Financial Reporting Council (FRC) – Proposed Revision to the UK Stewardship Code (January 2019)

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In need of a revised Stewardship Code for 'shareholder stewardship' as a matter of corporate governance relations in UK listed equity

Executive Summary

1. The broader definition of stewardship conduct in investment management is not suitable for the FRC's Stewardship Code. The FRC's Stewardship Code should continue to uphold and enhance its original objective of promoting 'shareholder stewardship' as a matter of corporate governance relations in UK listed equity.

2. We advocate the new Principles 4 and 5 and we support the new Principle 3 as long as it focuses on monitoring of UK listed equity. Stewardship responsibilities in investment processes and beyond listed equity should be under the remit of the FCA.

3. We welcome the recognition of environmental, social and governance (ESG) issues as an integral part of shareholder stewardship, but such factors should be clearly incorporated in the Provisions accompanying Principles 3 and 4.

4. The introduction of the 'apply and explain' approach for the Principles can be welcomed as a constructive, albeit incomplete move in the direction of enhancing the outcomes-focused stewardship. It is the generality of the new Principles themselves, however, that needs to be addressed first. Any movement from the tried and tested principle of comply or explain to apply and explain needs to be part of the joint FCA and FRC efforts to strike the right balance between regulatory- and code-based stewardship expectations.

5. We support the Guidance, but we believe that it should include specific examples of good and bad shareholder stewardship practice and be updated on an annual or bi-annual basis to better reflect changes on shareholder stewardship. The annual Activities and Outcomes Report can feed into the Guidance.

Answers to the 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.

The definition of stewardship (pg. 2) is much broader than the original expectation on the part of asset managers and asset owners to carry out best practice stewardship as shareholders of UK public listed companies. This is a beneficial step in relation to the need for there to be policy thinking regarding the standards of investment management conduct. This is consistent with our proposal to specify and clarify asset owners' and managers' stewardship conduct in investment management (see our response to FCA/FRC DP 19/1). However, this definition of stewardship is not suitable for the FRC'S Stewardship Code due to its particular objective.

This new definition of stewardship eclipses the narrower definition of what can be termed as 'shareholder stewardship' (or 'shareholder engagement' under the EU Shareholder Rights Directive) featured in the previous two versions of the UK Stewardship Code. The main aim of the original UK Stewardship Code (2010) and its 2012 revision was to improve 'long-term returns to beneficiaries by enhancing the quantity and quality of *engagement* between investors and companies' (UK Stewardship Code 2012, pg. 1). And, it is on this basis of improved shareholder engagement that stewardship principles can be now found in seventeen countries around the world as well as in the amended EU Shareholder Rights Directive (SRD II) and the ICGN Global Stewardship Principles. In other words, the core and original objective of the Stewardship Code has to do with the conduct of shareholders *as a matter of corporate governance relations* in UK public listed companies. The Stewardship Code should continue to uphold and enhance norms in relation to this objective.

The proposed UK Stewardship Code has conflated and integrated issues that are for the regulatory remit of the FCA, i.e. the integration of stewardship in investment management more generally. We believe that while the conduct of investment management, including investment decision-making, mandate design and other activities, is a matter for the FCA, shareholder stewardship in UK listed equities is a matter of a different nature and it remains beneficial for there to be a set of norms *as a matter of corporate governance* for how shareholders of UK listed companies should conduct themselves. The UK Stewardship Code, for example, guides minority activist shareholders towards constructive and not disruptive conduct.

This becomes apparent if one considers the originating purpose of the UK Stewardship Code. Historically stewardship was about engagement with public listed companies to improve corporate performance and exercise of shareholder rights. The UK Stewardship Code was introduced to complement the UK Corporate Governance Code and give force to the 'comply or explain' system which relies on the market generally and the shareholders specifically to determine the quality of explanations to code provisions and then to take some action (UK Stewardship Code 2012, pg. 1). For instance, under Principle 3 of the 2012 Stewardship Code, investors should seek as part of their monitoring of investee companies to 'satisfy themselves that the company's board and committees adhere to the spirit of the UK Corporate Governance Code' (UK Stewardship Code 2012, pg. 7). Also, under Principle 3, institutional investors 'should consider carefully the explanations to the company, in writing where appropriate, and be prepared to enter a dialogue if they do not accept the company's position' (UK Stewardship Code 2012, pg. 7).

