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Corporate Governance and Stewardship
Financial Reporting Council
8th Floor
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Submitted via e-mail to stewardshipcode@frc.org.uk

Re: Proposed Revision to the UK Stewardship Code

Dear FRC Board Members,

Thank you for the opportunity to respond to the Consultation on the Proposed Revision to the UK Stewardship Code (the **Consultation**). I am writing in my individual capacity as a lecturer in business law and an expert in company law and corporate governance to share my opinion regarding reporting recommendations for the signatories of the draft 2019 UK Stewardship Code (the **Draft 2019 Code**). My comments thus mainly deal with **Q5** of the Consultation.

The Draft 2019 Code introduces two separate reporting elements for the signatories. First, every signatory to the Draft 2019 Code must submit a Policy and Practice Statement upon signing the code. Second, every signatory should also submit an Annual Activities and Outcomes Report (the **Report**) after one year of being a signatory to the Draft 2019 Code and every 12 months thereafter. The Report will be made publicly available by every signatory.

An integral part of the Report is the description of the activities the signatory has undertaken to implement the provisions of the Draft 2019 Code in the preceding 12 months. In addition to an annual report, Provision 26 of the 2019 Draft Code requires signatories to disclose their voting records in investee companies. Section 5 Guidance further explains that voting records should include rationale for voting decisions, particularly where the vote is against the investee company management's recommendation. The expectation is that signatories to the Draft 2019 Code will demonstrate their engagement and stewardship efforts by including both quantitative and qualitative information in the Report. Examples include case studies and summary statistics of voting records.

The annual report, along with the Provision 26 requirement to disclose voting records, aims to provide all interested actors with information about engagement and stewardship activities of the signatory. This will allow evaluating stewardship efforts of signatories. At the same time, reporting and disclosure requirements are expected to create incentives for more active stewardship and engagement.

The introduction of an Annual Activities and Outcomes Report is therefore definitely welcome. But to make the report an effective tool for evaluating stewardship efforts it is necessary to link reporting explicitly with different forms of engagement with investee companies which may take place – and most often do – outside the formal voting at shareholders' meetings. Importantly, other means of engagement often are more potent tools to advance change given the trivial or routine nature of many items of the agendas at shareholders' meetings. The focus of the Draft 2019 Code's reporting recommendations on voting engagement and voting record disclosure may undermine the role of other means of engagement.

There are two traditional ways in which asset managers can engage with their investee companies. One option is to "exit" an investee company by selling shares owned by funds associated with the asset manager when dissatisfied with the company's management. Informed trading can reward good management by increasing share prices and punish bad management by low share prices.

Alternatively, asset managers can rely on voice-based strategies which, in turn, offer three possible engagement options. First, an asset manager can use its voting rights as a leverage to engage directly with the investee company management via various forms of behind-the-scenes discussions. Empirical evidence shows that closed-door negotiations are, indeed, a common instrument used by asset managers.[1] Second, asset managers can employ their rights to submit shareholder proposals. The third voice-based governance strategy available to asset managers, the use of voting rights to support shareholder proposals or oppose management-sponsored governance initiatives at shareholders' meetings, is the most visible aspect of engagement.

Effective engagement reporting needs to cover all possible engagement strategies and give sufficient consideration to each strategy. Voting engagement can actually be the weakest option available to asset managers given the trivial or routine nature of many proposals included in the agendas of shareholders' meetings of UK companies. I have spent considerable time studying voting records of FTSE 100 companies and the evidence does not support the argument that voting record disclosure itself can

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1. *See* J. A. McCahery, Z. Sautner, & L. T. Starks, 'Behind the Scenes: The Corporate Governance Preferences of Institutional Investors' (2016) 71 *J Finance* 2905, 2906. Anecdotal evidence offers further support: some large asset managers have disclosed the total numbers of private engagement efforts or reported case studies over the last years.

strengthen engagement. UK-based investment funds, unlike their US peers, are not subject to mandated voting record disclosure requirements. As a result, there are wide variations in reporting practices, yet there is no evidence that UK-based asset managers are less active in shareholder engagement through voting shares than their US-based peers.[2] This result is consistent with an earlier study based on data from US mutual fund voting records which found that mutual fund voting behaviour remained unchanged after the introduction of the mandated vote disclosure requirement in the US.[3] Mandated disclosure can thus improve access to uniform information, but it is far from obvious that disclosure can strengthen shareholder engagement as well.

Accordingly, the Draft 2019 Code Provisions and Guidance (Section 5, in particular) can better reflect the reality of shareholder engagement by clarifying and explaining that engagement efforts can take different forms and asset managers are required to report on all forms of engagement in a balanced manner.

The disclosure of voting records and rationale for voting is only one of the reporting aspects. Other examples of reporting may include summary statistics on private engagement efforts (number of companies, type of private engagement, intensity, outcomes), case studies of private engagement, information on submitting or supporting shareholder proposals, case studies on divesting major shareholdings with explanation of the rationale, and overview of public statements with detailed discussion of some examples. Balanced reporting recommendations will also better correspond with the Draft 2019 Code's recognition of various forms of engagement in Section 4 Guidance.

Certainly, private negotiations and reasons for exiting investments may sometimes include sensitive information but this alone cannot be a justification for not disclosing engagement activities. Reporting focusing on the overall engagement efforts with the use of some case studies can help avoiding problems with the disclosure of confidential information. A common counterargument against publicity of private engagement efforts is that public disclosure may discourage one-on-one meetings and limit the range of issues discussed at these meetings. In a similar manner, not so long ago voting records were often considered to include sensitive information public disclosure of which could discourage rather than promote engagement. Yet, the disclosure of voting records is a widely accepted practice now.

The Draft 2019 Code also introduces reporting recommendations for service providers, such as proxy advisory firms. The core problem of the activities of service providers is associated with potential conflicts of interests, particularly when a service provider offers advice both to an issuing company on corporate governance and to shareholders on how to vote their shares. Principles and provisions in the Section on Service Providers recommend signatories to establish policies to manage conflicts of interest, disclose the policy and its application. The Draft 2019 Code does not go as far as to recommend the disclosure of actual conflicts of interest. In response to **Q16**, service providers like proxy advisers must report about all activities involving a conflict of interest, including the list of issuers who received corporate governance advice from the service provider if the service provider also advised, made voting recommendations to the issuer's shareholders, or executed their votes.

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2. *See* S. Gomtsian, 'Large Asset Managers Get Active: Challenging the Common Beliefs About Shareholder Engagement' (2019), working paper available upon request.
3. *See* K. J. M. Cremers & R. Romano, 'Institutional Investors and Proxy Voting on Compensation Plans: The Impact of the 2003 Mutual Fund Voting Disclosure Rule' (2011) 13 *Am L & Econ Rev* 220, 234, 239-242.

Regarding **Q2**, the Draft 2019 Code with its more specific and detailed provisions and guidance is a significant improvement. The proposed revision takes into account recent developments in corporate governance and investment industry, but also, importantly, remains realistic by not including impractical engagement recommendations. Large asset managers have been stepping up their monitoring efforts on governance, environmental and social matters – primarily through promoting standard best practices – but we cannot expect them to be effective in engaging over company-specific performance and operational monitoring in a portfolio including hundreds of companies. This also means that there is still lot of work ahead of us in the coming years to design mechanisms for effective business and strategy engagement. Hopefully the Consultation results will contribute towards further improvements.

Sincerely,

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