Corporate Governance and Stewardship
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GC100 Response to Proposed Revision to the UK Stewardship Code

Introductory comments

GC100 welcomes the opportunity to respond to this consultation and we set out below our comments on it.

GC100 is the association for the general counsel and company secretaries of companies in the UK FTSE 100. There are currently over 120 individual members of the group, representing over 80 companies from across the FTSE 100. Please note, as a matter of formality, that the views expressed in this Response do not necessarily reflect those of each and every individual member of GC100 or their employing companies.

Overall Comments on the Proposals

We understand and support the underlying objectives of the proposed reform and note that it imposes substantially higher expectations for stewardship. We do, however, have some concerns with the proposed changes, in particular in relation to unregulated proxy advisors, which we set out below.

1. Proxy Advisors

It is accepted that proxy advisors offer an important service to institutional investors. The size and spread of institutional investors' portfolios, as well as their business models and (in many cases) overseas locations, mean that they do not always have the resources to monitor and engage with every company they invest in. Many investors therefore use proxy advisors to do this work for them and companies understand that they need to engage with them.

Our concern is, however, that despite the call for increased engagement between companies and investors, and the ongoing efforts of many companies represented by GC100 members in this area, proxy advisors generally do not wish to engage with our members in a meaningful or timely way or in some cases at all, as some do not even respond.[1] Instead, proxy advisors tend to adopt a less nuanced and more box-ticking, one-size-fits-all approach and then only once they receive the Annual Report or relevant Circular. Typically they are only willing to engage with companies on their reporting and AGM resolutions at the last minute with very short and impractical deadlines. "Engagement" is then often merely an opportunity to read the relevant draft report (which may require the payment of a fee) principally to correct factual errors. Indeed, one major proxy advisor does not even offer this level of engagement: it does not make its full reports available in draft for fact-checking, and instead relies on a data sheet. These practices leave little time or scope to explain non-compliance in its proper context which reduces the all-important flexibility that is at the heart of the UK's world class governance regime.

The net effect of this is a growing trend whereby the views of investors who have made the effort to engage with our members and to give themselves an informed view on a resolution are increasingly being diluted by auto-votes based on the views of proxy advisors who have refused to engage in a meaningful way. This problem is particularly significant where there is a shareholder requisitioned meeting or resolution or other special situation. In our members' experience, in those circumstances the relatively unfettered power that proxy advisors hold together with their unwillingness (and lack of any duty requiring them) to meaningfully engage with the relevant company means that the large proxy advisors can act as an unregulated regulator on substantive points. Moreover it means that, despite our members' efforts, proxy advisors can and do unilaterally determine the outcome of significant situations without properly engaging with companies or understanding the impact of their voting recommendations.

In our view unfortunately these problems will become more acute under the new Code. This is because the significantly expanded stewardship obligations proposed in the new Code (including beyond equity and beyond the UK) mean that many more investors will feel the need to retain, and as a matter of substance, delegate to, proxy advisors as this will be the only way that they can, or will chose to, "comply" with the new regime. This is, of course, compounded by the fact that, in contrast to a successful private trade or investment, successful and meaningful engagement by one investor on a material point will typically produce benefits for all investors and not just the engaged investor - an important consideration in the context of a market where there is currently a significant focus on competitive advantage and costs as well as a pressure to deliver short term results.

We do not believe that the Service Provider related principles and provisions (which are designed to deal with proxy advisors as well as other Service Providers) will resolve the problems outlined above. In this response we therefore make a number of practical suggestions which the FRC might like to consider including:

[1] *In its response to the 2018 UK Corporate Governance Code Consultation ISS, the largest proxy advisor, itself said that "Whilst ISS agrees that companies, investors and proxy advisory firms should work together to ensure the revised Governance Code is appropriate and impactful, we believe it is important to recognize that it is still primarily incumbent on companies to make high quality and fulsome disclosures to all their shareholders in respect of their corporate governance arrangements, and particularly any departures from recommended good practice. A company's shareholders (or their advisors) should not have to formally "engage" in order to get important explanations and all key information needs to be made available to all shareholders.".*

- The creation of a standalone FRC sponsored Code for proxy advisors which could, amongst other things, require proxy advisors to engage in a meaningful way; to provide draft reports for the purpose of fact checking within a sensible time and without charge and to report on their engagement activity with companies.

- The imposition of greater obligations on investors to monitor proxy advisors that act on their behalf so as to prevent investors abdicating their responsibility in this area.

The issues outlined above will not only impact listed companies. By making it difficult for boards to engage properly on relevant areas they will potentially also frustrate the government's wider stakeholder engagement agenda. By way of explanation, in proxy advisor organisations there are often relatively small numbers of individuals carrying out stewardship duties (as compared to the number of investee companies they cover). This not only limits the capacity of those individuals to engage but also means that significant influence is consolidated into the hands of a very small group of people with the power to materially impact voting decisions across the whole corporate environment.

