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Dear Sir/Madam

Proposed revision to the UK Stewardship Code

EY is pleased to respond to the Financial Reporting Council's ("FRC") consultation Proposed Revision to the UK Stewardship Code, January 2019 (the "Consultation"). We are very supportive of an enhanced UK Stewardship Code (the "Code") and we outline in this letter our overall views on the Consultation and provide answers to the questions in the attached appendix. Please note that we have focused on only answering questions where EY, as a professional services firm, can provide the most relevant insight.

Wider UK review

EY is mindful, when forming its response to the Consultation, of the need to consider the wider reviews taking place in the UK related to corporate governance, reporting and auditing[1]. Investor stewardship touches on all aspects of the corporate reporting and governance framework, therefore the FRC should consider pausing this Consultation until there is more clarity about the future of this framework.

EY's position on the reviews has remained consistent. They should cover the following scope of developments.

1. Corporate reporting needs to evolve. Corporate reporting needs to evolve to meet society's needs, particularly regarding the going concern and viability of companies, the measurement of long-term value creation for stakeholders and other risks. In this regard, we welcome the FRC review led by Paul Druckman[2] into the future of corporate reporting.

2. Audit must be reformed. Audit itself must be brought up to date by taking advantage of technology to enhance reliability and focusing assurance on both the financial statements and other key indicators. Audit firms must also have a revitalised purpose clearly focusing on the public interest. The Brydon Review into UK audit standards provides the opportunity to ensure

[1] BEIS Committee – Future of Audit inquiry, 2019. This focuses on the likely impact of the CMA market study on the statutory audit market, and the review of the FRC by Sir John Kingman (the "Kingman Review"). The Committee intends to feed into the CMA study and ensure audit reform is linked to coherent reform of the wider corporate governance agenda. LINK
[2] The FRC project aims to challenge existing thinking about corporate reporting and consider how companies can more effectively meet the information needs of shareholders and other stakeholders. LINK

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audit meets the needs of stakeholders in the 21st century.[3]

3. Regulatory reform for auditors. All audit firms need to focus on better quality audits. There should be accountability at senior levels in audit firms where audit quality systematically falls short. We believe the focus on audit quality is key and any changes to promote greater choice should not be at the expense of audit quality.

4. Regulatory reform for management and directors. Management and directors (including audit committees) are primarily responsible for the accuracy of corporate information, upon which shareholders and stakeholders rely.[4] They should be held accountable through a framework of enhanced regulatory oversight which, for example, could include operating standards for making specific disclosures e.g., the confirmatory statement on “fair, balanced and understandable”. Management accountability could also be increased through reforms adapted to the UK market, based on the Sarbanes-Oxley reforms[5] for investor protection in the US where, among other things, management of public companies are required to certify the material accuracy of the financial statements.

5. Strengthened regulator. The UK needs an enhanced regulatory framework that ensures there is appropriate scrutiny of companies, directors and auditors. In this regard, we welcome the direction set by the proposals in the Kingman Review, including the creation of Audit, Reporting and Governance Authority (“ARGA”), and its proposed role in ensuring resilience of the audit market. [6]

EY’s overall view on the Consultation

Within the current framework, referred to earlier, EY supports the proposed revisions in the Consultation which include, amongst other things, a closer alignment of the Code with the UK Corporate Governance Code, and the encouragement of more disclosures on the use of proxy advisers (i.e., provisions 24 and 25). In particular, we welcome the introduction of a requirement for signatories to provide an annual activities and outcomes report, as well as a policy and practice statement (i.e., provision 8, and sections 2 and 8 in the guidance).

Other areas for consideration

Outlined below are other issues and matters related to investor stewardship which are not directly addressed in the Consultation, but are nonetheless relevant to the proposed revision to the Code.

[3] The Brydon Review was commissioned by BEIS in response to the widening audit expectations gap. The report is expected at the end of 2019. LINK

[4] Companies Act 2006: Part 10, Chapter 2, General Duties of Directors. Part 15, Chapter 4, Annual Accounts. Part 16, Audit. LINK

[5] SOX reforms include a requirement for CEOs and CFOs to make a separate certification that each periodic report containing financial statements complies with securities laws and fairly presents, in all material respects, the financial condition and results of operations of the company. A false certification is a criminal offence. LINK

[6] Kingman Review report includes 83 recommendations for changes to the regulation of auditing, reporting and corporate governance in the UK. LINK

Resource, disclosure and regulatory framework

- To help change behaviours and improve the level of direct and indirect investment in stewardship, and most importantly increase the effectiveness of outcomes, consideration needs to be given as to how the Code can help to:

    - drive a greater level of transparency of the time and effort spent by investors engaging with investee companies, and collaborating internally within firms between fund managers and stewardship/corporate governance specialists (e.g., percentage of management fees invested in these tasks);

    - assess the effectiveness of stewardship e.g., reporting on the level of active engagement with investee companies – focusing on outcomes not just activities - with references to matters that go beyond voting activity and results; and

    - encourage investors to disclose the value they derive from their stewardship activities, and explain how the value of stewardship to investment performance is measured.

