

UK Stewardship Code

The AIC's response to the FRC's consultation

The Association of Investment Companies (AIC) welcomes the opportunity to respond to the Financial Reporting Council's (FRC) consultation on the UK Stewardship Code.

The AIC is a trade body for the closed-ended investment company sector. We represent 358 investment companies, holding assets of over £165 billion. The AIC's members are predominantly listed on the Main Market of the London Stock Exchange. Some have shares admitted to trading on the Specialist Fund Segment; others are quoted on AIM.

The AIC's members include investment trusts, Venture Capital Trusts, UK REITs and non-EU companies. Our non-EU members are usually domiciled in Guernsey and Jersey.

Stewardship and governance of investment companies

Closed-ended investment companies are collective vehicles which pool their shareholders' capital and hold a portfolio of assets to spread risk and generate an investment return.

With the exception of a few self-managed investment companies, their boards are entirely comprised of non-executive directors. On behalf of the shareholders, the directors appoint third party service providers to carry out the day-to-day running of the company. This includes appointing an investment manager which, if the investment company invests in UK equities, can report on a comply or explain basis against the Stewardship Code in its capacity as an asset manager.

Investment companies are not within scope of the UK Stewardship Code. Instead, "stewardship" activities are entrusted to the external manager.

As a matter of practice, where investment companies employ external investment managers, the manager is making the day-to-day investment decisions and is therefore best placed to engage with investing companies. This work should not be duplicated by the investment company.

The investment manager is contracted to invest the assets in line with the investment company's investment strategy and policy, as set by the investment companies board of directors.

Given this structure, the Stewardship Code is not directly relevant to investment companies. Instead, best practice standards in relation to stewardship are established via the 2018 UK Corporate Governance Code (the UK Code). This has been interpreted for investment companies in the 2019 AIC Code of Corporate Governance (the AIC Code), which has been endorsed by the FRC.

The AIC Code recommends that the board should explain in the annual report the areas of decision making reserved for the board and those over which the manager has discretion. This includes stewardship. Provision 16 states:

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“The board should explain in the annual report the areas of decision making reserved for the board and those over which the manager has discretion. Disclosure should include:

- ...;
- *the manager’s remit regarding stewardship, for example voting and shareholder engagement, and environmental, social and corporate governance issues in respect of holdings in the company’s portfolio...”*

The Supplementary Guidance to this Provision states that this may include *“agreeing a policy with the manager regarding stewardship, for example voting and shareholder engagement, and environmental, social and corporate governance issues in respect of holdings in the company’s portfolio. The agreement should take account of the UK Stewardship Code”*.

The FRC notes that the Stewardship Code *“has long been, and remains, closely tied to the UK Corporate Governance Code”*. The AIC welcomes the restructuring of the Stewardship Code to align and mirror the UK Code Principles and Provisions.

The majority of our members report against the AIC Code which has been tailored to reflect the characteristics of the sector. This allows member companies who report against the AIC Code to make a statement that, by reporting against the AIC Code, they are meeting their obligations under the UK Code and associated disclosure requirement under paragraph 9.8.6 of the Listing Rules.

Strengthening the provisions for proxy advisers

As the focus on governance and stewardship has increased more asset and wealth managers have employed the services of proxy advisers. Proxy advisers provide research and many make voting recommendations on investments held by the asset and wealth managers. Although proxy advisers play a significant role in corporate governance and the investment making decision process, they are unregulated and are not required to report against codes of best practice.

The AIC supports the redrafting of the Stewardship Code to include a section on service providers which includes proxy agencies. Whilst this change is welcome, we consider the provisions relating to proxy agencies should go further than currently drafted.

The FRC has already concluded that achieving best practice in relation to stewardship requires it to go further than the Shareholders Rights Directive II (SRD II). It states that the new Stewardship Code requirements *“are more demanding”* than those of the SRD II. The AIC supports this approach.

The AIC **recommends** the Stewardship Code guidance for proxy advisers is enhanced. The current proposals meet the requirements of Article 3(j) of the SRD II which require proxy advisers to disclose certain information such as the methodologies they use, the policies and procedures they follow for voting and requiring them to manage conflicts of interest. These disclosures do not fully achieve best practice in relation to the governance and stewardship practices of proxy advisers.

The AIC **recommends** the Stewardship Code guidance on the provisions for service providers is enhanced to recommend service providers:

- Establish and explain their policy on engagement with companies which are the object of their research, advice or voting recommendations. This should include:
 - describing how they engage with companies throughout the year;
 - setting and disclosing minimum time deadlines for engagement with companies to allow companies to respond appropriately to any issues raised; and
 - describing the extent to which they engage with companies in circumstances where they make a negative research finding or voting recommendation;
- Describe whether, and if so how, they consider explanations provided by companies which are the object of their research, advice or voting recommendations and describe how they communicate these explanations to their clients; and
- Establish and explain their procedures to prevent and detect factual inaccuracies in research, advice or voting recommendations.