We acknowledge, however, that it is mainly the asset managers that can undertake such an aspired role. An additional concern here is likely to relate to the nature of the UK Stewardship Code, which is currently soft, but likely to be elevated to a hybrid one if the 'apply and explain' approach is introduced. We are of the view that more articulation is needed in relation to whether a hard law approach is required (see our response to FCA/FRC DP 19/1 in Appendix).

We contend there are two conceptions of 'stewardship' that have been confused. One is 'stewardship' as a matter of investment management conduct, whose development we support. The second is 'shareholder stewardship' which is shareholder conduct as a matter of corporate governance relations. Shareholder engagement does have public interest implications and can benefit society in supporting a well-functioning economy (Kay 2012). Even though we agree that 'signatories should use the resources, rights and influence available to them to exercise stewardship, no matter how capital is invested' we believe that the core and original responsibility of *shareholder stewardship*, that is monitoring of UK listed equities, needs to be strengthened. This should be the focus of the UK Stewardship Code.

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

We agree with the regulatory choice of not introducing separate stewardship codes for asset managers, asset owners, proxy advisors and investment consultants. And, we support the development of separate principles and provisions for service providers. Shareholder stewardship is part of investment management overall, but different asset owners with equity investments have different needs and this would cascade into different expectations for their asset managers (see our response to FCA/FRC DP 19/1 in Appendix).

We specifically advocate Principles 4 (constructive engagement and clear communication) and 5 (exercise rights and responsibilities) and their Guidance. The Guidance to Principles 4 and 5 do improve from the current Stewardship Code (2012) in recognising the need for shareholder engagement to be part of a fund's overall objectives, yet also introduce norms of conduct that shareholders should be mindful of, e.g. reference to stock lending policy and empty voting. However, Principles 4 and 5 themselves may benefit from an expansion of the relevant Provisions, including, for instance, reference to ESG factors in the Provisions of Principle 4.

We also support Principle 3 (active monitoring) as long as the focus is on monitoring how investment equity is managed and aligned with clients' investment and stewardship policies (e.g. monitoring company's performance, director's application of section 172 of the Companies Act 2006, adherence to the UK Corporate Governance Code etc.). The Guidance to Principle 3 specifically focus on ESG factors, but this should be included in the Provisions. The complementary relationship between the Stewardship Code and the UK Corporate Governance Code (as in the current Principle 3) should be emphasised (see also our answer to Question 1). It is also important for the asset owners and asset managers to explain their prioritisation policy and feed this into investment management and shareholder engagement. Finally, we agree that reporting against Principle 3 can satisfy the requirements of disclosing an engagement policy under Article 3g, 1(a) of the SRD II.

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

The 'comply or explain' principle has been for a long time a 'trademark' of corporate governance in the UK and was adopted by the UK Stewardship Code (2010, 2012) on the basis that it is a tried and tested principle in the UK and abroad. While voluntary compliance with good corporate governance and stewardship practices based on the principle of 'comply or explain' has gained wide recognition as possibly one of the best ways to achieve flexibility and adaptability to individual circumstances, questions have nonetheless arisen with respect to whether this approach most effectively ensures that companies and investors act responsibly. For instance, in the past the FRC has become concerned that excessive compliance with the UK Corporate Governance Code is viewed as the primary enforcement problem (e.g. Walker Review 2009), while, on the other hand, poor or non-compliance is not typically followed by a clear market response. In a similar vein, it is questionable whether the signatories to the current Stewardship Code (2012) take seriously enough the idea that they can explain non-compliance. In addition, while the comply-or-explain approach of the UK Corporate Governance approach is aimed to be supported by the UK Stewardship Code (see also answer to Q1 above), the comply-or-explain approach of the Stewardship Code is only supported by the FRC's tiering exercise and the (rather premature) market for stewardship.

Introducing 'apply and explain' for the Principles of the Stewardship Code is in our view beneficial. The 'apply and explain' approach (first advocated in the King IV Report for South Africa) refers to applying the Principles and then explaining how they are being effected, enabling the beneficiaries and/or clients to evaluate the signatories' statements. 'Apply and explain' is not viewed as a compliance exercise, but rather as a signatory's demonstration of commitment to stewardship. The idea is that this approach will encourage qualitative application of the Principles where the emphasis is on the outcomes of stewardship practices. Arguably the introduction of such an approach can support the outcomes-focused stewardship (Kingman Review 2018), while it could also potentially help institutional investors to actively exercise their rights to monitor the compliance levels of their investee companies with the UK Corporate Governance Code (see our answer to Question 1 above).