- The wider regulatory framework also needs to be taken into consideration, to see whether there may be impediments to effective stewardship that could be revised or removed. An example could be the introduction of a requirement to file Code compliance reports (within a specified timeframe) via a third party (e.g., Companies House) which might help to improve the promptness and accessibility of stewardship reports. The FCA/FRC discussion paper, Building a regulatory framework for effective stewardship, presents a welcome opportunity to explore how regulation might be able to improve stewardship.

Sustainable and effective allocations of capital

- EY believes there are investors who take their stewardship responsibility very seriously, and those who do provide a positive reflection on the value of the Code. What is more difficult to assess is whether that engagement, and corresponding transparency, leads to a better allocation of capital and more sustainable returns for asset owners and managers.[7] A greater focus on the correlation between these outcomes and stewardship activities would offer a strong incentive for more active engagement from investors.

- It should be noted when discussing stewardship that the investor community's primary purpose (domestically and internationally) is to provide a return to its clients and beneficiaries, with sustainable and effective capital allocations. However, some firms in the investment chain look to secure appropriate financial outcomes over shorter timeframes. This highlights the importance of finding a balance between both short and long-term investment time horizons. EY is therefore pleased with the Code's references to the alignment of ESG risk analysis and stewardship with the different investment time horizons of clients, beneficiaries and other stakeholders.[8]

[7] EY: Is your capital allocation strategy driving or diminishing shareholder value? The capital allocation process must change. Without a systematic approach, companies will fail to benefit from long-term value creation. LINK
[8] The Embankment Project for Inclusive Capitalism (EPIC) published a report in November 2018 which identifies value drivers important for sustainable and inclusive growth, as well as potential metrics to assess them. LINK

Reporting and extraterritoriality

- There is no defined structure in the Code for stewardship reporting. While EY does not advocate standardised templates, a lack of structure makes it difficult to compare one report with another. However, if the signatories to the Code are prepared to follow the detailed guidance, over time the depth and breadth of these reports should become more consistent. This should help clients, beneficiaries and other stakeholders to compare more effectively how different investors report on their stewardship obligations. It might also make it easier to assess whether (and to what extent) certain levels of stewardship engagement result in greater value to the investor.

- A significant proportion of capital is invested from outside the UK (e.g., via sovereign wealth funds, private equity houses and/or hedge funds). These investors are not obliged to follow this or any other code. EY would therefore encourage the FRC to consider working with international organisations (e.g., the Organisation for Economic Cooperation and Development)[9] to develop a framework of stewardship principles which might be reflected in codes used by different countries. The International Corporate Governance Network launched its Global Stewardship Principles in 2016 which could be used as a good starting point.[10]

Encouragement and enforcement

- An important aspect of this or any other code is how compliance might be encouraged or even, in exceptional circumstances, enforced. The Consultation raises this subject, but there is no discussion on sanctions. For example, the FCA's Conduct of Business Source Book requires investors to either disclose their commitment to the Code, or refer to an alternative investment strategy - in effect stating if they are a signatory to the Code.[11] There is no rule requiring disclosures on the effectiveness and outcomes of stewardship, and consequently no means to encourage or enforce this. If the intended disclosures do not materialise after a couple of reporting cycles under the revised Code, we recommend that the FRC gives this matter closer attention. It should be noted that the FCA and FRC are drawing closer attention to the regulatory framework in their joint discussion paper, as mentioned above, and the FRC has stated that it will be devoting more resource to evaluating the quality of disclosures on stewardship policies and activities.

- EY also recommends that the FRC should introduce a Code Reporting Review Panel, after the Code has been revised.[12] This would be responsible for a "scoring system" based on the findings of inspections of individual stewardship reports and thematic reviews. This could result in the public censure of those investors that require improvement in one or more of the

[9] OECD issued updated Principles of Corporate Governance at the meeting of G20 Finance Ministers and Central Bank Governors in Ankara on 4-5 September 2015. They were subsequently endorsed at the G20 Leaders' Summit in Antalya on 15-16 November 2015. LINK

[10] ICGN's Global Stewardship Principles includes a total of seven principles, with detailed guidance underpinning each one. ICGN's explains that "stewardship is about preserving and enhancing long-term value as part of a responsible investment approach. " LINK

[11] FCA's Conduct of Business Source Book was last updated in March 2019. It is a comprehensive rule book spanning 730 pages. It applies to firms which are designated investment businesses in the UK, including long-term insurance (life policies) and deposit takers. LINK

[12] This recommendation takes into consideration the FRC's Financial Reporting Review Panel (operating under the auspices of the FRC's Conduct Committee) in terms of how the Panel operates and undertakes reviews of accounts. LINK

scored metrics.