2. Constraints on the Disclosure of Information

It would be helpful if the FRC could emphasise that both the market abuse regime and the commercial sensitivity of different types of information mean that companies cannot always discuss topics that investors might like them to. In some cases the law will not allow this, in other cases disclosure might compromise the competitive position of the company. For example, information in respect of a change in strategic direction, a new product or on senior management succession.

3. Limited Impact

Whilst the new Stewardship Code clearly aims to significantly raise the standards in this area, which we strongly support, it is important to realise that it can only have limited impact. The introduction to the Code acknowledges that capital is allocated *"to a range of asset types over which investors have different terms, rights and levels of influence*". Unlike the FCA Discussion Paper, it does not however, acknowledge the fact that the capital is allocated by a range of different investors, many of whom are overseas investors to whom the Code does not, technically, apply.[2] The most effective stewardship would therefore be achieved if overseas investors were also active voluntary signatories of the Code. The level of detail and extensive reporting requirements in the proposed Code, however, relative to the equivalent codes and requirements in other jurisdictions, may discourage those investors from voluntarily adhering to the Code, therefore significantly limiting its impact and potential success.

[2] *At the end of 2016, data from the ONS indicated that 56% of shares of FTSE 100 companies were held for beneficial owners outside the UK.*

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ANSWERS TO CONSULTATION QUESTIONS

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 proposed Sections cover purpose, objectives and governance; investment approach; active monitoring; constructive engagement and clear communication; the exercise of rights and responsibilities and the use of service providers. We therefore believe that they cover the core areas of stewardship responsibility based on the definition of "*stewardship*" given in the revised Code.

Please see our comments above in relation to proxy advisors. In addition to those comments, we think that the drafting of the section on "*Service Providers*" could be clearer:

- We believe that the Service Provider is meant to make the disclosure described in the "*Service Providers*" section. Please can you confirm if that is correct. If our understanding is correct, we think it would be helpful if the drafting on this could be made clearer. We understand that a number of the requirements in the Service Providers section come from the new requirements on proxy advisors in the Shareholder Rights Directive II but we have not yet seen the detail of how proxy advisors will be required to comply with these provisions. It would be helpful to have more information on this.

- Provision 6 provides that "*Signatories should establish a code of conduct*". It is not clear what the scope of any such code of conduct should be and how it should work. In addition to our comments raised in relation to proxy advisors on this (see above) will the FRC also be creating a new Code of Conduct for Service Providers? If so how does it expect the Code of Conduct to work, what areas will it cover and what would the consequences of breach be? Will there be different Codes of Conduct created in order to apply to different Service Providers? Please also see our answer to Question 16 in relation to proxy advisors.

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

Yes, with the exception of Service Providers.

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

Yes, the GC100 considers there should be no distinction between companies who follow the Corporate Governance Code and institutional signatories who sign up to the Stewardship Code. As is the case with the Corporate Governance Code, it is critical that this flexible approach is maintained so as to accommodate the range of investment approaches, styles and goals that exist across the market. In our view the Corporate Governance Code provides a well-tested and well-regarded route map for how successful this approach can be. The depth of compliance and quality of explanation are the milestones of its effectiveness.

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

In giving any guidance the FRC should be mindful of the comments made in the Kingman Review on this area. In particular, it should consider Recommendation 31 of the Review which provides that: "*The Review recommends that the new regulator should be more sparing and disciplined than the FRC in promulgating guidance and discussion documents. These documents should only be issued if they are genuinely useful, and their utility clearly exceeds the considerable costs they impose through users having to read and check them*". The FRC therefore might want to consider alternative ways that it could promote best practice. For example, through annual monitoring surveys or reporting more generally on stewardship practices.

Based on our experience with the Corporate Governance Code and if the final version of the Code includes guidance, the FRC should make it clear that it is not binding as otherwise it risks significantly compromising the "*comply or explain*" approach. In our view, like corporate governance, best practice stewardship is constantly evolving. The FRC should also, therefore, take care that any guidance it gives does not inadvertently inhibit the development of best practice. In addition, we understand that it may be easier to give clear guidance for some areas, but may be more difficult for others, especially when there is a need to accommodate a range of investment approaches, styles and goals across the market. The FRC should therefore not to feel compelled to give guidance in all areas.

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?

Yes. We believe that current reporting on policies is not as helpful to readers as it potentially could be and that there may be some merit in more fulsome reporting on the activities and outcomes. The emphasis should, however, be on producing short, accessible and user-friendly reports which are available online. We note that whilst many investors will view stewardship as a worthwhile concern, not all investors will do so and, of those that do, their approaches will not necessarily align, nor will they necessarily consider any non-compliance with the Code or poor reporting to be a significant factor in evaluating performance. It would be helpful if signatories were required to outline where following engagement they exercised discretion and voted outside of their voting guidelines. Disclosure on this area - even if only at high level - would help to demonstrate meaningful engagement and a commitment to the flexibility enshrined in the "comply or explain" regime.

In addition, we note that reporting on engagement activities and outcomes can present a challenge mainly due to the need for context (and in some cases confidentiality); the time engagements may take; the variety of investment approaches taken and the overriding need to create a user friendly, succinct document. The FRC should try to encourage a materiality-based approach rather than a box ticking checklist of specific issues. It should also encourage investors to create short, reader friendly reports.

