INVESTMENT ASSOCIATION RESPONSE

FRC CONSULTATION ON A REVISED UK STEWARDSHIP CODE

MARCH 2019

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.

1. EXECUTIVE SUMMARY

The Stewardship Code (the 'Code') is an important tool for setting best practice standards for stewardship in the UK. Since its inception it has played an important role in setting expectations and driving up standards.

The FRC should have clear objectives for what an effective market for stewardship looks like and how the revised Code will contribute to its development - the FCA/FRC joint discussion paper "Building a regulatory framework for effective stewardship" provides a compelling framework for a good market for stewardship.

A revised Code should contribute to a good market for stewardship by setting clear best practice standards for all market participants to aspire to, being clear on the differing roles and responsibilities of asset owners and asset managers (and other market participants) and promoting transparent reporting that enables signatories to demonstrate the outcomes of their stewardship activities and clients and beneficiaries to hold them to account.

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. We particularly welcome the intention to:

- Develop signatories' disclosures on their approach to stewardship across all asset classes. Stewardship can facilitate sustainable value creation across all asset classes.
- Introduce a new 'Activities and Outcomes' report. Done effectively, this will start to shift the focus away from policies and processes and towards the outcomes of stewardship, and will be an important accountability mechanism for asset owners.
- Adapt the Code to set explicit standards for stewardship at different junctures in the investment chain, in particular by setting more demanding expectations of asset owners. This is essential to creating demand for stewardship.
- Explicitly reference Environmental, Social and Governance (ESG) factors – this is an important development that reflects market best practice.
- Require signatories to coordinate their approach to stewardship with their firms' overarching objectives and governance, and integrate stewardship into the investment process.

However, we have 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. In particular:

1. **Definition of Stewardship:** The new proposed definition of stewardship conflicts with asset managers' and asset owners' fiduciary duty to clients and beneficiaries.
2. **Activities and Outcomes**: The Code is too prescriptive about certain policies and processes, and doesn't have sufficient emphasis on improving outcomes for clients and beneficiaries.
3. **Stewardship for active and index strategies:** The Code doesn't have sufficient flexibility to be adopted across different investment strategies. It assumes that good stewardship can only be achieved by active management, when in fact stewardship forms an essential component of both index and active management strategies.
4. **Differentiation of the roles and responsibilities of asset owners and asset managers:** The Code conflates the roles and responsibilities of asset managers and asset owners; this may dis-incentivise asset owners from becoming signatories.

Alongside new, relevant content that drives best practice, the Code needs to be complemented by an appropriate role for 'ARGA', the regulatory body that will replace the FRC, in terms of monitoring and assessing the quality of signatories' reporting. This will be essential to promoting the integrity of the UK stewardship market. Investors need to have

confidence that the new regulatory body has the expertise, resources and effectiveness to drive best practice.

The revision of the UK Stewardship Code is a crucial step in helping to create a more effective market for stewardship. The proposed Code is being developed amidst a number of significant reforms in the stewardship market, including the implementation of the Revised Shareholder Rights Directive (SRD II), which will help set minimum standards for all market participants; the reform of the FRC itself, and a number of questions pertaining to the appropriate regulatory approach to stewardship. The FRC needs to take stock of these developments before publishing the new Code to ensure that it provides a holistic and coherent approach to stewardship.

Our concerns are summarised below and set out in more detail in our responses to the particular questions in this consultation. With careful redrafting, we believe that this Code can deliver on expectations and make a significant contribution to a better market for stewardship.

1. Definition of Stewardship

The Stewardship Code 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 owners of capital. By *sustainable value*, we mean sustainable over the relevant time horizons for beneficiaries – both short and long term. 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 legitimised – 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.

The new definition of stewardship proposed in this consultation conflicts with asset managers' and asset owners' fiduciary duty to 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."

The FRC needs to make 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. 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' fiduciary duty 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.

2. Activities and Outcomes

The Code should be focused on how to improve effective disclosure and reporting on outcomes; this is the key shift in approach recommended by the Kingman Review and that the IA has been advocating for some time. It has not yet achieved this – the Code is still too focused on prescriptive guidance on policies and processes.

Disclosures ought to be underpinned by the definition of stewardship and should clearly articulate how stewardship is generating sustainable value for beneficiaries.

The IA's Stewardship Reporting Framework contains recommendations for how asset managers' can make public disclosures on the outcomes of stewardship and is informed by market best practice. Disclosures ought to be underpinned by the definition of stewardship and should clearly articulate how stewardship is generating sustainable value for the beneficiary.

3. Stewardship for active managers and index strategies

Stewardship is an invaluable tool which 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 a number of places the Code 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 Code should instead to refer to the investment *process*, to reflect the important role that stewardship plays in generating sustainable value in different investment strategies.

4. Differentiation of the roles and responsibilities of asset owners and asset managers.

A key mark of success for the new Code is whether it encourages asset owners to generate better demand for and distinguish excellence in stewardship. However, certain Provisions conflate the roles and responsibilities of asset managers and asset owners, resulting in expectations for asset owners to carry out stewardship activities that are typically delegated to their asset manager. This may deter asset owners from becoming signatories to the Code.