- To help ensure major shareholders are held to account (e.g., owing 30% plus of voting rights), a potential option for consideration could be the introduction of a “red flag” provision in the Code, requiring these investors to report to an appropriate regulator their issues or concerns with the directors/governance of an investee company. EY recognises that there would be practical challenges in introducing such a scheme (e.g., establishing which regulator should be notified, when and on what grounds) however we believe this idea should be explored further.

Audit quality

- EY takes note of the guidance - specifically sections 14 and 18 - which refer to audit quality and the requirement for the investor to engage on this subject. As an audit firm we very much welcome this guidance. Investors need to play a stronger role in engaging with audit committees about the work they do (e.g., audit quality), a view we shared recently with Sir John Kingman as part of his review of the FRC. Although the Kingman report did not refer specifically to audit committee information and engagement, recommendation 30 stated that the Government, working with the FCA and new regulator, should consider whether regulation needs to be strengthened to drive up the quality of companies’ disclosures in the UK. This would include matters related to a company’s audit and audit committee.

- We would like to see the subject of audit quality elevated and emphasised in the Code. One way of doing this could be the inclusion of a reference in the section of the Code called Defining Stewardship, where it refers to investors engaging with issuers. The term issuers could be expanded to include references to boards, committees and management. A provision could also be included on the importance of investors understanding the audit, and engaging with auditors and audit committees on audit quality and audit tenders and appointments respectively.

- EY believes that once changes to the Code are finalised and have had time to bed in, it would be appropriate to re-examine the assurance (internal or external) on stewardship reports. For example, assurance could be provided on both activities and outcomes (in line with the evolution of the reports themselves), rather than on whether signatories have the policies in place, as is done under the current framework.

- Other aspects of governance which might also merit a specific reference in the Code include diversity, director remuneration, appointments and pensions for example.

EY is encouraged by what the FRC has undertaken with this Consultation, and we agree with the FRC’s view, outlined in the revised Code, that the responsible allocation and management of capital across the institutional investment community creates sustainable value for beneficiaries, the economy and society. Therefore, initiatives which help to improve this situation deserve the full support and backing of all stakeholders.

It should also be noted that whatever steps are taken to revise the Code, it’s important to recognise that investor stewardship forms part of a wider corporate governance, reporting and auditing eco-system. Accordingly, the Code should not be reviewed in isolation from these activities and the associated accountabilities across different stakeholders. The FRC should consider how a revised Code might operate in an evolving regulatory environment, including the future scope of the audit.

EY fully supports the wider UK reform referred to earlier, especially since it will have a bearing on the UK accountancy profession and the contribution it makes to the UK economy and wider society[13].

If you would like to discuss any of the views in this response please contact me.

Yours faithfully

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Partner, UK Head of Regulatory & Public Policy
Ernst & Young LLP

[13] In 2017 the UK accountancy profession contributed £59bn to UK GDP, and this also resulted in tax revenues of £8.9 bn. In total 613,100 people were employed in the profession generating £3.1bn in the export of accounting services.

Appendix

Please note, as a reminder, that we have focused on answering questions where EY, as a professional services firm, can provide the most relevant insight. Accordingly, we have not responded to questions 2, 6, 9, 12, 15 and 16.

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 core areas of stewardship are covered in the principles and provisions with one exception – the investors' engagement with the audit. Although audit quality is mentioned briefly in the guidance (sections 14 and 18), neither audit quality nor audit tendering/appointment feature in any detail. For the sake of completeness, and in recognition of the current regulatory climate, EY believes that these aspects of the audit should be elevated and emphasised in the Code, as mentioned in our cover letter.

To engage in audit quality and tendering/appointment matters - as managed by the audit committee - investors can play an important role by engaging effectively with the committee. This will help to ensure the accountability of both audit committees and auditors, as referenced in our response to the Kingman Review.

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

Yes, we support the mirroring of the two Codes in this regard (corporate governance and stewardship). The principles of the Code are sufficiently high level to be applied, and the provisions providing more detail under a 'comply-or-explain' framework allow for a flexible approach to complying with the Code without an investor being able to "opt out"' of a principle.

This approach also works well with a focus on outcomes and actions, and it will help to avoid boilerplate reporting.

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

Good practice examples should be included over time in the guidance to the Code (perhaps updated every two or three years), although care should be taken when documenting these examples that they also remain current. This could be determined by reviewing periodically the stewardship practices of the signatories.

