

Corporate Governance and Stewardship
Financial Reporting Council
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Sent by email to stewardshipcode@frc.org.uk

Dear Sir or Madam,

29th March 2019

FRC: Proposed Revisions to the UK Stewardship Code

I am writing to respond to the consultation on proposed revisions to the UK Stewardship Code on behalf of ShareAction, a registered charity established to promote transparency and responsible investment practices, including stewardship, by pension funds and other institutional investors. We are a member organisation and count amongst our members well-known NGOs and charitable foundations, as well as over 26,000 individual supporters.

We work with institutional investors to promote stewardship and engagement. We conduct annual industry-wide surveys to rank them on these activities. We have ranked asset owners and asset managers on compliance with key elements of the Stewardship Code since its inception, and published these rankings. We have extensive experience of research and policy development on barriers to long-termism, and fed into the 2012 Kay Review, the related BIS Select Committee inquiry, both Law Commission reviews of trustees' fiduciary duty and the BEIS Select Committee inquiry on corporate governance.

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.

We support the proposed core areas of stewardship responsibility. In particular, we support the new Code's:

- Robust definition of stewardship.
- Tailoring of its Provisions and Guidance to signatory type.
- Increased scope to asset classes beyond equities.
- Explicit mention of ESG within a Principle.
- Requirement (on a comply-or-explain basis) for investors to:
 - disclose information relevant to their selection of investments; and
 - describe how they take account of beneficiaries' views.

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

We broadly agree that the Principles set appropriately high expectations of effective stewardship for signatories. We think the Code is on the right track in terms of its definition of stewardship and setting out processes, and that the Activities & Outcomes report will help create a sense of accountability for how those processes are put in place. However, we think that there is a risk that some reports will just be reports on processes and fail to look at change to corporate practices (or failures to change) and real-world impact. The FRC should make it clearer within the Code that signatories should be looking to capture and report on the **outcomes and effectiveness** of stewardship (as identified in the Kingman Review), rather than (for example) simply listing the number of phone calls they have had with companies.

We would also support the High Pay Centre's point that there should be greater emphasis on providing evidence that signatories have met the Code's requirements. For example, references to 'describe' might be more usefully replaced with 'demonstrate.' Where the code suggests that signatories should 'state how' they have fulfilled a particular provision, it could say 'state how and provide evidence...'

We would also like to see an amendment to the definition of stewardship in the new Code, adding 'the environment' to 'beneficiaries, the economy and society'. While we understand that the term 'society' could be read as including 'the environment', we think it is important to state this explicitly. Some may not read 'society' in this way and this could cause them to give less weight to environmental concerns. In addition, we would argue that the inherent value of the natural environment goes beyond the needs of human societies.

We understand there has been pushback from some stakeholders on the definition of stewardship in the new Code, on the basis that it is not compatible with their fiduciary duties. Our view is that the definition **is** compatible with investors' fiduciary duties. The Law Commission has twice confirmed that ESG factors **should** be considered by fiduciaries where financially material to investments and **may** be considered where not financially material (subject to a two-part test based on beneficiaries' likely views). This has since been reflected in regulatory clarification by the Department of Work and Pensions and we anticipate similar provisions for contract-based schemes to be introduced by the FCA this summer.

Creating sustainable value for beneficiaries and society are not mutually incompatible aims. For example, if an investor engages with a company to improve their workforce practices, both beneficiaries (through better long-term returns, increased goodwill and reputation for the company, and improved quality of life in a more equal society) and wider society should benefit. This is recognised by Larry Fink (CEO and Chairman of BlackRock) in his 2018 'Dear CEO' letter¹ in which he said that to "prosper over time, every company must not only deliver financial performance, but also show how it makes a positive contribution to society. Companies must benefit all of their stakeholders, including shareholders, employees, customers, and the communities in which they operate".

¹ <https://www.blackrock.com/corporate/investor-relations/2018-larry-fink-ceo-letter>

Moreover, Section 172 of the Companies Act 2006 requires company directors to have regard to the longer-term and wider consequences of their decisions on the community and environment. Under the non-financial reporting regime, companies must annually publish a strategic report on their impact on the environment, the company's employees, and social, community and human rights issues.

