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Dear Sirs

ICSA response to the Financial Reporting Council (FRC) consultation on Proposed Revisions to the UK Stewardship Code (the Code)

We welcome the opportunity to comment on the proposed revisions to the Code.

As you know, ICSA: The Governance Institute is the professional body for governance. We have members in all sectors and our Royal Charter purpose is to lead 'effective governance and efficient administration of commerce, industry and public affairs'. With more than 125 years' experience, we work with regulators and policy makers to champion high standards of governance and provide qualifications, training and guidance. ICSA is the professional body that qualifies Chartered Secretaries, which includes company secretaries. Company secretaries have a key role in companies' governance arrangements, including the development of governance policies, the application of and compliance with the Code and supporting the board on all governance matters. Our members are therefore well placed to understand the consequences of the proposed revisions to the Code.

In preparing our response we have consulted, amongst others, with our members, including the ICSA Company Secretaries Forum, a group of company secretaries from more than 30 large UK listed companies from the FTSE 100 and FTSE 250, including members working for some of the major investors. However, the views expressed in this response are not necessarily those of any individual members, nor of the companies they represent.

We set out below some comments on the revised definition of Stewardship, followed by our responses to the specific questions set out in the consultation document.

Definition of Stewardship

Although not specifically covered by any of the consultation questions, we question the value of the new definition of Stewardship, its purpose and the extent to which it would make any difference other than requiring a variety of reporting.

The original Code led to significant improvements in voting by institutional investors, leading to a clearly differentiated approach and increased engagement. The new definition of Stewardship is extremely broad and appears to be seeking to capture all types of investment, potentially leading to very long reports which include a lot of detail, much of which will add little value. It does not seem to be focused on a clearly stated problem that the proposed changes are seeking to solve. It is therefore not clear what would be successful outcomes or how they might be measured.

The new definition of Stewardship also appears to confuse different forms of investment. Investing in share capital constitutes ownership of the investee company, bringing with it control rights such as to vote at general meetings, including on the appointment of directors, to requisition meetings and to receive a share of profits. Bond investments, by contrast, are loan capital, issued for a set period of time with a fixed interest rate payable to the bondholder and the return of investment capital at the end of the time period. As a debt, an investment in bonds carries less risk and, in addition to a fixed rate of return, ranks ahead of ordinary shares for repayment of the debt (i.e. the capital invested) in the event that the company becomes insolvent. It carries neither voting rights nor a right to participation in profits.

ESG factors are enormously important to both companies and investors, but we are concerned by the degree of additional focus placed upon them in the draft Code as they do not always reflect a comprehensive view of companies' activities. Indeed, too much focus on ESG factors could be a serious distraction from important issues that might be going on in a company.

It is our view that Stewardship should be focused on assets held in companies that are subject to the UK Corporate Governance Code (the Corporate Code). This will provide clarity for investors and companies, with clear meaningful and substantive alignment between the Code and the Corporate Code, helping investors to hold companies and their management teams to account for compliance with the Corporate Code.

RESPONSES TO SPECIFIC QUESTIONS ABOUT THE REVISED UK STEWARDSHIP CODE

Q1 Do the proposed Sections cover the core areas of stewardship responsibility?

Generally yes, but we believe that the draft Code does not place sufficient emphasis on engagement with investee companies, which we believe to be the most important stewardship activity. The Code appears to have broadened the definition of stewardship to cover a huge range of factors and so reduced focus on this key aspect.

The Kingman review's criticisms of the Code focused on differentiating excellence in stewardship and focusing on outcomes and effectiveness, rather than policy statements, and that this focus should be supported by increased powers. In our view, the revised Code should focus on identifying clear forms of engagement, setting out what is/should be required or expected. For example, we believe that the Code should require investors to actively engage with a company prior to voting against the board recommendation on any resolution at a General Meeting and explain in advance, in writing, their reasons for their decision. This will support the company's compliance with its obligation to understand the reasons for shareholder dissent.

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

No. As discussed above, one of the most important aspects of effective stewardship is engagement and the expectations on engagement set out in the Code are too low. The balance appears wrong, with more emphasis on the inclusion of ESG factors and the extension of stewardship responsibilities to holders of loan capital, but too little on requiring investors to engage with companies – particularly before voting against resolutions at the AGM. The section of the revised Code relating to service providers is a positive development, but does not fully recognise the pervasive influence of proxy advisers in the stewardship world and needs more explicit provisions in this regard.

