuse regulations. Paragraph 3.25 in this Discussion paper identifies that investors should "consider how to handle inside information in line with the Market Abuse Regulations" and "demonstrate to their internal compliance functions that they are not 'acting in concert' when engaging on a collective basis with a subset of the company's investors.

To do this confidently, it would be helpful for the FCA to set out clear expectations on the legitimacy of different stewardship activities in the UK market, so as to provide assurance for non-UK investors on activities such as collective engagement.

Issuers often cite these concerns as a reason not to engage with shareholders individually or collectively and some shareholders can be hesitant to engage without legal certainty that their engagement activities do not constitute 'acting in concert'. This is a particular issue for non-UK investors that are accustomed to regulatory impediments to these activities in other markets. Many investors refer to an old practice statement from the FSA written in 2009 on this issue. Since then, the market for stewardship has evolved significantly.

While bodies such as the Investor Forum provide a framework for collective engagement and these can give investors more certainty in these activities; investors ought to have confidence in conducting these activities outside of this context. FCA ought to formally set out in detail what they consider to be permitted activities so as to provide this certainty.

Q7: TO WHAT EXTEND DO YOU CONSIDER THAT THE PROPOSED BALANCE BETWEEN REGULATORY RULES AND THE STEWARDSHIP CODE WILL RAISE STEWARDSHIP STANDARDS AND ENCOURAGE A MARKET FOR EFFECTIVE STEWARDSHIP?

We support a flexible, non-prescriptive approach to the regulation of stewardship, which sets clear minimum standards for all relevant market participants (as set out in the Shareholder Rights Directive) and aspirational standards through the UK's Stewardship Code. Regulation should not prescribe how to conduct stewardship, but seek to ensure there is sufficient transparency and accountability for market participants' to effectively scrutinise and distinguish between different providers based on where their approach meets their investment objectives.

At this point in time, we do not think it would be appropriate for any additional powers to be granted to regulators to better enforce stewardship until we can see how the implementation of the Shareholder Rights Directive and new Stewardship Code are working in practice. If these reforms are successful, then better demand for quality stewardship should drive up market standards independent of regulatory intervention – these reforms should address a number of the concerns that have been raised in this Discussion Paper, including any concerns about the potential for free-riding in the market. The relevant regulatory bodies should have the appropriate combination of skills, expertise and regulatory authorisation to identify, monitor and review progress on these reforms with respect to their regulated entities.

In particular, regulatory bodies with responsibilities for different market participant should encourage and promote effective stewardship:

- Alongside their role in monitoring the implementation of the Shareholders Rights Directive, the FCA will need to consider their role in the regulation of stewardship given the significant reforms in this area. It will be helpful for the FCA to continue to engage with their regulated entities to understand how they are adapting to the reforms.
- The body that will replace the FRC, 'ARGA', will need to effectively promote the integrity of the UK stewardship market through the development and monitoring of the effectiveness of the new UK Stewardship Code.
- The FCA, DWP and the Pensions Regulator should monitor the effectiveness of the new regulations requiring pension fund trustees and IGCs to incorporate stewardship into their Statement of Investment principles on the quality of demand for stewardship from asset owners and implementation of the Shareholder Rights Directive requirements.

This discussion paper provides an excellent starting point in terms of identifying the core criteria of an effective stewardship market. The need for further regulatory developments can therefore be informed by benchmarking against these criteria. Recent reforms in stewardship should result in a significant shift in the stewardship market – a review of their success against these criteria should take place in 3-5 years' time. Of particular interest in this review will be the success of the outcomes based approach to stewardship reporting, driven by the new Stewardship Code and whether this is driving better demand from asset owners, the effectiveness of ARGA in monitoring signatories disclosures and addressing areas of malpractice, as well as the extent of coverage that is being provided by the implementation of the Shareholder Rights Directive.

