THE INVESTOR FORUM

Financial Reporting Council
8th Floor
125 London Wall
London EC2Y 5AS

29th March 2019

Dear Sir or Madam,

Consultation on the Proposed Revision to the UK Stewardship Code

We welcome the opportunity to comment on the FRC's draft revised Stewardship Code.

The Investor Forum supports the FRC's ambition to raise standards to help ensure that investor stewardship of UK companies continues to lead global best practice. While the draft incorporates some valuable changes, we are concerned that this ambition may not be delivered on.

It does not appear to us that the proposed new Code suitably responds to the current debate on the value of stewardship nor takes fully into account the changing supervisory and regulatory framework. Without greater clarity on definitions, roles and responsibilities, we are concerned that the proposed revisions will lack the necessary support to deliver meaningful change.

The Forum's focus is on delivering effective collective engagement outcomes, as a practitioner response to the Kay Review and to address two of the seven principles of the existing Stewardship Code. Given this focus, we will add our voice to those issues where our practical experience is relevant, recognising that engagement is just one, albeit very important, aspect of stewardship. The views expressed are those of the Investor Forum – many of our Members will respond directly to the consultation and other parties, most notably The Investment Association, will represent the industry's views on the broad range of issues.

The need for a Principle-led approach

We fully recognise that investors can, and should, do more to demonstrate effective stewardship – but the draft moves substantially towards a rule-driven approach which may not enhance the impact of stewardship activity and risks creating an excessive focus on reporting rather than outcomes.

The strength of a principle-driven Code is that it sets a framework within which investment institutions can operate with professionalism and apply their own judgement to deliver engagement outcomes. The Code has a key role to play in encouraging institutions to meet the challenge of delivering stewardship excellence and then to demonstrate how they have delivered change for the benefit of their clients. It is our view that significant clarification and simplification is required if the proposed Code is to foster the delivery of effective stewardship outcomes.

In reviewing the draft Code, it has been important to re-consider the definition of stewardship and we include in the attached appendix a summary of our thoughts to provide a backdrop for the comments that follow. Alongside the definition of Stewardship, we would draw your attention to the importance of defining engagement as an active dialogue with a specific and targeted objective. It is intended to put stewardship into effect.

Actions to enhance the proposed Code

We believe significant changes to the draft Code should be actively considered in four main areas:

1. Review the definition of stewardship

The proposed definition does not capture the true essence of stewardship in an investment context. We believe that stewardship is preserving and enhancing the value of assets with which one has been entrusted on behalf of others. It reflects the fact that an investment intermediary looking after assets on behalf of a beneficiary or client has obligations of a fiduciary nature.

The Code plays a crucial role in framing expectations for stewardship. It is therefore important to derive the most robust definition and this consultation has catalysed a valuable debate among market participants. Providing clarity in this regard represents a significant opportunity to enhance the effectiveness of stewardship throughout the investment chain.

2. Reconsider the role of Guidance

We are concerned that the detail included in the proposed guidance may result in a compliance-driven approach to reporting on stewardship activity rather than a principles-driven approach that encourages more effective stewardship outcomes. The Stewardship Code is a Code – which means that to be effective it should be about principles, not detailed rules.

In our opinion the balance of the current draft shifts towards that of a detailed rulebook. Our view is therefore that the FRC should consider dropping the detailed guidance altogether, or at least cut it back significantly so that the weight of the document is on the principles and provisions.

3. Ensure accountability for the Activities and Outcomes Report

The concept of the annual Activities and Outcomes Report is welcome, and represents a positive addition to the Code. It reflects existing best practice; our own experience of publishing an annual review of collective engagement activity, which can be scrutinised and challenged by our Members and the public, confirms to us the value of introducing such a requirement.

However, we believe the concept could be expanded to further emphasise the need for investor stewardship to focus on outcomes in the context of the investment approach, rather than policies and processes. Among other steps, a formal sign-off of the published document by the Chief Investment Officer (or equivalent) of the signatory organisation would reinforce the embedding of the Stewardship agenda throughout the signatory, and help ensure that the activity is appropriately and adequately resourced. Such an approach would ensure that Stewardship is at the heart of investment decision making and represent a powerful response to the criticisms raised in the Kingman Review.

