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Proposed Revisions to the UK Stewardship Code

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I very much welcome the opportunity to participate, in my capacity as an interested party, in the proposed revisions to the UK Stewardship Code. I will not answer all questions included in this Consultation as I will focus on matters directly related to my area of academic expertise and my ongoing research in corporate governance that I hope will be useful for your purposes. I will also make more detailed comments on a series of matters by responding to the FCA/FRC public consultation 'Building a regulatory framework for effective stewardship'. The current response should be therefore seen as a general assessment of the proposed version of the Code.

Short Biography

Dr Konstantinos Sergakis joined the University of Glasgow as Senior Lecturer in Law in 2015, where he has convened the LL.M in Corporate & Financial Law since 2016 and he has acted as School International Lead since 2017. In 2017, he was elected as a member of the Executive Board of the International Association of Economic Law (AIDE). He is the author of *The Transparency of Listed Companies in EU Law* (Sorbonne - IRJS Editions 2013) and of *The Law of Capital Markets in the EU* (Palgrave Macmillan 2018). He is a Fellow of the Higher Education Academy (2014) and a qualified Advocate, a member of the Athens Bar Association since 2004. His research interests are related to Corporate Law, EU Capital Markets Law and Corporate Governance.

Consultation Questions

Question 1: I agree with the overall spectrum of stewardship aspects. My only reservation is that other – equally important – facets of stewardship have not been taken into account in the revised version. For example, the 'lifetime' of stewardship extends before and after the investment itself: the *ex ante* aspect is manifested via continuous research efforts to decipher which investment is the optimal one for ultimate beneficiaries/clients and the *ex post* aspect is the decision to divest, which may also have beneficial effects on investee companies (given its disciplining function).

I therefore think that the Code could take into account these stewardship aspects and portray an even more holistic vision of stewardship to which concerned parties will need to respond following the 'apply and explain' and 'comply or explain' principles.

Question 2: Yes, they do. I note that there is an ongoing concern about the flexible approach adopted by the Code since its creation. What these opinions do not acknowledge, in my view, is the fact that stewardship will be effectively implemented through gradual escalation towards higher standards, even if concrete results may not appear in the short term. This is due to the ever-changing nature of engagement within the investment chain and the considerable diversity of profiles, strategies and overall characteristics of market actors and investee companies. Additionally, the Code has valuable educational features and that should not be abandoned for the sake of dictating specific behavioural patterns; this would prove counter-productive and would impede engagement in any form (since market actors will perceive stewardship as a source of liability – that needs to be mitigated if not acted upon accordingly – instead of an opportunity for a sounder and more prosperous market).

What is important to acknowledge is that the Code is constantly being enriched with new stewardship facets and with new recommendations/expectations (e.g. ESG); this is a testimony of the merits of flexibility, allowing the Code itself to operate as a malleable educational framework that continues to encourage sound practices, while allowing concerned parties to maintain some of their operating idiosyncrasies. Nevertheless, focus on outcomes and effectiveness should become a priority to avert the risk of mindless compliance or boilerplate statements.

Question 3: I welcome the combination of the 'comply or explain' and 'apply and explain' principles, which create a harmonious disclosure framework with that adopted in the UK CG Code.

By expanding disclosure obligations in relation to best practice expectations, the UK Stewardship Code needs to maintain the 'comply or explain' principle in relation to the provisions. As analysed in our study,[1] the 'comply or explain' principle is vital for disclosure obligations that are still at a relatively recent stage since it allows the concerned parties to gradually develop their activities within an evolving soft law framework that purports to transform itself into an 'expectation driven' operational framework.

As for the Principles, the 'apply and explain' mindset is aligned with the departure from 'mindless compliance' and should therefore be adopted. Application of the Principles will thus be assumed, and emphasis will be placed on the explanatory part to allow information recipients to have a more holistic view of the overall stance of the concerned parties.

[1] K. Sergakis, 'Deconstruction and Reconstruction of the "Comply or Explain" Principle in EU Capital Markets' (2015) 5(3) Accounting, Economics and Law: A Convivium 233, available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2516741.