These developments need to be complemented by an appropriate role for 'ARGA', the regulatory body that will replace the FRC, the FCA and other relevant government bodies such as BEIS and DWP in promoting the integrity of the UK stewardship market. Government needs to take a joined up approach to ensure that the interplay of different regulations and standard results in a coherent regulatory framework that promotes best practice across the investment chain. In particular, consideration needs to be given to the interplay between different regulatory mechanisms that promote investor stewardship including:

- FCA implementation of the Shareholder Rights Directive II and expectations set out in the handbook.
- FRC responsibility for the UK Stewardship Code
- The implementation of the EU's Sustainable Finance Action plan and accompanying regulatory developments.
- Expectations on asset owners with respect to Stewardship set out in regulations – including DWP Investment regulations for pension funds, implementation of the Shareholder Rights Directive and the Local Authority Pension Fund Investment Regulations.

In our response to the FRC's Consultation on the new Stewardship Code, we argued that the proposed Code makes some progress towards developing an effective market for stewardship. We strongly welcome the direction of travel and the broad changes to the Code that have been proposed. However, we also articulated a number of concerns with how these important developments have been drafted. If not addressed, these will result in a Code that hinders the development of an effective market for stewardship.

Q8: TO WHAT EXTENT ARE THERE ISSUES WITH PROXY ADVISERS THAT ARE NOT ADEQUATELY ADDRESSED BY SRD II AND PROPOSED REVISIONS TO THE STEWARDSHIP CODE?

IA and IVIS

It should be noted that the IA has a corporate governance research service, the Institutional Voting Information Service[7] (IVIS) that provides corporate governance research on FTSE All Share and FTSE Fledgling companies ahead of their AGM and facilitates engagement between investors and investee companies. IVIS does not provide directed voting advice, instead it highlights issues or concerns through a colour coding system – clients then go on to make their own voting decisions, informed by the research. IVIS upholds IA guidance[8] on a range of corporate governance issues for companies, highlighting particular issues or concerns that are of importance to our members to aid them in making informed voting decisions.

The role of proxy advisers

Proxy advisers play an important role in stewardship and the wider investment chain. Their activities can play a significant role in informing asset managers' stewardship activities and also their voting behaviour.

The DP sets out a number of concerns regarding how proxy advisers and their activities are contributing to an effective market for stewardship. SRD II and the revised Stewardship

[7] https://www.ivis.co.uk/
[8] https://www.ivis.co.uk/guidelines/

Code will help to address some of these concerns, while others will require continued engagement from asset managers.

Our stewardship survey highlighted that 89% of respondents use proxy agencies for processing voting instructions. 84% of respondents use proxy advisors for research which helps them make informed voting decisions, with 63% using proxy advisors for recommendations that may or may not be followed by the asset manager. In most cases, asset managers use one service provider. Where more than one service providers are used, this tends to be for providing research. Where service providers are used for recommendations, all respondents specified that these are tailored to their own stewardship policies rather than being based on the proxy advisor's standard policy.

Potential concerns

This discussion paper notes a number of concerns regarding proxy adviser activities.

Quality of research: A number of issuers have raised concerns about the quality of research produced by the proxy advisers. In assessing these concerns it is important to distinguish whether these relate to the factual accuracy of the proxy advisers' interpretation of issuer information, or in fact to the judgements being made about company governance and management. Some complaints may stem from the high level of scrutiny being applied to company accounts, and the corresponding attention being drawn to poor governance practices, rather than genuine concerns over the quality of research.

Proxy Advisors are tasked with highlighting the key issues that their clients wish them to highlight or raise as a voting issue. This will often create tension or concern with issuers if their approach has been questioned. For example, this AGM Season, IVIS is particularly focussing on executive director pension contributions and diversity. The IA set out its expectations on pension contributions in our updated Principles of Remuneration in November 2018, followed by explicit guidance on how IVIS will implement the new Principles of Remuneration in February 2019. Both the new Principles and the IVIS approach were written by and are at the request of the IA's members. The IA's Stewardship Committee have directed the IA to focus on these issues and how IVIS should highlight the issues.

IVIS sends reports to companies in advance if they are being red topped (our most serious level of concern) whilst all other reports are sent on publication. Whilst companies do highlight factual errors such as typographical errors (which IVIS will address and correct), a significant number of comments which IVIS receives from companies are attempts to change our judgement or opinion on concerns that our members have asked us to highlight.