4. Retain collective engagement as a Principle of the Code

We remain firmly of the view that the Principle in the current Code that calls for collective engagement should be retained, given both academic evidence and the track record of The Investor Forum and others which demonstrates the impact of the activity. It would be unfortunate for the FRC to de-emphasise the valuable contribution of this approach in the way implied by the current draft. The principle of apply and explain is important to encourage such activity, and restoring this concept to the Principle level would retain the strength of the current Code in this regard.

It is also important to maintain a consistency of language across the various codes and rules which will inform Stewardship activity. The term 'collective engagement' is a widely recognised and appropriate term in the UK, and we are not convinced that the introduction of the term 'collaborative' advances the debate. We also note that the FCA is planning to adopt the term 'cooperative' from the Shareholder Rights Directive II.

Conclusion

We recognise that each of these actions may require a significant change from the current draft, and that collectively they would lead to a substantially different document. We firmly believe that all four issues need to be addressed in order to create a form of Code that properly supports the delivery of appropriate stewardship outcomes by investors, even if this requires a further round of consultation.

To be impactful, the new Code must take into account the changing regulatory and supervisory frameworks and respond to the broader stewardship debate. We believe that clarity with regard to definitions, roles and responsibilities is an essential pre-requisite to create a Code that supports the delivery of best-in-class stewardship of UK companies for the benefit of clients, beneficiaries, and the whole of UK society.

We hope that our comments will help inform further debate which can ensure that the UK continues to lead stewardship practice globally. We would welcome an opportunity to discuss any of the issues raised further; please do contact Andy Griffiths or me.

Yours faithfully,

Simon Fraser
Chairman

Appendix: Defining stewardship and effective engagement

This section sets out our thoughts on the important areas of stewardship and engagement, based on our observations and experience since the Investor Forum was established in 2014..

Definitions of stewardship and engagement

We believe that **stewardship** is preserving and enhancing the value of assets with which one has been entrusted on behalf of others. It reflects the fact that any investment intermediary looking after assets on behalf of a beneficiary or client has obligations of a fiduciary nature.

Engagement is active dialogue with a specific and targeted objective. It is intended to put the stewardship role into effect. The underlying aim of the engagement dialogue should always be to preserve and enhance the value of assets on behalf of beneficiaries and clients.

We have summarised the perspectives of the Investor Forum on the key characteristics and desired outcomes of stewardship in Table 1.

Characteristics of good engagement

Effective engagement requires a process that:

- is set in an appropriate context of long-term ownership and has a focus on long-term value preservation and creation, so that the engagement is aligned with the investment thesis
- is framed by a close understanding of the nature of the company and the drivers of its business model and long-term opportunity to prosper
- is based on clear objectives, focused on effecting change
- recognises that change is a process and that, while haste may at times be necessary, change should not be inappropriately rushed
- employs consistent, direct and honest messages and dialogue
- is appropriately resourced so that it can be delivered professionally in the context of a full understanding of the individual company
- uses resources efficiently so that engagement coverage is as broad as possible whilst using all the tools available, including collective engagement
- involves reflection so that lessons are learned in order to improve future engagement activity

These elements are necessary in order for engagement to receive the most favourable response from the engaged company and to give the best chance of delivering value-enhancing change through engagement.

To be impactful, engagement requires clear objectives, professional resource and persistency. There are no short-cuts to the delivery of effective engagement, and most complex situations require bespoke strategies rather than a more generic “one size fits all” approach.

Barriers to engagement

One context for understanding the delivery of effective stewardship outcomes is to consider how the key barriers to engagement and how they can be overcome. Through our work we have identified 5 key barriers to engagement, which are:

1. **Resourcing** – even the largest stewardship functions will always be resource-constrained and must overcome this to deliver across the breadth of companies in which the institution invests.
2. **Consensus** – it can be a challenge to reach consensus within an organisation, including between individual portfolio managers and between portfolio managers and the stewardship team; consensus between different investment institutions is still harder.
3. **Visibility** – companies and other investors may not know about the investment exposure that an investor has, and may not understand the drivers for an investment position, making dialogue and trust harder to achieve.
4. **Conflicts** –conflicts of interest may limit the scope of action of investors; it is important they have mechanisms for ensuring that client interests are always put first.
5. **Competition** – as stewardship becomes more of a differentiating factor for fund managers, more may sense they have a competitive interest in acting alone.