<u>Question 7</u>: I also find it important to underline the fact that the Code itself has functioned on a voluntary basis since the beginning and has managed to inculcate the basic features of stewardship in engagement within the EU, with the welcome outcome of the revised Shareholder Rights Directive that transformed these disclosure obligations into 'hard law' instruments. It is therefore vital to distinguish between the informational content (which I find promising and ever-evolving) and the legal environment within which the Code has functioned all these years (voluntary adoption) and will be called to function in the future (developments to take place upon transposition of the SRD and the new authority that will replace the FRC).

<u>The FRC's remit is clear and legitimate, according to its flexibility imperative</u>, since, when it comes down to deciphering the informational content of disclosure related to stewardship (or of the explanation of non-compliance), it is <u>particularly difficult to delineate the contours of overall compliance</u> due to the inevitably variable circumstances surrounding engagement and investment strategies that also impact the content of the engagement shareholder duties and the overall understanding of whether such duties are effectively complied with. Indeed, it is this vast range of information that cannot be monitored (and eventually sanctioned) with legal enforcement mechanisms as it will be particularly challenging to draw the line between violations of disclosure (or explanation) duties and simple 'borderline cases' that cannot and should not be sanctioned given their specificities and the perils of bluntly turning to legal enforcement.

<u>Question 8</u>: By all means as this will gradually <u>enhance educational benefits</u>; information disclosed in this particular regard will enable a series of interested parties/market actors to better understand the conceptual and operational mindset of asset owners/managers. This evolution towards better understanding of other actors' operational features can also increase engagement across the board. Nevertheless, **<u>sufficient acknowledgement of likely changes in this area (purpose and strategy) must also be in place</u>**; indeed, legitimate changes may occur depending on the different orientation that various market actors may wish to implement in the long term.

<u>Questions 9 and 15</u>: I welcome the FRC's approach but <u>more guidance on its expectations</u> in relation to compliance is needed. Other asset classes present specificities that will inevitably impact the content and framework of disclosure on stewardship/engagement. Without creating an over-prescriptive framework, the Code should provide some additional information of indicative good practices of stewardship for other asset classes.

<u>Question 11</u>: Disclosing investment beliefs may prove to be useful only under the condition that the recipients of information also acknowledge that their ideological stance may change from time to time.

<u>Question 13</u>: 'Collaborative engagement' may impede shareholder activism in the case where there are disagreements amongst shareholders or between shareholders and companies more generally. I find that dissenting opinions may be equally productive and constructive in terms of engagement outcomes and stewardship quality. I think that the Code should provide more clarity on the term 'collaborative' so as for the transition to this term (from 'collective') to be understood across the board and in a similar way.

<u>Question 16</u>: First of all, I welcome the FRC's approach that acknowledges that it is ultimately the role of asset owners and asset managers to ensure they discharge their stewardship responsibilities. Secondly, I note with great concern and regret that the criticism against proxy advisors – especially in the US – is not always well founded (although some reasonable concerns about some firms should, of course, be taken into consideration) and that the risk of shifting the attention to proxy advisory firms for the well-known pathologies within the investment chain is that the responsibility of asset owners and asset managers will ultimately remain unchallenged (or will be seen as a less important issue compared to proxy advisors' responsibilities).

I welcome the Principles and Provisions on service providers. The code of conduct referred to in the Provisions should, in my opinion, be the Best Practice Principles (BPP) since this is the only notable initiative in this area that has managed to cover an even wider spectrum of issues (compared to those covered by the SRDII).[2] Most importantly, the BPP are under review; their final version, expected later this year, will be an ideal opportunity for proxy advisors to adhere to an updated set of principles.

Various national frameworks currently in place (for example, the UK and French ones) provide different disclosure spectrums and show the reason why flexibility may need to be maintained in the proxy advisory industry's disclosure obligations. The argument for more flexibility focuses mainly on the fact that proxy advisory firms have not previously been subject to any disclosure obligations at the EU level, including in some EU Member States. It would therefore be only utopic to assume that the SRDII will – on its own – secure a uniform and widely applicable regulatory approach and bring substantial results in terms of transparency and comparability between different practices experienced at the EU level. BPP can function as an important auxiliary reference to the emerging EU regulatory framework and offer a non-binding useful informational framework for both proxy advisors and interested parties in this type of information.