The Corporate Governance Code's first principle is: "A successful company is led by an effective and entrepreneurial board, whose role is to promote the long-term sustainable success of the company, generating value for shareholders **and contributing to wider society**" [our emphasis]. A fiduciary investor's role is to provide the appropriate support and impetus for directors to ensure directors are carrying out these responsibilities, so it is entirely appropriate that their stewardship responsibilities include consideration of wider society.

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

We support this approach. It is important for signatories to apply all of the Principles, as all of the Principles are important for effective stewardship and applicable to all signatories. It seems appropriate for the Provisions to be applicable on a 'comply or explain' basis, as not every Provision will be relevant to every signatory.

However, comply or explain can look like a weak mechanism if there are no consequences for signatories. Our surveys in this area have found evidence of explanations being very poor or even non-existent. The success of a comply or explain approach is therefore dependent on checking stewardship statements, investigating whether they are being applied in practice and taking enforcement action in relation to non-compliant signatories. The key to ensuring the effectiveness of a comply-or-explain approach is increasing powers and resources for the regulator.

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

It would be helpful to include more guidance on the following:

- The detail of what the Activities & Outcomes report should include. As previously said, it is important that signatories focus on stewardship outcomes (in particular, the real-world impact of their investments) rather than processes. We discuss this in more detail in Q5.
- Further clarity about how escalation strategies might fit into a signatory's general engagement strategy. For example, if a signatory does not develop and agree clear engagement objectives with an investee company, it may not be obvious when would be an appropriate time to escalate the strategy.
- Examples of the kinds of ESG issues that signatories should consider, such as the examples given by the PRI.²
- Further detail on engaging with asset classes beyond equities and bonds (see Q9).
- Voting disclosure, e.g. how signatories should disclose votes and rationales, and within what timeframe. We would recommend the following on voting disclosure:

² <https://www.unpri.org/pri/what-is-responsible-investment>

- Working with the FCA and/or industry on a binding template setting out what high quality voting disclosure should cover. Providing a template would mean that asset owners, consumers and consumer groups would be able to find, understand and compare this information. It would also help to drive performance and efficiency in the fund market. The template should cover:
 - A full list of AGMs and resolutions where they were able to vote.
 - Votes cast for/against/abstained/did not vote at individual resolution level.
 - Rationales for votes against management and for votes with management where a significant number of shareholders voted against the resolution. Where the number of rationales to be disclosed is considered excessive, the investor could instead give explanations for the votes they considered to be significant and state that rationales for other votes are available on request.
- Setting a clear expectation of the timeframe for disclosure, preferably within one month of an AGM.

We would also suggest including more visual content, such as diagrams and text boxes, to assist signatories with navigating the material. It may also be helpful to move the Guidance so it sits next to the relevant Principles and Provisions.

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 to introduce an annual Activities and Outcomes Report. It should:

- Help minimise the risk of the Policy and Practice statement being a box-ticking, compliance exercise that does not reflect organisational practices.
- Ensure that even those schemes producing good Stewardship Code statements reflect on how those statements are influencing their actual decision-making.
- Enable better transparency about how well signatories are living up to their stewardship policies.

We agree that it is appropriate for signatories to include case studies of engagement on particular issues, description of monitoring activities and voting records including explanations for voting decisions. They should also include:

- An overview setting out 'x number of companies were within our stewardship scope, we had engagements with y number, resulted in z number of successful outcomes'.
- The proportion of engagements per theme (E/S/G), region and issue.
- Numerous detailed case studies setting out the objectives, processes, outcomes (both positive negative) and lessons learned in engaging with specific companies on specific issues, as well as their public policy work.
- (In relation to asset owners) how they have consulted with beneficiaries on their ethical views and integrated these into their stewardship activities, where considered appropriate.

The FRC should publish clear guidance and possibly a template setting out what information should be covered. We are concerned that without clear guidance the reports will amount to window-dressing in which signatories cherry-pick their successful engagements and do not refer to challenges they have faced. We have also found, in our experience of looking at engagement reports, that some investors focus on the number of engagements without explaining the impact or outcome these have had.

These statements are only worthwhile and effective if someone is reading them, supervising the signatories to find out if they are accurate and enforcing if they are not.

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?

The proposed schedule is reasonable and should allow signatories sufficient time to produce both their first Policy and Practice Statement (by 31 December 2019, for those who want to be included in the first list of signatories) and Activities and Outcomes Report (12 months later).