Principles 3, 4 and 5 at the moment are high-level and general in nature, and this can result in varying qualities of explanation in relation to application. If apply-and-explain is to be adopted, this needs to be accompanied by additional Guidance on explanation so as to avoid boiler-plate statements. Specific examples of application should also be required to be made, even if investee companies' names are anonymised. We also contend that the holistic policy considerations for regulating investment management must avoid focusing on 'single issues' as silver bullets, such as mandating asset owners to issue ESG-related mandates or asset managers to engage with companies over these matters (Principle E). While it is easy to associate well touted aspects like ESG with responsible stewardship, introducing Principle E on a apply and explain basis does not account for alternative business models.

As such, the introduction of the 'apply and explain' approach for the Principles can be welcomed as a constructive, albeit incomplete move in the direction of enhancing the characteristic flexibility of the Code's application, which should in turn help mitigate the effect of the increased prescriptiveness of its key Principles. In this regard, we contend that apply-and-explain should apply to all institutional shareholders of UK companies whether they are foreign or domestic. This will ensure that shareholders in UK companies are equally subject to a set of expectations with respect to their conduct in corporate governance relations in UK listed companies.

The nature of the Stewardship Code also needs be considered within the broader regulation of investment management conduct. As engagement with investee companies is only one aspect of investment management generally, we have elsewhere proposed reform to the FCA's governance of investment management conduct (see our response to FCA/FRC DP 19/1 in Appendix). If a hard law option for articulating and clarifying investment management conduct becomes the preferred regulatory (FCA) solution, the 'apply and explain' approach of the FRC's Stewardship Code should extend to the Provisions or the Principles themselves need to be expanded to appropriately support the practice of shareholder stewardship (consider, for instance, Principle J on the exercise of shareholder rights).

In overall, while we support the introduction of the apply and explain principle and the extension of the Stewardship Code to all the institutional shareholders of UK public equity, any movement from the tried and tested principle of comply or explain to apply and explain needs to be part of the joint FCA and FRC (and the succeeding Audit, Reporting and Governance Authority) efforts to strike the right balance between regulatory- and code-based stewardship expectations (see our response to FCA/FRC DP 19/1 in Appendix).

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

We view the Guidance to the UK Stewardship Code as a step to the right direction, but specific (good and bad) examples of shareholder stewardship practice distilled from experience and real stories should be included. The annual Activities and Outcomes Reports to be prepared by the signatories can feed into the Guidance (see also our response to Question 5).

For example, the Guidance could focus on the different ways of monitoring and shareholder engagement using the (good but different) examples of Standard Life Investments and Hermes EOS, the kind of shareholder conduct we do not encourage such as 'selfish' activist conduct or Colchrane's opportunistic litigation in the Interserve case. The examples to be included should be updated on an annual or bi-annual basis to reflect on a wide range of activities. This can also address the Kingman Review's critique of the current state of aspirational stewardship reporting and the lack of emphasis on outcomes.

Given the way we view the supporting function of the Guidance, we contend that some of the information currently contained in the Guidance should be part of the Code's Provisions (e.g. issues to be monitored and engaged with, escalation activities, ESG, collaborative engagement etc.).

The FRC's (and in the future, the ARGA's) work on shareholder stewardship can support the FCA's development of regulatory reform on the broader notion of stewardship as conduct of investment management (see our response to FCA/FRC DP 19/1 in Appendix). We will be conducting an empirical study with pension asset owners of different scales and preferring different mandates to distil qualitative and quantitative findings with respect to barriers, difficulties etc. in relation to selection and monitoring of asset managers. This can help provide a more granular taxonomy of the relational obstacles that need to be addressed and form the basis for regulatory guidance to clarify the conduct of asset owners as part of stewardship. This type of study should be replicated across different asset owners and asset managers in order to distil more granularities so that specific articulations and clarifications in asset-owner-manager relations can be formed. These can feed into developing clearer expectations of the stewardship roles and responsibilities of those at different points in the investment chain and concretising soft or hard law options for regulating investment management conduct in different aspects. We welcome engagement by the regulators in relation to this work.

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?

Yes, we support the introduction of an annual Activities and Outcomes Report. Such a report will support the much-needed focus on outcomes (Kingman Review) and move away from merely aspirational statements. We also agree that the tiering process has been devalued by having too many signatories in Tier 1, despite the significant differences in the stewardship statements and approaches of Tier 1 signatories. Further, good and bad practices reflected in the annual reports can usefully feed into the FRC's work on Guidance for shareholder stewardship (see our response to Question 4).