Guidance notes are undoubtedly a very useful tool to enable proxy advisory firms to continue to provide their clients and the public at large with a wider spectrum of information. This flexibility offers important educational advantages to all market actors interested in proxy advisory services since it allows for a wider engagement platform amongst actors. Confining the UK Stewardship Code and the BPP to the new provisions of the SRDII only would compromise such educational and dialogue potential and would transform disclosure in this area into a simplistic compliance exercise.

The UK Stewardship Code and the BPP can therefore work as a preparatory exercise for all proxy advisory firms as to their compliance with the Shareholder Rights Directive, while giving them the opportunity to disclose information related to additional matters.

It is hoped that the review of BPP may bring the private and the public sectors even closer to the creation of a more coordinated disclosure framework.[3] This result will benefit

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[2] https://bppgrp.info/the-principles/.

[3] The main concern about the revised Shareholder Directive's framework is that, by leaving it to Member States to require proxy advisors to disclose information on a specific series of issues, national frameworks will inevitably move towards this informational minimum without necessarily making the effort to trigger further reforms and create a more sophisticated and elaborate informational spectrum for the benefit of the rest of the market. At the same time, the BPP issued by BPPG will continue to exist at the EU level as a private-sector initiative that offers a broader informational spectrum and, as a non-binding document, which invites proxy advisory firms to become signatories and follow its principles.

The rather unfortunate result might therefore be that proxy advisory firms will be required to follow a minimum of binding disclosure requirements at the national level, with variable outcomes, while maintaining the discretion to adhere to a broader non-binding set of principles at the BPP level. The main concern about this potential inconsistency is that it may become rather burdensome for the rest of the market to understand the information disclosed according to the regulatory framework at both the national and EU levels. Although it is rather premature to predict the outcomes of these different regulatory initiatives, the EU agenda needs to take into serious consideration potential sources of informational inconsistency and confusion that will make the overall disclosure exercise somewhat burdensome and – ultimately – of little use to market participants. This both proxy advisory firms, who will avoid extra compliance costs, and investors as well as stakeholders who will be able to find the information they need in a more concentrated and useful manner.

General comments

Expectations in terms of outcomes: I welcome the fact that expectations of best practice stewardship remain generic, at least at the current stage, and do not lead to a fragmented framework composed of a series of different reference points for each and every concerned market actor in the investment chain. I also find useful some basic differentiation between such actors in the Code. This would help target better some specific actions/outcomes tailored to their distinctive profiles. Focus on outcomes is vital as it will allow for a better understanding of the overall stance of market actors signing up to the Code.

Nevertheless, if it is desirable to provide more details regarding the expectations of best practice stewardship, this could be done via the provision of a non-exhaustive list in the form of guidance notes so as to allow the concerned parties to adhere to some generally accepted principles while maintaining their own operational methods.

Fiduciary duties and ESG: The issue of fiduciary duties in the investment chain is a highly debatable one. I agree that duties must be clarified[4] along with the periodic revision of the Stewardship Code in the years to come since realistic expectations in this field can only be achieved when a common understanding around the duties themselves has been reached.

Nevertheless, it is not the Code's purpose to clarify such duties as this issue does not fall within the Code's current mission and overall approach. In other words, as I have repeatedly argued, the Code is a set of principles aiming to increase awareness and convey key messages to the entire investment chain. Its main characteristics are aligned with educational and 'culture transformation' purposes. Nudging sound practices is key in this ever-evolving field.

Empirical data have not only shown the vagueness of 'fiduciary duty' as a concept, but also the difference of opinions in the market of what such duty actually covers.[5] It is therefore vital to maintain flexibility in areas such as ESG given the fact that, notwithstanding the very laudable aims of integrating ESG into stewardship activities (which I fully support), the concerned parties will struggle to reconcile this new agenda with their fiduciary duty to their clients (which does not necessarily coincide with new challenges). I believe it is important to first educate market actors towards integrating other elements into stewardship and conveying the message that non-financial risks have now become truly relevant for the fulfilment of their fiduciary duty since ESG is translated into tangible financial risks when at stake.