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

Yes. This proposal brings the Code into line with the format of the Corporate Code in a way we believe is helpful. However, as discussed above, it is also important that there is also alignment of scope and responsibilities between the Code and the Corporate Code, so that investors can hold companies to account for compliance with the Corporate Code. Our concern is that, as currently drafted and with the revised definition of stewardship, the Code will increasingly diverge from the Corporate Code, rendering compliance with the Code less helpful in terms of holding companies to account for compliance with the Corporate Code.

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

Our comments above regarding the revised definition of stewardship and the broadening of its scope apply to both the Code itself and the Guidance. An example of our concerns over the broadening of the scope of stewardship to include bondholders is in Guidance paragraph 19. This paragraph gives specific bullet point examples of how bondholders should escalate concerns, such as by submitting resolutions to General Meetings, requisitioning General Meetings and proposing to change board membership. However, bondholders are not able to take any of these actions – only shareholders have these rights.

It would also appear that some of the Guidance set out under section 4 Constructive engagement and clear communication, seems to be more relevant to section 5 Exercise rights and responsibilities.

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?

In principle, yes. However, we are concerned that the proposed reporting requirements are likely to lead to extensive boilerplate reporting that will give little clarity or understanding of how investors exercise their stewardship responsibilities, notwithstanding the significant outsourcing of voting decisions to proxy advisers. There is a risk that as reporting becomes more onerous it will reduce the time allocated to engagement, which should be the priority.

We believe the focus of reporting should be on engagement. In particular, it is essential that investors are transparent about their engagement with companies prior to submitting their votes against a resolution at the AGM. They should also describe the engagement, whether it was satisfactory and, if applicable, why it did not result in a change of voting intention. It is also important that investors disclose their use of proxy voting agencies, and the manner of that use.

We believe that a register should be created, similar to the Investment Association's Register of Significant Votes Against, to provide equal transparency between investors and companies and provide a complete picture. Transparency would also provide investee companies with clarity over what certain investors expect and so support engagement. It could also drive the change in behaviours over engagement that is needed.

We also have concerns that the proposed publication of some of the engagement and reporting requirements may lead to unintended market consequences, for example allowing fund managers to 'short' a company's stock where particular issues have been identified.

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 believe it is important that the FRC takes time to reflect on current proposed amendments to the Code before implementing the proposed changes, as we are not convinced that the current proposals will achieve their intentions and may be detrimental. .

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?

No. We do not believe the proposed revisions to the Stewardship Code address the recommendations of the Kingman Review.

Recommendation 42 of Sir John Kingman's report was that "a fundamental shift in approach is needed to ensure that the revised Stewardship Code more clearly differentiates excellence in stewardship. It should focus on outcomes and effectiveness, not on policy statements. The Government should also consider whether any further powers are needed to assess and promote compliance with the Code. If the Code remains simply a driver of boilerplate reporting, serious consideration should be given to its abolition."

As discussed above, we believe the revised Code places an emphasis on ESG issues and expanding its scope to other investments. Neither of these issues were mentioned by the Kingman Review, and they seem likely to provoke more 'policy statements' rather than the 'outcomes and effectiveness' recommended by the review. We believe that, for the Code to be more effective and deliver better outcomes, the main focus needs to be on investors engaging with companies and ensuring proper communication.

The FRC has an important role in monitoring reporting by signatories to the Stewardship Code and, if reports are not issued, there should be consequences for investors. This leads us to the question of powers and sanctions, alluded to in the question. The Government giving the FRC additional powers would be one way of making the Code more effective but, in our view, a more practical solution would be for the Government to require the Financial Conduct Authority to make signature of the Code a condition of regulatory approval, with the FRC being given the power to decide whether or not the signatory was compliant and what sanction should be applied in such cases.

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

Possibly. It would seem appropriate to require signatories to report on their values and culture, along with their policies and practice. However, reporting on their organisational purpose and strategy may be more difficult. It seems appropriate for companies to report on this as they vary widely, but investment companies overall strategy and objective will be providing a return for their clients – regardless of the nature of the investee. We have some concerns this will lead to boilerplate reporting. The consultation indicates that that there was 'clear support' for this, but the explanatory footnote does not seem to relate to this question.

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

No. Our view is that the draft Code should not extend stewardship responsibilities beyond listed equity. We understand the FRC's wish to include other asset classes but, as discussed above, fixed interest investments such as bonds are a debt (loan capital) whereas equity carries control rights in the company (share capital). There are different investment objectives associated with investment in debt versus equity. Bonds, as debt, are lower risk but with a lower return, whereas equity is much higher risk but with potentially higher returns.