The introduction of an annual Activities and Outcomes Report also ties in with our proposal to articulate and clarify asset owners' and asset managers' conduct in terms of disclosure to beneficiaries and clients (see our response to FCA/FRC DP 19/1 in Appendix).

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?

We agree with the introduction of more rigorous reporting requirements in the form of a Policy and Practice Statement and an annual Activities and Outcomes Report. But caution is required against making all sorts of policy statements sufficient for discharge of the stewardship roles and responsibilities of different actors in the investment chain. Clarified duties and guidance must be for the purpose of enabling meaningful conduct, not the framing or expression of conduct only.

Q7. Do to 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 emphasised on outcomes and effectiveness, rather than on policy statements. While the introduction of an annual Activities and Outcomes Report is a step to the right direction, it cannot alone address box-ticking and boilerplate reporting. The Guidance should be re-directed to outcomes and effectiveness of shareholder stewardship (see our response to Question 4 above).

Also, the remit of the new Audit, Reporting and Governance Authority should relate specifically to shareholder engagement practices in the UK *as a matter of corporate governance.* The FCA should further support the articulation and clarification of the stewardship conduct of asset owners and asset managers (see our response to FCA/FRC DP 19/1 in Appendix).

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

We first think that the Stewardship Code should apply equally to all institutional shareholders of UK listed equity and should not be binding only upon voluntary signatories (see also our response to Question 3). We are of the view that institutional shareholders' organisational purpose, values, strategy and culture are relevant as matters of concern for investment management of UK-originated assets and should be dealt with under the development of reform by the FCA. In relation to the FRC's (and in the future, ARGA's) remit of overseeing institutional shareholder conduct, the disclosure should be geared towards activities and outcomes. As the Kingman Report already identified it is the emphasis on outcomes and effectiveness that is still missing.

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?

We agree that stewardship has an important role to play in investment beyond listed equity, but we believe that the Stewardship Code should focus on shareholder stewardship as a matter of corporate governance relations.

We also believe that there should be development for comprehensive and joint regulatory thinking about investment management for asset owners and managers, such as proposed in the joint FRC/FCA paper to which we also respond (see our response to FCA/FRC DP 19/1 in Appendix).

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?

We believe that Principle 1 relates to the optimal practices in investment management that should be either subject to soft law by the FCA or hard law in relation to investment management, adding to the FCA's work on the Asset Management Market Study (see our response to FCA/FRC DP 19/1 in Appendix).

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?

See our answer to Question 10 above.

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

While Section 3 as currently worded (monitoring the agents that operate on the behalf of asset owners and asset managers) should be under the FCA's remit of stewardship, the new Stewardship Code should keep the well-established principle of monitoring by asset managers of investee companies is a well-established stewardship activity (Principle 3 of the 2012 Code). This should continue to be a central activity of shareholder stewardship as a matter of corporate governance relations.

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

We think that the avoidance of the term 'collective engagement' is so as to prevent any misunderstanding as to the legal notion of 'acting in concert'. 'Collaborative' engagement may suggest the maintenance of individual identifies and objectives and avoids triggering legal thresholds. We think that as a lot of clarification has already gone towards supporting the old 'collective engagement', the change in the term is likely to be cosmetic and is not sufficient to change stewardship practices.

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

The chief benefit of having a mechanism for investors to escalate concerns about an investee company in confidence is that the matter remains private and not alerted to markets that may trigger an irrational reaction. However, allowing investors to raise concerns under confidence allows them to cultivate different intensities of relationships with boards and may result in unevenness and unfairness in boards' treatment of all investors. Such behaviour could put the board in danger of a breach of section 172 of the Companies Act 2006, as explicated by the recent decision of *Routledge v Skerritt* (2019). We thus do not support the introduction of such a mechanism. Instead, we encourage more open-ness in relation to informal shareholder engagement and for shareholders to consider their style and tone of engagement carefully bearing in mind the behavioural flaws in capital markets.

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

No. In our view, the Stewardship Code should focus on shareholder stewardship as a matter of corporate governance relations.

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?

We believe that these should be part of the FCA's (soft or hard law) remit of stewardship (see our response to FCA/FRC DP 19/1). However, the role of service providers in relation to the narrower shareholder stewardship concept could be brought into the Stewardship Code, such as the role of proxy advisers in shareholder monitoring, engagement and voting activities. However, we may not wish to do more than transposing Article 3i of the SRD II at this stage (see our response in relation to the SRD II).