Overcoming barriers to engagement

A discussion among Investor Forum members in late 2018 revealed that investors perceive two main solutions to these barriers and to ensuring that engagement is effective:

- reinforcing the close integration of stewardship with the fund management activity; and
- making full use of all available resources, including collective engagement.

The decision to engage should always be closely linked to investment decision-making. For many, engagement success is about enhancing value and being able to stay invested; exit must always be an option for an active house. Thus ideally, engagement should be part of the role of every fund manager and every analyst. Where this is done, issues around resourcing significantly reduce as there is no longer the same dependence on specialist stewardship staff.

In order to reach consensus internally as much as externally – and certainly for collective engagement with other institutions – it is often necessary to focus on areas of agreement not of disagreement, which may mean directing attention to the problems at companies rather than over-emphasising specific solutions to those problems.

What matters most to clients is delivering change at the companies of highest significance – both in terms of large investment positions and in terms of sizeable exposures to risks that are of the greatest concern to those clients. Investors should therefore use the most appropriate tool available to achieve their desired outcome.

Collective engagement

The Investor Forum has built a track record over the last four years in conjunction with its members. We believe this practical approach, supported by academic evidence, and the recommendations of the Kay Review, illustrates the value of collective engagement as part of an investor's stewardship activity.

There are many practical challenges involved in encouraging collective engagement. It requires a large number of, often global, investors employing a wide variety of investment strategies to work together, in a complex legal and regulatory environment. If done effectively it helps company chairs understand the underlying reasons for investors' concerns, while respecting that it is their duty to run the company, and therefore puts them in a much stronger position to take action, rebuild trust and hopefully develop their long-term strategy on behalf of all stakeholders more effectively

For collective engagement to work effectively, participants need to be clear about the objectives, the boundaries of engagement, and to feel comfortable that they are operating in a safe and secure environment. This is why it was critically important that we create a comprehensive framework. We believe that the establishment of the Forum's Collective Engagement Framework has made an important contribution to the development of engagement practice.

Table 1: The components of Stewardship

<table>
<tr><td></td><td colspan="2">Stewardship
Preserving and enhancing the value of assets with which one has been entrusted</td></tr>
<tr><td rowspan="3">…delivered through…</td><td colspan="2">Investment approach and decision
Allocation of capital in accordance with investment purpose, mandate and client interests, at portfolio and individual asset levels</td></tr>
<tr><td colspan="2">Dialogue
Active discussions between companies and investors, of which there are two principal forms:</td></tr>
<tr><td>Monitoring
Dialogue for investment purposes: to understand the company, its stakeholders and performance.
Informs incremental buy/sell/hold decisions</td><td>Engagement
Purposeful dialogue with a specific and targeted objective to achieve change
Individual or collective basis as appropriate</td></tr>
<tr><td>…typified by…</td><td>Detailed and specific questioning; investors seeking insights</td><td>Two-way dialogue; investors expressing opinions</td></tr>
<tr><td rowspan="2">…characteristics of high quality delivery…</td><td colspan="2">• Framed by close understanding of nature of company and drivers of its business model and long-term opportunity to prosper
• Appropriately resourced so dialogue can be delivered professionally in the context of full understanding of individual company
• Dialogue must be consistent, direct and honest
• Dialogue is respectful and seeks to build mutual trust</td></tr>
<tr><td>• Set in a context of mutual understanding of fund manager's investment style and approach
• Recognises that change within companies is a process and sometimes takes time to be reflected in external indicators of performance
• Resources are used efficiently so that neither party's time is wasted
• Fuller insight leads to better informed decisions
• Includes feedback so that mutual understanding can be reinforced over time</td><td>• Set in a context of long-term ownership and focus on long-term value preservation and creation, so that engagement is aligned with investment thesis
• Recognises that change is a process; while haste may at times be needed, change cannot be inappropriately rushed
• Overall resources used efficiently so engagement coverage is as broad as possible whilst also proving effective
• Clear and specific objective leads to effective change
• Involves reflection so lessons are learned and taken fully into account in future</td></tr>
<tr><td>…resulting in…</td><td>• Changed investor decision-making
• Efficient capital allocation by investors
• Appropriate risk-adjusted returns for clients
• Preserved/enhanced value
• Delivery of client objectives and investment purpose</td><td>• Changed company behaviours
• Efficient capital allocation by companies
• Appropriate risk management by companies
• Preserved/enhanced value
• Delivery of corporate purpose and culture, through effective oversight</td></tr>
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