Please see Appendix 1 which sets out how these amendments could be made.

Responses to the consultation paper questions

Q1. Do the proposed Sections cover the core areas of stewardship responsibility? Please indicate what, if any, core stewardship responsibilities should be added or strengthened in the proposed Principles and Provisions.

Please see our comments above in relation to proxy advisers.

With regard to the 'Glossary of Code Terms', the AIC **recommends** the definition of asset manager be amended to state:

*"An individual or organisation to whom the responsibility for the day-to-day management of assets is delegated, **for example** by an individual or institutional asset owner. The asset manager will act based on instructions given to them in an investment mandate, with discretion to buy and sell assets on behalf of another entity or person."*

Recommended insertions are in **bold and underlined**.

This revision recognises that it is not just individuals and institutional asset owners, but also entities that can also delegate duties to an asset manager.

Q2. Do the Principles set sufficiently high expectations of effective stewardship for all signatories to the Code?

Please see our comments above in relation to proxy advisers.

Q3. Do you support ‘apply and explain’ for the Principles and ‘comply or explain’ for the Provisions?

Yes. The success of the ‘comply or explain’ model has been replicated around the world. It is right that this continues to form the basis of corporate governance reporting in the UK. This mirrors the obligations for reporting against the UK Code and the AIC Code.

‘Comply or explain’ provides a mechanism for signatories to explain their approach to provisions of the Stewardship Code. Different signatories should be able to take different approaches to reach the same end goal. Those evaluating the explanations should form an appropriate judgement.

Q4. How could the Guidance best support the Principles and Provisions? What else should be included?

Please see our comments above in relation to proxy advisers.

Q5. Do you support the proposed approach to introduce an annual Activities and Outcomes Report? If so, what should signatories be expected to include in the report to enable the FRC to identify stewardship effectiveness?

The AIC has no comment on this question.

Q6. Do you agree with the proposed schedule for implementation of the 2019 Code and requirements to provide a Policy and Practice Statement, and an annual Activities and Outcomes Report?

The AIC has no comment on this question.

Q7. Do the proposed revisions to the Code and reporting requirements address the Kingman Review recommendations? Does the FRC require further powers to make the Code effective and, if so, what should those be?

The Kingman Review recommends that the new regulator should have a strategic objective to *“protect the interests of users of financial information and the wider public interest by setting high standards of ...corporate governance, and by holding to account the companies and professional advisers responsible for meeting those standards.”*

Furthermore, Kingman recommends that the *“Government should also consider whether any further powers are needed to assess and promote compliance with the [Stewardship] Code.”*

Proxy advisers are an increasingly important part of the investment chain, yet they remain unregulated, and are not required to report against an independently written Code of best practice such as the UK Code or the Stewardship Code.

In contrast, issuers, such as investment companies, have substantial obligations under company law, the FCA’s Listing Rules and Disclosure Guidance and Transparency Rules. In the case of a listed company incorporated in the UK the company’s annual report and accounts

must include a statement as to whether the company has complied with the relevant provisions of the UK Code or AIC Code or its reasons for non-compliance.

Likewise, institutional investors have extensive regulatory obligations. For companies carrying out a regulated activity, such as managing investments for a professional client, they must disclose the nature of their commitment to the Stewardship Code.

Similar obligations do not apply to proxy advisers. The AIC **recommends** that proxy advisers be separately required to disclose the nature of their commitment to the Stewardship Code. This would go further than the requirements of the SRD II which states that proxy advisers must “*publicly disclose reference to a code of conduct which they apply and report on the application of that code of conduct*”. If implemented it would bring proxy advisers into line with disclosure requirements of other significant participants in the investment chain.

Q8. Do you agree that signatories should be required to disclose their organisational purpose, values, strategy and culture?

The AIC has no comment on this question.

Q9. The draft 2019 Code incorporates stewardship beyond listed equity. Should the Provisions and Guidance be further expanded to better reflect other asset classes? If so, please indicate how?

The AIC has no comment on this question.

Q10. Does the proposed Provision 1 provide sufficient transparency to clients and beneficiaries as to how stewardship practices may differ across funds? Should signatories be expected to list the extent to which the stewardship approach applies against all funds?

The AIC has no comment on this question.

Q11. Is it appropriate to ask asset owners and asset managers to disclose their investment beliefs? Will this provide meaningful insight to beneficiaries, clients or prospective clients?

The AIC has no comment on this question.

Q12. Does Section 3 set a sufficiently high expectation on signatories to monitor the agents that operate on their behalf?

In the 2012 Stewardship Code, the FRC states that it “*regularly monitors the take-up and application of the [Stewardship] Code*”.