Appendix

Response to FCA/FRC Discussion Paper (DP19/1), Building a Regulatory Framework for Effective Stewardship

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Making stewardship meaningful, effective and sustainable: Considering options in legalising duties of asset owners and managers

Executive Summary

1. The FCA and FRC rightly consider it time to subject investment management conduct, i.e. what asset owners and managers do in delivering responsible, effective and sustainable investment management, to comprehensive regulatory and policy thinking.

2. We suggest that there are aspects of asset owners' and managers' conduct that can benefit from more articulation and clarification. Such would result in options along a spectrum of legalisation. We view two options in this regard. Expectations of conduct can be articulated and clarified as a matter of best practice flowing from general fiduciary and care duties (*soft law approach*). Or, alternatively, expectations of conduct can be articulated and clarified as a matter of specific regulatory duties developed in the FCA Handbook, such as in COLL and FUND (*hard law approach*).

3. Asset owners' conduct should be further articulated and clarified in terms of their *selection* (of consultants or asset managers), *monitoring* of asset managers and *disclosure* to beneficiaries.

4. Asset managers' conduct should be further articulated and clarified in terms of *allocation*, *turnover*, *review* and *disclosure*.

5. The conduct we identify above is not dissimilar to the new FRC Stewardship Code for consultation (January 2019). However, such a Code presumes a soft law approach and would be administered by the FRC, and the now proposed Audit, Reporting and Governance Authority. We contend, however, that investment stewardship should be part of the FCA's regulatory regime (either via a soft or hard law approach) and the FRC's Code should be refined to 'shareholder stewardship' as a matter of corporate governance relations.

6. We are currently conducting a pilot phase empirical study into pension funds as asset owners to distil qualitative findings on the problems they face in selecting, monitoring, and receiving reports from asset managers, and making meaningful reports to their beneficiaries. This study will enable us to finalise more concrete recommendations on whether a *soft* or *hard* law

approach is needed for articulating and clarifying asset owners' and managers' conduct. We welcome engagement by the regulators in relation to this work.

Overview

A regulatory framework for effective stewardship should be seen in the wider context of the FCA's role in regulating fund management, and not merely as relating to asset owners' or managers' roles as engaged shareholders in equity investments. Hence, the broadened definition of 'stewardship' adopted in this consultation and in the FRC's consultation on the revised Stewardship Code (January 2019) is welcome. With the change in definition of stewardship from narrowly focusing on corporate governance and equity investments to expectations of an effective, responsible and sustainable investment management industry, we expect to see marked changes in regulatory and policy thinking.

First, we expect to see comprehensive and joined up policy thinking in terms of regulating investment management conduct. This means, in particular, connecting stewardship with the FCA's work in the Asset Management Market Study conducted over the last two and a half years. Second, we expect to see an extension of policy thinking to all aspects of asset management, including different treatment of asset owners' and managers' conduct, and conduct of intermediaries in the investment chain and inclusion of all asset classes across geographies. The extension in scope may, however, be in phased stages.

The FCA has in its Asset Management Market Study discussed issues such as the disengagement of asset owners from understanding and scrutinising asset management, and disappointed expectations in relation to ultimate returns (one of the reasons for which are the high cost of fees and charges that severely diminish performance returns). Its key reforms are to facilitate market discipline, i.e. to assist asset owners in being better able to scrutinise asset managers' practices and call them to account. For example, new FCA rules mandate asset managers to assess value for money in the incurring of charges and costs in the investment chain and ensure that these are justifiable and disclosed to investors (April 2018). Asset managers are required to clearly explain to investors and in a non-technical manner fund objectives and allocations (including non-financial and ESG objectives) (February 2019), and to allow investors to be able to scrutinise fund performance against a clearly explained target or constraining benchmark (active or passive mandate) or how performance should be assessed in the absence of the adoption of a benchmark (February 2019). Finally, fund fees, expenses etc. have been mandated to be a single all-in fee (MiFID, 2014, 2017). There are several measures of a more 'regulatory' character that compel certain conduct to occur, such as the crediting of 'box profits' to clients (April 2018), mandating that performance fees can only be based on fund performance after all deductions (February 2019) and considering compelling funds to switch investors into the most cost-effective classes (June 2017).