Since applications will continue to be accepted on an ongoing basis from 31 December 2019, we cannot see how any respondents could object to this time frame.

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?

We are pleased to see proposals for the new Code to require board approval of the Code statement. This should send the right messages to signatories about accountability.

However, we do not think the proposed new measures on enforcement go far enough. Our research and engagement work indicates that investors perceive a lack of consequences for non-compliance to be a real weakness of the Code (for example, where an investor makes a statement of compliance but contravenes this in practice or where they do not comply, but the explanation as to why not is either inadequate or not publicly disclosed).

Stewardship Code statements are, and should be, used to determine whether mandates are given to asset managers and advisers. There need to be consequences for people who are not implementing what they say they will do. Those who are doing a good job should receive the competitive advantages of their efforts. This was supported by the Kingman Review, which had concerns that the existing Stewardship Code may drive boilerplate reporting with its focus on policy statements, rather than outcomes and effectiveness.

The regulator of the Stewardship Code needs to have full powers to supervise signatories and to take enforcement where necessary. We are calling for further measures around accountability, to include:

- Clearer carrot **and** stick-based consequences for signatories for good/poor practice.³ These could include introducing mechanisms for:
 - Publicly recognising the most effective activities and outcomes reported by signatories, including how well they articulate their objectives, how they follow through and translate these into action, what the outcomes were across the board and how these have been evidenced, how the signatory evaluates this process and makes changes for future. This could be something like a ‘starred status’ for signatories who have shown exemplary practice in one or more of these areas.
 - Constructively dealing with signatories who are failing to achieve the required standards. This could involve (in order of escalation):
 - Private engagement with signatory (firstly the named individual responsible for stewardship and then the board).
 - Publishing public notice to flag issue.
 - Suspending signatory status.
- Increased investigative powers and capacity to conduct random audits of stewardship practices beyond only looking at the quality of a stewardship code statement. If the FRC does not feel it is appropriate or feasible to introduce these measures this year, we would expect that it would review the effectiveness of the Activities and Outcomes reporting in two years’ time and consider introducing these measures then.⁴
- Educational activities to help signatories to understand how they can improve the effectiveness of their stewardship activities. This could include best practice, roadshows and private engagement (as above).⁵

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

We agree that signatories should be required to disclose their organisational purpose, values, strategy and culture. We have often heard comments from stakeholders that it is difficult to understand how integrated stewardship is within an investment philosophy.

Requiring signatories to disclose organisational purpose, values, strategy and culture will provide useful context which should address these concerns. It should also encourage signatories to think about how consistently stewardship is applied across their organisation’s wider strategy and culture, (rather than treating it as a ‘compliance issue’).

As stated in the consultation document, introducing this requirement aligns the Stewardship Code with the FRC’s previous work on company culture and the revised Corporate Governance Code. It also reflects good practice overseas (the Australian stewardship code includes a similar principle).

³ We would not anticipate the FRC needing any further powers from Government to be able to do this.

⁴ The FRC will need further powers and/or resources to do this. Our expectation is that the Government would equip the regulator with the appropriate tools and resources to perform its stewardship role effectively. We see it as necessary that the FRC is granted enhanced powers and resources for a larger stewardship team to ensure that stewardship is integrated within the signatory’s broader purpose at board level, not simply an issue for the compliance team that is later signed off by the board.

⁵ Ditto.

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 support the Code's increased scope to asset classes beyond equities. We strongly agree that signatories should use the resources, rights and influence available to them to exercise stewardship, no matter how capital is invested.

We also support the inclusion of guidance for bondholders on engaging and escalating engagement. Our recent report, *Sleeping Giants: Are Bond Investors Ready to Act on Climate Change?*,⁶ found that bond investors' engagement practice still falls short of what is required for climate change mitigation.

We would suggest including infrastructure in the Provisions and Guidance, given the Government's interest in encouraging pension funds to invest more extensively in infrastructure (for example, the Government's recent consultation on investment innovation).⁷ For example, an investment in an overseas project in a jurisdiction with low levels of worker protection could involve high levels of risk for the investor. While some of this risk could be mitigated by effective due diligence at the outset, problems may occur as the project progresses that would require careful stewardship.