In our response to question 7, the AIC **recommends** that proxy advisers be required to disclose the nature of their commitment to the Stewardship Code. As signatories to the Stewardship Code, the AIC **recommends** that the FRC, or its successor the Audit, Reporting

and Governance Authority, extends its monitoring duties, as stated in the 2012 Stewardship Code, to include proxy agencies.

The AIC **recommends** that this monitoring be extended to all signatories to the Stewardship Code, including proxy advisers.

Q13. Do you support the Code's use of 'collaborative engagement' rather than the term 'collective engagement'? If not, please explain your reasons.

The AIC has no comment on this question.

Q14. Should there be a mechanism for investors to escalate concerns about an investee company in confidence? What might the benefits be?

The AIC has no comment on this question.

Q15. Should Section 5 be more specific about how signatories may demonstrate effective stewardship in asset classes other than listed equity?

The AIC has no comment on this question.

Q16. Do the Service Provider Principles and Provisions set sufficiently high expectations of practice and reporting? How else could the Code encourage accurate and high-quality service provision where issues currently exist?

No, the AIC recommends the Principles and Provisions in relation to service providers are enhanced. Please see our comments above in relation to proxy advisers.

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To discuss the issues raised in this paper please contact:

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Appendix 1 – Amendments for service providers

Suggested amendments for the provisions and guidance in relation to service providers has been marked up below. Recommended insertions are in **bold and underlined** and deletions are in ~~bold and struck through~~;

Provisions for service providers

1.	Signatories must indicate the range of services they offer, and how they serve the interests of clients and enable them to deliver effective stewardship.
2.	Signatories must inform clients about the accuracy of their services and demonstrate service quality by providing information about how products and services are prepared to best support clients' stewardship.
3.	Signatories should explain what activities they undertake to work with other stakeholders and exercise their role as stewards of the market.
4.	Signatories should ensure their workforce has appropriate experience, qualifications and/or oversight to deliver their services.
5.	Signatories should disclose their conflicts of interest policy and how it has been applied.
6.	Signatories should establish a code of conduct.

Guidance for service providers

1.	<p>Signatories may provide a range of services, including: vote execution, voting advice, research and data analysis, and consultancy. Signatories should indicate which services they offer to asset owners and asset managers to support their stewardship objectives. We recognise also that some service providers are part of larger organisations, e.g. an investment consultant that is part of a larger consultancy firm.</p> <p>Where service providers offer engagement services they should set out an engagement policy and how this supports clients' stewardship.</p>
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<p>2.</p>	<p>Reporting against this Provision should seek to satisfy requirements in SRD II, chapter 1b, article 3j, 2.</p> <p><u>Additionally, signatories should:</u></p> <ul style="list-style-type: none"> • <u>Establish and explain their policy on engagement with companies which are the object of their research, advice or voting recommendations. This should include:</u> <ul style="list-style-type: none"> ○ <u>describing how they engage with companies throughout the year;</u> ○ <u>setting and disclosing minimum time deadlines for engagement with companies to allow companies to respond appropriately to any issues raised; and</u> ○ <u>describing the extent to which they engage with companies in circumstances where they make a negative research finding or voting recommendation.</u> • <u>Describe whether, and if so how, they consider explanations provided by companies which are the object of their research, advice or voting recommendations and describe how they communicate these explanations to their clients;</u> • <u>Establish and explain their procedures to prevent and detect factual inaccuracies in research, advice or voting recommendations.</u>
<p>3.</p>	<p>In addition to their effective stewardship of assets, we expect Code signatories to fulfil their role as stewards of the market, meaning that they support well-functioning financial markets in whatever function they serve.</p> <p>The effective implementation of stewardship requires constructive coordination of many market participants working towards positive outcomes for stewardship and sustainable financial markets.</p> <p>Signatories should explain what activities they undertake to support effective stewardship and positive outcomes that contribute to building a sustainable financial system, which both manages systemic risks and drives capital towards more sustainable investments.</p> <p>Activities may include, but are not limited to: engagement with other participants in the financial market, policymakers, regulators, representative bodies and relevant industry initiatives.</p>

4.	<p>Signatories should explain how they ensure they <u>devote sufficient time and</u> have the necessary resources in place, including teams with the appropriate levels of seniority, integration, qualifications and experience to deliver their stewardship objectives; <u>particularly in relation to companies with unusual or different market characteristics.</u></p> <p><u>Signatories should appropriately train their staff to ensure they have the expertise required to understand the companies which are the object of their research, advice or voting recommendations.</u></p>
5.	<p>Reporting against this Provision should seek to satisfy requirements in SRD II, chapter 1b, article 3j, 2(g).</p>
6.	<p>Reporting against this Provision should seek to satisfy requirements in SRD II, chapter 1b, article 3j, 1.</p>