Although market discipline is important, the FCA's own studies indicate dangers that asset owners and retail investors are not necessarily able to effectively scrutinise asset management. There is indication of concern over jargonistic language, infrequent switching and investors' inability generally to assess whether to 'vote with one's feet'. There is relatively little foray into regulatory policy for investment management practices except in relation to equity investments, where since 2010, the UK has introduced a Stewardship Code to encourage the management of equity investments in the capacity of 'engaged shareholders', a position that the European Shareholder Rights Directive 2017 (SRD II) agrees with. This has caused a discrepancy between policy-makers interest in asset managers' equity investments as opposed to other asset classes, prompted by a need to ensure that corporate conduct is monitored, given the consistent numbers of significant corporate scandals in the UK and EU (e.g.

Parmalat 2003, Royal Ahold 2003, EU and UK banks during the global financial crisis 2007-9, Tesco 2014, Volkswagen 2015, Carillion 2018, Patisserie Valerie 2019). The opportunity has come to level this discrepancy so that holistic and comprehensive regulatory policy for investment management can be designed.

The FRC's proposed Stewardship Code (January 2019) reflects that change in policy and broadens the scope of stewardship to include investment decision-making and investment in assets other than listed equity. Under the new proposed Stewardship Code, the primary purpose of stewardship is to create sustainable value for investors through the responsible allocation and management of capital across the institutional investment community. While we support this broader remit of stewardship, we contend that the FRC's new Code is not the right means to achieve the stated policy objectives. The FRC has merely adopted the broad policy, overreached its remit and disregarded the precise achievements it has made in encouraging shareholder stewardship/engagement thus far. The FRC should return to providing an improved Stewardship Code focusing on 'shareholder stewardship as a matter of corporate governance relations', relating to equity investments, while the principle of being engaged in investee companies should become elevated as a soft/hard law articulation for asset managers under the FCA Handbook.

We are of the view that asset owners' duties in fiduciary, trust and contractual law are well-developed in principle but often the details in conduct are arguable, such as the highly contested issue of whether asset owners' fiduciary duties allow them to consider ESG aspects in monitoring their asset managers. We also believe that more regulatory leadership over investment management is beneficial. Over the years the legal framework for investment management has already become a patchwork of general law added to by regulatory law. For example, the 'value for money' consideration that are bound to undertake under the reforms pursuant to the Asset Management Market Study, or the Commission Directive 2010's exposition of UCITs' managers' duties of diligence, best interests etc are evidence of such a movement. Asset managers carry out different investment management strategies and mandates and there may be concerns with respect to particular strategies such as illiquidity, synthetic portfolios etc. There is room for developing more specific articulations and clarifications of optimal conduct where there may be problems or hazards to asset owners that are difficult to detect.

We contend that asset owners' conduct should be further articulated and clarified in terms of their *selection* (of consultants or asset managers), *monitoring* of asset managers and *disclosure* to beneficiaries. Asset managers' conduct should be further articulated and clarified in terms of *allocation*, *turnover*, *review* and *disclosure*. Such articulation and clarification of asset owners' and managers' conduct would result in options along a much broader spectrum of legalisation. One option can be to articulate and clarify expectations of conduct as a matter of best practice flowing from general fiduciary and care duties (*soft law approach*). Alternatively, expectations of conduct can be articulated and clarified as a matter of specific regulatory duties developed in the FCA Handbook, such as in COLL and FUND (*hard law approach* or a mixed approach along the spectrum of *hard* and *soft* law).

The conduct we identify above is not dissimilar to the new FRC Stewardship Code for consultation (January 2019). However, such a Code presumes a soft law approach and would be administered by the FRC, and the now proposed Audit, Reporting and Governance Authority, when it should be part of the FCA's regulatory regime. Further, as there are different types of asset owners and expectations of asset managers (see Barker and Chiu, 2018), specific regulatory duties or guidance can be warranted in relation to the needs of specific asset owners. For example, small defined contribution schemes that are concerned about fees and charges may prefer passive management mandates. How a passive mandate should effectively consider shareholder engagement would be different from how an active one would. Further, we can consider developing specific regulatory thinking in relation to asset managers with different capacities and focuses; a passive mandate given to a large global asset manager like Blackrock may entail special concerns, such as how such an asset manager is exercising power over important corporate economies.

We are of the view that the FCA should have a framework, whether in soft or hard law, for asset owners' and managers' conduct in the underlined aspects above, fleshing out optimal practice. To finalise more concrete recommendations on whether a soft or hard law approach is preferred for articulating and clarifying asset owners' and managers' conduct, we are conducting a pilot phase empirical study into pension funds as asset owners to distil qualitative findings on the problems they face in selection, monitoring, receiving reports from asset managers and making meaningful reports to their beneficiaries. We welcome engagement by the regulators in relation to this work.