It is important to note that Proxy Advisors base their reports on the public information of companies and asset managers are reliant on the quality and accuracy of these disclosures. In recent years, we regularly had to seek clarifications from companies on their disclosures. In the most extreme cases IVIS has highlighted to a company that it was unable to pay benefits to its Executive Directors as their new Remuneration Policy excluded this element in their disclosures. The Company had to seek a new policy the next year.

Transparency: The DP notes that concerns have been raised about a potential lack of transparency in the proxy adviser market. We note that under SRD II proxy advisers will be required to increase the transparency of their activities especially with regard to conflicts of interest. Furthermore, the revised Stewardship Code will facilitate greater transparency on how asset managers use proxy advisers in their stewardship activities. The new Code also includes specific provisions for service providers, against which proxy advisers will be required to report. Proxy advisers will be required to provide information on matters such as the range of services they offer, how they serve the interests of clients and enable them to deliver effective stewardship, and explain the activities undertaken to exercise their role as stewards of the market. They will also be required to produce an annual Activities and Outcomes Report, explaining the actions they have taken to carry out these requirements.

Timeliness of research: In the UK, there is significant concentration of AGMs in a short "AGM Season" from April to July. Where the majority of December and March year-end companies hold their AGM. Annual Reports and Notice of Meetings can be published less than a month before the AGM. Given the absolute volume of companies with their AGMs in this period it does create issues for the proxy advisors and asset managers. This is a systemic issue due to the volume of AGMs in this period rather than as a result of the specific practices of proxy advisors.

Conflicts of Interest: We support the drafting of the new Stewardship Code on conflicts of interest for service providers. To improve confidence in this important segment of the stewardship market, it would be helpful for proxy advisers to have a conflicts of interest policy in place that sets out how they manage any conflicts that arise from servicing both asset managers and issuers.

<u>New requirements under SRD II and the revised Stewardship Code</u>

As important actors in the investment chain it is right that the proxy advisers are within scope of both SRD II and the new Code. The new requirements under SRD II and the new Code will also help to address some of the concerns highlighted here. The revised Stewardship Code will facilitate greater transparency on how asset managers use proxy advisers in their stewardship activities, and also has new requirements for proxy advisers that will lead to a higher level of disclosure. The FRC and FCA will no doubt monitor whether these new requirements effectively address some of the potential concerns identified.

Other concerns highlighted here will require continued engagement from shareholders as the clients of proxy advisory firms. Shareholders regularly engage with the proxy advisers to provide a client perspective on the quality of research and highlight areas in which more scrutiny or a different emphasis is required. It is important that shareholders continue to do so.

Q9: WE WELCOME FEEDBACK ON OTHER SPECIFIC ASPECTS OF THE REGULATORY FRAMEWORK DESCRIBED ABOVE. IN PARTICULAR, WE ARE INTERESTED IN VIEWS ON:

I) WHETHER AND TO WHAT EXTENT THE FCA'S PROPOSED RULES FOR ASSET OWNERS SHOULD BE EXTENDED TO SIPP OPERATORS?

An effective market for stewardship will involve greater demand for stewardship from all asset owners. Many SIPP operates are also asset managers that are already carrying out stewardship activities. The FCA should consider a proportionate approach to promoting better consideration of stewardship from the asset owners within its regulatory remit, where the asset owner represents underlying beneficiaries who have interests in stewardship being conducted on their behalf. The FCA should bear in mind that duplication of reporting requirements for entities that act as both asset owner and asset manager may be unhelpful.

II) THE CASE FOR REGULATORY RULES TO EXPAND THE REACH OF STEWARDSHIP BEYOND LISTED EQUITY?

As discussed in response to Question 4, we are supportive of the scope of stewardship being broadened out beyond listed equity and into other asset classes, as Stewardship can help to play an important role in creating sustainable value across all assets.

In our response to the UK Stewardship Code we welcomed principles and provisions that encouraged signatories to disclose their approach to stewardship across different asset classes. Stewardship activities will vary significantly across different asset classes, driven to a certain extent by the different rights and responsibilities that come with ownership.

With this in mind, the framework for Stewardship set out in the Shareholder Rights Directive will not be directly applicable to other asset classes. Therefore, we do not think it would be appropriate to extend the scope of regulatory rules, including the implementation of SRD II beyond listed equity at this time. It will be helpful to review the quality and content of signatories reporting on other asset classes in their Stewardship Code disclosures to inform a future assessment of whether expectations need to be strengthened.