Dictating ESG at all costs will probably have counter-productive effects (superficial/formal compliance, insufficient attention to real challenges, mindless consideration of new opportunities in this area etc.). The ongoing communication between

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and other national specificities will inevitably create discrepancies amongst Member States and will impede transparency in this area for the recipients of information.

Having said that, I do find the additional requirements set out in the Stewardship Code welcome since they accentuate the focus on effective stewardship.

[4] In this respect, see Peter Montagnon, 'Good stewardship must begin with fiduciary duty', Financial Times, 11 March 2019.

[5] See, for example, the very interesting study by Anna Tilba and Arad Reisberg, 'Fiduciary Duty under the Microscope: Stewardship and the Spectrum of Pension Fund Engagement' (2019), Modern Law Review.

the FRC and market actors with the disclosure of good (and less good) practices, as well as soft monitoring systems, as analysed below, may contribute to achieving such goals. Educational efforts need to precede other initiatives also in light of studies that highlight gaps in understanding and integrating ESG in various practices.[6]

Enforcement issues: Highlighting a select group of signatories that engage in a 'best practice' reporting fashion is currently the most realistically achievable way to give greater visibility to such practices without incurring burdensome costs. I have also recently supported the idea that it will be particularly challenging for national regulators to enforce the stewardship duties, as provided in the SRDII, and that social enforcement should be maintained in this area.[7]

Most importantly, awarding the power to impose administrative sanctions and measures to the FRC (or the new Authority) to ensure the effectiveness of the Code and market actors' compliance would not only be counter-productive but would also jeopardise engagement.[8] Initiating a dialogue with actors following the examination of their statements of poor quality could be one way forward. 'Naming and shaming' could be another option (but it depends on how far the new Authority will be allowed to go in its enforcement powers and also on the market's reaction, which may not always be expressed, especially if non-compliant companies are profitable).[9]

I would argue that social enforcement should be preferred in such cases and that the only way to encourage the efficient implementation of stewardship provisions would be the empowerment of recipients of the disclosed information via enhanced educational efforts and ongoing dialogue with other market actors. The discreet reinforcement of social sanctions through the use of disclosure as an exposure tool vis-à-vis other market actors should be a welcome evolution, but its ultimate efficiency will depend on the behavioural patterns of these actors. For social sanctions to take on a meaningful dimension and to act as a counterbalance to various 'borderline practices', market actors must already have the necessary education and evaluation skills to act responsibly when they receive any information related to stewardship. Education is key here, as it will prove critical for market actors that must reprioritise their strategies and not focus solely on the financial implications of stewardship activities.

I strongly believe that the revision of the UK Stewardship Code will contribute to the enrichment and maintenance of a more meaningful disclosure framework. I hope the comments provided in this letter are of interest for the Consultation's purposes.

Should you require any further information on the points raised above, please do not hesitate to contact me at Konstantinos.Sergakis@glasgow.ac.uk.

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[6] See, for example, the recent report by CFA and PRI, 'ESG Integration in Europe, the Middle East, and Africa: Markets, Practices, and Data' (2019), available at https://www.cfainstitute.org/research/survey-reports/esg-integration-emea : 'ESG integration remains in its relative infancy, with investors and analysts calling for more guidance on exactly "how" they can "do ESG" and integrate ESG data into their analysis.'

[7] K. Sergakis, 'Legal versus social enforcement of shareholder duties' in K. Sergakis and H. Birkmose (eds), *Enforcing Shareholder Duties* (Edward Elgar 2019) 128.

[8] K. Sergakis, 'The Perils of Public Enforcement of Shareholders' Duties', Oxford Law Blog, 12 September 2018, https://www.law.ox.ac.uk/business-law-blog/blog/2018/09/perils-public-enforcement-shareholders-duties.

[9] For other recommendations in this area that address the concerns raised in the Kingman Review and the current Government consultation on the recommendations about the FRC's review, see my consultation response at https://www.gla.ac.uk/media/media_601148_en.pdf.