The relatively more detailed developments regarding practices for shareholder stewardship/engagement with equity investments may be contrasted with the lack of development of best practices in other types of asset classes and mandates. Such levelling up is needed eventually although policy development should be carried out in stages. Hence, it is surprising and retrograde for the FRC's proposed Stewardship Code to marginalise its specific focus on optimal shareholder stewardship practices in relation to equity investments. We believe that the FRC's Stewardship Code should be improved by focusing on the practice of shareholder stewardship as a matter of corporate governance relations.

Answers to Selected Specific Questions:

Q1: Do you agree with the definition of stewardship set out here? If not, what alternative definition would you suggest?

We agree with the definition here which is much broader than the expectation to carry out shareholder engagement in equity investments. This is consistent with our proposal to specify and clarify asset owners' and managers' conduct in investment management.

It is submitted, however, that this definition of stewardship eclipses the narrower definition of stewardship used by the FRC before in relation to the best practice of shareholder stewardship as a matter of corporate governance relations. We contend that the adoption of this broader concept of stewardship, which we support, should not eclipse the importance of shareholder engagement norms that have already been developed, as shareholder engagement does have public interest implications and can benefit society in supporting a well-functioning economy (Kay 2012). In other words, there should be development for comprehensive regulatory thinking about investment management for asset owners and managers, including incorporating the developments already made about how equity investments should be managed in an engaged manner.

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 (eg ESG outcomes, innovative R&D, sustainability in operations, executive pay)?

We believe that there is a need for more granular work in distilling aspects of stewardship, as we posit above. This is because it is easy to associate well touted aspects like ESG with responsible stewardship or see encouraging R&D as a recipe for future success, without considering causative relationships. The holistic policy considerations for regulating investment management must avoid focusing on ‘single issues’ as silver bullets, such as mandating asset owners to issue ESG-related mandates or asset managers to engage with companies over these matters. It is further necessary to clarify whether ESG-related matters are important because of their materiality or their achievement of potentially non-financial but socially beneficial goals. As we support a broad ‘stewardship’ definition, it is important to avoid justifying stewardship merely by financial outcomes. Stewardship should be considered as optimal conduct in reflecting the outworking of fiduciary, care and contractual duties, not just as a means to certain calculative ends.

We will be conducting an empirical study with pension asset owners of different scales and preferring different mandates to distil qualitative and quantitative findings with respect to barriers, difficulties etc. in relation to selection and monitoring of asset managers. This can help provide a more granular taxonomy of the relational obstacles that need to be addressed and form the basis for regulatory guidance to clarify the conduct of asset owners as part of stewardship. This type of study should be replicated across different asset owners and asset managers in order to distil more granularities so that specific articulations and clarifications in asset-owner-manager relations can be formed. These can feed into concretising soft or hard law options for regulating investment management conduct in different aspects.

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.

We support the four key attributes of stewardship but there is a lack of clearly choosing soft or hard law options with respect to them. Further, these key attributes need to be joined up with the soft law practices proposed in the FRC’s new Stewardship Code, which we see as more appropriately cut away in order to fall under the FCA’s remit. The FCA needs to consider the spectrum of legalisation i.e. soft/hard law approaches and in relation to what levels of precision of articulation for practices in investment management conduct.

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 stewardship across borders, be overcome?

We should not maintain geographical and asset class scope discrepancies in clarifying the expectations of stewardship as this would cause perverse incentives in relation to the practice of investment management.

Q5: We welcome examples of how firms with different objectives and investment strategies approach stewardship. In particular, we welcome input on how stewardship practices differ across active and index tracker funds, in the following areas:
i: how firms prioritise and conduct stewardship engagements
ii: what investments firms have made in stewardship resources
iii: how stewardship activity is integrated with investment decisions.

Barker and Chiu (2018) provide a meta-level survey of the incentives and structures affecting shareholder engagement as stewardship by different types of equity-owning funds. This framework can be broadened to encompass more extensive empirical research on each of the following aspects of asset owners' conduct and asset managers' conduct: asset owners in relation to 'selection', 'monitoring' and 'disclosure' and for asset managers, guidance in 'allocation', 'turnover', 'review' and 'disclosure'.

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.

There is a need to look at how regulatory regimes apply to contradictory effects and therefore affect practices of investment management in contrary directions. For example, regulatory rules that intend to protect investors' liquidity expectations and redemptions put pressure on funds and may shape their short-termist tendencies.