We would recommend publishing guidance mapping out what signatories should consider for **all** asset classes where stewardship could be relevant and the key leverage points where signatories can best use their influence.

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 support the requirement for asset managers to disclose how far stewardship practice differ across funds. The provision should require signatories to list how far the stewardship approach described applies to each and all of the funds they manage.

We have seen numerous instances of asset owners and managers referring to their responsible investment and/or stewardship approach and linking to a website page that outlines their work as a corporate group. This will give clients and beneficiaries little insight into how their specific assets are being stewarded.

To avoid lengthy reporting, we agree that the Provision should ask signatories to explain their general approach to stewardship and set out any funds where this does not apply (explaining how it differs in these funds).

⁶ <https://shareaction.org/wp-content/uploads/2019/01/Sleeping-Giants.pdf>

⁷ https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/776181/consultation-investment-innovation-and-future-consolidation.pdf

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 believe it is appropriate to ask asset owners and asset managers to disclose their investment beliefs. Stewardship is part and parcel of an investor's overall investment approach and it is unhelpful to create artificial divides between the two.

Decisions about whether to hold or disinvest from an asset are considered to be part of an investor's stewardship approach, so it seems logical that decisions where to invest should be considered part of stewardship as well. It is also useful for beneficiaries and clients to have access to this information, so they can understand what the signatory's views are on key ESG issues.

However, in general we feel that the wording of the Code is more applicable to active management than passive management. We would recommend that the FRC ensures that the Provisions and Guidance are phrased in such a way to be equally applicable to both: otherwise this could perpetuate the idea that stewardship is only achievable in active management.

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

We believe that Section 3 sets an appropriately high expectation for signatories to monitor the agents that operate on their behalf. However, the Principle should state more explicitly that asset owners cannot delegate their responsibility for stewardship.

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

We agree that 'collaborative' is a more meaningful and widely used term.

In general, we believe that the idea that only the biggest investors can effectively engage with their investments is a myth that needs debunking. We support the focus on collaborative engagement in this consultation, as an accessible means for investors of varying sizes to engage on key ESG issues. ShareAction helps to coordinate numerous investor coalitions that engage on specific ESG issues and has seen real change result from these campaigns.

For example, we were closely involved in coordinating an investor coalition from 2015 to 2017 focusing on reducing the use of antibiotics in meat supply chains. We worked closely with FAIRR, ICCR and a network of NGOs to bring together a group of around 40 investors (with total AUM of £3.5tr) to engage on this. This issue is crucial for investors (from a reputational and regulatory risk perspective) and society alike, as the systematic overuse of antibiotics in human and animal medicine is undermining our ability to cure life-threatening infections. Experts now predict that, globally, 10 million people a year could die from antibiotic resistant infections by 2050.

As a result of this engagement work, several large food companies (including McDonalds) set timelines to reduce or eliminate certain antibiotics from their meat supply chain. This was a collaborative and long-term effort that brought significant results.

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

We think it would be a good idea for investors to have a mechanism for reporting concerns to the regulator. It should provide asset managers (and owners) with a useful route for raising concerns. Some careful thought is required about what the regulator would do with this information, once received.

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

See Q9.

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 the Service Provider Principles and Provisions set appropriately high expectations for practice and reporting. However, we strongly encourage the FRC to explicitly state that service providers must “demonstrate how they take into account material ESG issues, including climate change” in the Service Provider Principles and Provisions.

The PRI’s recent Investment Consultant Services Review found that most investment consultants and their asset owner clients are still failing to consider ESG issues in investment practice. Surveys indicate that many pension trustees rely heavily on consultants’ advice in their decision-making. 2015 landscape research from the Pensions Regulator said “it was rare that the trustee board disagreed with its external advisors. Across all of the advisor types, the majority of schemes indicated that they rarely (58%) or never (24%) disagreed with this advisor”.⁸ We have similar concerns about the extent to which proxy advisors are applying ESG factors to their decisions, especially given how much reliance is put on their advice.

We also support the PRI’s recommendation that the Guidance to Provision 2 should be amended to encourage signatories to publish details and statistics of errors made in their service provision. Proxy advisors play a powerful role in influencing voting decisions and they have received a great deal of criticism for making factual errors in AGM season.

⁸ This report no longer appears to be available on The Pension Regulator’s website. We are happy to request a copy from them if required.