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?

Yes, provided that the Code is published on time and does not include significant changes. We note that the end of the calendar year/Q1 is a very busy time for companies, investors and proxy advisors. The time needed for signatories to make any necessary changes to their systems and procedures will depend on what is required for the Policy and Practice Statement and the annual Activities and Outcomes Report.

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?

Recommendation 42 of the Kingman Review recommended 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*". It is clear that the FRC has aimed to create excellence in stewardship and that for asset managers and owners there has been a shift towards a focus on outcomes and effectiveness. The approach taken to the reporting for Service Providers, however, seems largely focused on policy statements rather than outcomes and effectiveness and does not entirely address the Kingman Review recommendations.

Further to our response to question 1, we would like more information on the mechanism or powers that will be used to require Service Providers to adopt the Code. Subject to that, we do not believe that the FRC needs any additional powers to make the Code more effective. The reality is that the nature and extent of stewardship will vary from one type of investor to another. The FRC and market more generally should, therefore, not expect the same levels of stewardship and reporting from all investors. Investors who choose a short-term oriented model will likely have a different approach to those who choose a long-term one.

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

Yes. We also believe that those statements should be repeated at the fund level. This would add transparency and be useful to the asset owners and companies in understanding the different purposes and approaches of various funds. There is of course a risk that these statements will add little value in the long term and simply become boilerplate.

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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?

Owners of financial securities other than shares have often been less active in stewardship. This is largely because often they do not have the same voting rights that shareholders do. We think that it may be better for the FRC to let best practice evolve rather than to dictate what it should be at this early stage.

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?

No, we do not think that it does provide sufficient transparency in this area. It only requires that "*Signatories should clearly disclose if, and how, stewardship policies and practices differ across asset allocation*". It would be extremely helpful if investors were required to explain how voting decisions are made. Voting practices vary between institutions and it would be helpful to understand the differences. For example, it can sometimes be difficult for our members to establish whether it is the portfolio manager or the governance expert that makes the voting decision and who that individual is. Historically there has been a focus on companies being transparent, we believe that it would be helpful for there to be equivalent transparency across the investment chain.

For the reasons mentioned above signatories should be expected to give the disclosure against all funds.

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?

GC100 offers no view on this.

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

No. Whilst we understand why investors need to use proxy advisor services we believe that there needs to be a reportable obligation on signatories to the Stewardship Code to scrutinise how the proxy advisors they employ are undertaking their responsibilities. Duties can be delegated but investors should not be permitted to abdicate their clear responsibility in this area. They should therefore be required to satisfy themselves that the relevant proxy advisor is willing to engage with companies in a meaningful and constructive way. For example, as drafted the proposed wording of the relevant provision says "*monitor service providers to ensure that their services enable effective stewardship".* We think it would be better for the relevant provision to say "*monitor service providers and confirm that their services enable and promote effective stewardship including by constructively engaging with companies on a timely basis*".

Please also see our comments above in relation to proxy advisors.

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

GC100 offers no view on this question. We do however make the comment that writing to companies or simply publishing or forwarding voting or corporate governance guidelines should not be considered to be "engagement".

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

In our view there are already many ways that investors can and do raise concerns about investee companies and their directors. Investors can already, for example, raise concerns via the AGM, investor presentations and retail shareholder events; ask questions of the directors including, where they think necessary, the senior independent director; vote against resolutions and requisition meetings and shareholder resolutions.

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

No. We believe that the FRC should let best practice on this develop.

We note that where an investor holds, for example, debt and equity in the same company, or group, the new call for stewardship beyond equity may create challenges where the relevant company faces financial difficulties, or strategic decisions are being contemplated, which affect the holders of different asset types in different ways.

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, it is crucial that the FRC reviews this area promptly and that proxy advisors are required to carry out their roles in a more responsible way. The principles and provisions do not address Recommendation 42 of the Kingman Review as they are too generic and largely focused on policy statements rather than outcomes and effectiveness.

In particular, Service Provider Provision 6 states that Service Provider signatories should establish a code of conduct. Given their significance and the approach taken to companies and to investors, we do not think that self regulating approach will be effective. For example, we are aware of the Best Practice Principles for Shareholder Voting Research Providers but do not consider that to have had any meaningful impact on the problems outlined above. Instead we believe that the FRC should create a standalone code for proxy advisors. Such a code could, for example, require proxy advisors to:

- require proxy advisors to engage in a meaningful way;
- provide copies of their draft reports to companies within a sensible period of time for the

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purposes of fact-checking;

- ensure that their workforce has appropriate experience, qualifications and time to deliver their stewardship obligations, and
- report on their engagement activity with companies (including whether this has been done on a timely basis).

This would introduce a more joined up and consistent approach to stewardship across the board.

Thank you for the opportunity to share our views on the consultation. We would be happy to discuss our response in further detail should that be useful.

Yours faithfully,

Mary Mullally
Secretary, GC100

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