We encourage the FRC to seek ways of enhancing stewardship practices to get desired improvements, similar to the way in which various revisions to the UK Corporate Governance Code have been developed. That code has evolved considerably over many years, including the level of compliance with its principles and provisions. The annual letters from the FRC to audit committee chairs about compliance with the code are taken seriously by preparers of reports and accounts. This, alongside the Financial Reporting Lab reports and incremental changes to the code, have led to improvements in corporate governance and narrative reporting. Our reviews of FTSE 350 annual reports over the past five years have also observed this trend.[14]

We also note that provisions 4 and 10 could benefit from more guidance, and/or perhaps the wording of those provisions could also be reviewed. For example, Provision 4 states that the signatories should ensure their "workforce has appropriate experience, qualifications and or oversight to deliver their stewardship objectives". It's not clear what "workforce" means in this context, and although stewardship should be ingrained in everything that the investors does, those responsible for delivering stewardship should be limited to senior management. We also believe that in addition to the "appropriateness" of an investor's experience, qualifications and oversight, the Code should also require a disclosure on the "adequacy" of the investor's resources to discharge its stewardship duties.

Provision 10 requires that signatories should "state their investment time horizon." As different funds have different time horizons (varying by several years), consideration should be given as to how this might be reported in a simple/concise way. Perhaps time horizons could be grouped into a limited number of different categories, each one based on a predefined range of time horizons. It should also be explored whether a time difference of a few years between funds would make any material difference to a signatory's stewardship activities. In particular, the data, tools and methodologies related to the management and reporting of ESG integration are still relatively new. Therefore, the FRC should consider how these changes in reporting on ESG can be encouraged, and the best examples promoted.

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?

We support the proposed approach however each signatory may undertake several different investment strategies for various funds, which necessitate different levels of stewardship and activities, particularly depending on whether such funds are of a long-term nature or not.

Therefore, it's important to keep the task of reporting at a reasonable level, so signatories are not expected to report on every aspect of their approach to stewardship for each fund managed. Reporting on an overall approach, and broadly how these might differ across funds, would seem to be the most effective way to provide this insight (e.g., activities and outcomes). This should include the purpose of the firm, how this is lived and to what extent stewardship and related factors are incorporated into the investor's remuneration practices.

Unless appropriate incentives are in place, it may be difficult to change a stewardship culture for the better. We are aware of instances where significant discretionary rewards are related to the extent to which individuals live the values of a firm. Subsequent feedback from the FRC on how signatories report against the Code should help to inform how "effectiveness" of stewardship should be reported in the future. We welcome the FRC's proposal to update more frequently the guidance to the Code, to reflect changes in good practice.

[14] EY Annual reporting in 2017/18: demonstrating purpose, creating value. LINK

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 makes two recommendations on stewardship (42 and 43).

The first (42) recommends that the Code focus on outcomes and effectiveness, and promotes compliance with the Code. This is addressed in the new Annual Activities and Outcomes Report, and the requirement for the Code's principles to be followed on a comply and explain basis. More powers to help increase compliance might also take the form of a revised FCA handbook.

Recommendation 43 states that the FRC needs to engage at a more senior level in a much wider and deeper dialogue with UK investors. EY is uncertain about the extent to which the second recommendation (43) could be achieved. Although the FRC has already sought feedback from 170 members of the investment community, the seniority of those contacts is unknown. We encourage the FRC to dedicate some of its future additional resource to strengthening its engagement with investors.

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

Yes, we agree that these disclosures should be made because they put into context an investor's stewardship policy and its intended outcomes. It should help to convey the extent to which the policy is likely to be effective (or in need of adjustment), by showing the degree of alignment (or misalignment) between the policy and the investor's purpose, values, strategy and culture.

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?

Provision 1 provides sufficient transparency because the stated "purpose" of the signatory should be all inclusive and at a high enough level to incorporate all funds under management. Listing the extent to which the Code applies against all funds could result in a significant administrative burden, especially for those investors with several funds under management.

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?

We are unable to fully answer this question as we believe the FRC first needs to clearly define the term "investment belief" and contrast it with other terms including purpose, investment objective etc. This and other investment terms could be usefully provided in a glossary, which might help to ensure that beneficiaries share the same frame of reference as the investors when these terms are being used and reported against.

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

Yes, insofar that the term "collaborative engagement" is more widely used internationally than "collective engagement" (e.g., the International Corporate Governance Network uses the former term). We also note that the term “collaborative” can be interpreted more widely to describe a more diverse group of activities by a broader mix of stakeholders (e.g., not just investors holding equity or debt). However, we add a note of caution to the Code’s references to “collaboration” and the potential conflict of interest with the Market Abuse Regulations (MAR). We suggest that adding a reminder of the investors’ obligations under MAR might be helpful in this part of the Code.

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

Yes, there should be a mechanism of some kind, perhaps in the form of a “red flag” provision in the Code requiring investors to report to the appropriate regulator any issues or concerns they may have with the directors/governance of an investee company. An arrangement like this might alert the regulator and prompt an early intervention into any one or combination of issues before it/they escalate into a crisis and cause public harm.