Q7: To what extent 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?

Regulatory rules have added to the fabric of general law investment management duties for both asset owners and managers, as we highlighted in the overview. This trend is likely to continue as specific problems in conduct need to be addressed by regulation if market failures persist. Hence, we see the articulation and clarification of conduct in investment management as an optimal way forward. In this respect the FRC's proposed Stewardship Code overlaps with the FCA's remit in relation to Principles 1, 2, 3 and 6 and should be joined up with the FCA's development of overall regulatory policy. The FRC's work on encouraging optimal shareholder engagement in equity investments is geared towards the paradigm of corporate governance relations and it does not need to be discarded or conflated in favour of the FCA's broad approach.

Q9: We welcome feedback on other specific aspects of the regulatory framework described above. In particular, we are interested in views on:
ii: The case for regulatory rules to expand the reach of stewardship beyond listed equity

Stewardship is rightly defined in this discussion paper as more broadly to deal with the conduct and quality of investment management in general, across asset classes and mandates. Hence, issues in relation to asset owners' selection, monitoring and disclosure in relation to portfolios besides equity investments should be dealt with as part of comprehensive and joined up policy thinking. The Asset Management Market Study should not stand separate from discussions in this DP, the CP on the implementation of the SRDII and Principles 1, 2, 3 and 6 of the FRC's consultation on the Stewardship Code.

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 regulatory regime for asset owners and managers of UK-based assets, i.e. UK pension schemes, mutual funds etc, is for the purpose of protecting beneficiaries in the UK. The existence of UK beneficiaries should be the litmus test of whether foreign asset owners or managers should adhere to our regime. If foreign asset owners or managers do not affect UK beneficiaries, their duties to their constituents should be governed by their home laws. However, there may be an interest in scrutinising whether their conduct vis-a-vis UK companies raises particular challenges for UK companies. This is a matter of corporate governance relations, which we believe that the FRC's Stewardship Code should deal with.

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

Please see our Overview above.

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.

In terms of asset owners' selection, monitoring and review, there needs to be careful consideration of how active mandates meet fund objectives, whether their higher cost is warranted. Aspects of 'activeness' must be made scrutable, in order to avoid closet index-tracking, and disclosures should be tailor-made to the different types of mandate. The selection of an index must be consistent with fund objectives and asset owners must understand its nature and its suitability as a benchmark for the fund. There should also be monitoring and review of the continued suitability of the benchmark and options to change.

Asset managers' need to make available and transparent any in-house policies, standardised methods in relation to different types of mandates, and clarify any tailor-made aspects. They should keep records and justify allocation and turnover and show evidence of regular diligence and review. We propose that the FCA considers specific conduct-based regulatory duties such as a ban on closet indexing, and guidance for 'suitability' assessments and reporting in portfolio management in relation to asset managers.

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 disclosure of matters under Articles 3g and 3h of the SRD II showcase a list of useful items for disclosure which we think can be added to and made mandatory as part of the asset owners' and managers' existing duties of disclosure. The SRD II provides a useful starting point. We, however, see room for improvement. There should be disclosure of specific key examples of engagement or voting and outcomes, in order for funds to see stewardship in action, but the particularity should meet the requirements of 'fair, clear and not misleading'. There should be identification of specific ESG concerns that were raised in key examples of engagement, and the outcomes of those episodes, again giving insight into stewardship in action but in a manner that is 'fair, clear and not misleading'. There should be disclosure of what tools or methodologies are used in ESG monitoring, and how ESG monitoring relates to fund objectives. Finally, particular expenses and costs, as well as estimated benefits can be presented in a quantifiable manner for investors to appraise the benefits of shareholder engagement.

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)?

This question touches more upon shareholder stewardship as a matter of corporate governance relations, and Chiu and Katelouzou (2018) propose a number of reforms to consider. One is that active engagement/activism needs to be disclosed in relation to intentions to the securities market (this would require amendment of DTRs), and two, shareholder duties in relation to controlling and even activist minority shareholders can be considered under company law. Thirdly, we consider it fruitful that the FRC (new Audit Reporting and Governance Authority) continues to maintain a code for shareholder stewardship as a matter of corporate governance relations in UK listed equity that sets out norms of good behaviour as citizens in corporate governance. This can usefully extend from Principles 3, 4 and 5 of the FRC's proposed Code in terms of reflecting upon the achievements of engagement and its causative consequences.