Stewardship is only relevant to listed equity. Holders of bonds are not owners of the investee company. They are paid a fixed rate of interest and their investment capital is returned to them at the end of a set period of time. They do not have the same rights as shareholders to act in the ways described in provision 19 of the draft Code to 'enhance the value of their assets'. They have no rights to engage in the activities set out in the Guidance to provision 19 such as voting at the AGM, requisitioning General Meetings, submitting resolutions and speaking at General Meetings, or proposing a change to board membership.

A well governed company benefits debt and equity holders alike. However, if the FRC wishes to include other asset classes in stewardship activities, signatories to the Code would need to carry out these activities alongside their engagement in relation to listed equity. It would also be necessary to ensure a joined up approach to engagement, through their Corporate Governance teams and, if this was not done, a need for signatories to report this. Currently, it is usual for engagement with debt holders to be carried out through the Treasury team.

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?

Yes. However, we suggest it would be sufficient for signatories to the Code to report by exception rather than having to report 'if, and how, stewardship policies and practices differ across asset allocation/at a fund level or between asset classes'. Investment in a company may be included in a number of different funds, managed by the same asset manager, or combined with other asset managers. It would seem sensible for stewardship activities to be coordinated to ensure the most efficient use of resources. It seems unnecessary to require detailed reporting on how stewardship practices vary across funds or to provide a list of the extent of the stewardship approach against each fund. However, a lack of engagement overall in an investee company by a signatory to the Code should be reported.

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 would defer to the views of investors on this point, but are concerned that it will be difficult to describe it other than a generic way, which would tend to boilerplate reporting.

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

No. There needs to be greater detail here about what is expected. We understand that those investors who take engagement seriously already monitor their agents and, for example, are prepared to be flexible if the proxy adviser recommendations run counter to the results of their engagement process. Those investors who do not invest the resources to engage will also not invest the resources to monitor advisers. This problem is particularly marked with overseas/remote investors who are less familiar with the UK investment and governance landscapes. Our corporate members felt that this is particularly an issue with the activities of proxy advisers and the degree of reliance placed upon their reports and/or recommendations.

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

Yes. We see no difficulty in using the term 'collaborative engagement' provided it is understood to have the same meaning as 'collective engagement', and we suggest this is included in the Glossary of the Code. We assume investors would need to take the same level of care to ensure they are not acting in concert, and that the same benefits of sharing resources and non-duplication of effort would apply.

Q14 Should there be a mechanism for investors to escalate concerns about an investee company in confidence?

No. We do not believe there is any need for an additional mechanism for investors to escalate concerns. This is the role of the Senior Independent Director and we believe it works well. There are a wide variety of sanctions already open to investors: they can vote against resolutions at general meetings, including those to elect directors; they can requisition meetings or resolutions; and can, of course, report the company to the regulator should it be in breach of law or regulation.

Given the strength of the powers that investors already possess, we are strongly of the view that any involvement of a regulator in the day-to-day discussion of issues between investors and companies would be detrimental to their resolution. If the company has not acted illegally, why should investors refer any matter to the regulator – they have the power to take direct and executive action themselves.

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

Yes, the FRC should make clear its expectations as to how investors in asset classes other than listed equity can take action against or exercise control over investee companies, and thereby demonstrate effective stewardship.

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

No. A number of our members have expressed particular concerns about the activities of proxy advisers including the lack of willingness on the part of some to engage with companies, or even provide a method of contact. This is a particular challenge for companies outside the FTSE 100. There is much anecdotal evidence of problems in this area including about possible conflicts of interest associated with proxy advisers' other activities, such as consultancy. ICSA will be liaising with companies over the 2019 AGM season to offer concrete examples to the FRC team.

Proxy advisers are in a position of having a great deal of power and there is a risk that the lack of competition in the market means there is little impetus for change.

One way of dealing with these problems, and those identified in Q12, and to ensure transparency, would be for investors who use proxy advisers to be required to disclose this. They should also make clear the basis on which they use their services, such as whether it is on an advisory basis or adoption of proxy advisors recommendations is a default position. In both cases, it is also important that the mechanism for going against proxy adviser recommendations is also disclosed.

It would also be helpful if proxy advisers were required to be explicit about their engagement policy and publish the results. We are aware that the FCA consultation on proposals to improve shareholder engagement includes a proposal for disclosure on the use of proxy advisers but we believe these proposals are far too vague.

We hope you find our comments helpful and would be happy to expand on any of these points should you wish to discuss them further.

Yours faithfully

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