III) WHETHER THERE IS A ROLE FOR UK REGULATORS IN ENCOURAGING OVERSEAS INVESTORS TO ENGAGE IN STEWARDSHIP FOR THEIR ASSET HOLDINGS IN THE UK

The UK plays a leading role in setting international best practice standards for stewardship. Other markets are monitoring the developments in stewardship reform currently taking place and we would expect many of them to reflect these over time. EU standards will also be improved as result of the new provisions of the Shareholder Rights Directive.

The majority of UK equities are now owned by overseas investors. Driving up stewardship standards internationally will therefore improve the quality of stewardship in the UK and promote issuer discipline and broader UK market integrity. ARGA and the FCA should work bilaterally with their global counterparts to shape international standards and drive excellence in global stewardship.

IV) THE EXTENT TO WHICH ADDITIONAL RULES MIGHT BE NECESSARY EITHER TO IMPROVE STEWARDSHIP QUALITY OR PREVENT BEHAVIOURS THAT MIGHT NOT BE CONDUCIVE TO EFFECTIVE STEWARDSHIP?

We do not consider there to be a need for additional rules at this time. As discussed in response to question 7, it is important to understand the outcomes of the current programme of stewardship reforms before assessing whether additional rules are necessary.

V) FOR DIFFERENCES BETWEEN ACTIVE AND INDEX-TRACKER STRATEGIES IN THE PRACTICE OF STEWARDSHIP, WHETHER THERE ARE PARTICULAR REGULATORY ACTIONS WE SHOULD CONSIDER TO ADDRESS ANY PERCEIVED HARMS?

As outlined in our response to Question 5, active and index strategies are both incentivised to carry out stewardship and carry out these activities at different stages of the investment process. Both types of investors use stewardship to help produce sustainable value for beneficiaries.

Evidence from the IA's 2018 Stewardship Survey shows that whether the holding was managed actively or as part of an index strategy was the least important consideration for prioritising engagement with a particular company.

VI) WHETHER THE FCA'S PROPOSED RULES TO IMPLEMENT CERTAIN PROVISIONS OF SRD II SHOULD APPLY ON A MANDATORY, RATHER THAN 'COMPLY OR EXPLAIN', BASIS

The IA supports the FCA implementing SRD II provisions Article 3g and 3h on a 'comply or explain' basis as per the original Directive text. It would be inappropriate at this stage to implement SRD II with more stringent requirements than the original Directive, without assessing the impact of its implementation and reviewing the case for enhanced requirements.

The implementation of the new requirements under SRD II will set a new mandatory baseline for stewardship disclosures. The higher level of transparency that this facilitates will give clients more information about the stewardship activities carried out by firms, and will ultimately help create a better market for stewardship.

Using the principle of comply of explain for the new provisions will also help foster a better market for stewardship. Comply or explain will allow firms to be innovative and realistic in their reporting, leading to a greater diversity of reporting, with more differentiation between firms. This will be more useful to clients seeking to understand how different firms carry out stewardship.

After a given period the FCA should monitor the quality of disclosures being produced against these new requirements and make an assessment as to whether comply or explain has been successful in fostering a good standard of reporting.

Q10: WE WELCOME FEEDBACK ON WHETHER, TO SUPPORT EFFECTIVE STEWARDSHIP, WE SHOULD CONSIDER AMENDMENTS TO OTHER ASPECTS OF THE REGULATORY FRAMEWORK THAT AFFECT HOW INVESTORS AND ISSUERS INTERACT (SUCH AS THE LRS, PRS AND DTRS)?

As discussed in response to Question 6 there is currently a lack of legal clarity on the extent to which stewardship activities such as engagement with companies and collective engagement might contravene inside information and market abuse regulations.

Issuers often cite these concerns as a reason not to engage with shareholders individually or collectively and some shareholders can be hesitant to engage without legal certainty that their engagement activities do not constitute 'acting in concert'. While bodies such as the Investor Forum provide a framework for collective engagement and these can give investors more certainty in these activities; investors ought to have confidence in conducting these activities outside of this context. FCA ought to formally set out in detail what they consider to be permitted activities so as to provide this certainty.