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The art and science of investing™

Corporate Governance and Stewardship
Financial Reporting Council
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By email to: stewardshipcode@frc.org.uk

21st March, 2019

To whom it may concern,

We are very encouraged by many of the enhancements in the proposed revisions to the Code, and believe that they respond substantially to the calls, including those from the Kingman review, to increase the ambition and impact of the Code. In particular, the focus on outcomes as well as policies, the expansion beyond equities and the integration of stewardship and the investment process are all very welcome.

We are particularly pleased to note the inclusion of reference to the creation of sustainable value *for our customers* in the new definition of the Code. In a number of instances the Code references effectiveness of engagement and stewardship. We are firmly of the belief that the yardstick for effectiveness must be how well stewardship serves clients' interests and supports the delivery of products to them that operate in a way that is consistent with those interests. Importantly, this refers not just to asset owner beneficiaries but also those direct savers via the wholesale and retail channels. We would therefore support additional strengthening of this in the Code such that client focus is front and centre of the Principles and Provisions, and that this covers all clients of both asset owners and managers. We offer some thoughts on how this could be achieved.

In the following pages we answer the questions from the consultation and also make additional comments that were not directly included, such as on the definition of stewardship. As ever, we would be very glad to discuss these comments with you in more detail; you can contact me at freddie.woolfe@merian.com.

Yours sincerely,

Freddie Woolfe
Head of Resposnible Investment and Stewardship

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.

Yes. We believe that the sections cover the main areas of stewardship responsibility.

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

As mentioned earlier, we are pleased to note many areas in which the Code has been strengthened which we believe substantially raise the bar.

One area in which we believe the Code could be further strengthened is in reinforcing the references to, and the importance of, beneficiary and client requirements and expectations when mentioning investment and stewardship practices and outcomes, as well as reporting. We suspect that much of the box-ticking approach to stewardship and ESG integration – which is unlikely to be sufficient for an integrated approach – comes from a lack of insights into client and beneficiary views and interests which in turn naturally reduces the importance given to the topics when considering an investor's processes and strategy. In order to cause the investment industry to enhance its ambitions around stewardship the activity needs to be seen within the context of delivering for clients, and a firm's strategic positioning and competitive advantage.

We would therefore strongly favour bringing forward a strengthened version of Provision 22 to Section 1, to make clear that consultation with clients in order to understand their expectations – as far as practicable - is fundamental to delivering effective stewardship. Indeed, conceptually we could see that this could be a Principle if properly worded to ensure that it works on an apply and explain basis. For asset managers as a Provision we would suggest language such as "Signatories should seek actively to understand the needs of their clients as they relate to their stewardship beliefs, needs and expectations, to ensure their products best deliver on these." We would also favour making the connection with clients and understanding their expectations as a pre-requisite for delivering effective stewardship in the preamble, as well as a review of the Principles and Provisions to see where this message could be further reinforced; we would particularly point to Principles A and E.

We would also favour a full sweep of the Code and guidance to ensure that both beneficiaries *and* retail clients are referenced as fully as possible where relevant. Much of the innovation and demand for stewardship to date has come from the institutional channel; however it is important not to exclude the wholesale and retail channels, which are increasingly developing in their own sophistication and requirements of stewardship and integration. For example, the description of stewardship should read "to create sustainable value for *asset owners'* beneficiaries *and asset managers' clients*".

With an increased focus on client interest and expectations, a subsequent question that arises is the definition of materiality. It is a term that is often used when describing ESG integration, but too easily hides a number of complexities. Firstly, defining the precise impact of ESG issues can be very hard – it is often challenging to set out exactly at which point in the future and to what extent an issue could arise – meaning that much of the analysis is subjective and very much lies in the art rather than the science side of investment. Secondly, the investment industry tends to interpret the term in the context of what could significantly impact the company's operations and/or valuation. While this is of course fundamental, it risks missing the point that some issues can be material to clients even if they might not be similarly material to the investee company, and that investors will best serve their clients' interests by also taking these into account. An interesting example to follow will be the emerging debate on investment in thermal coal, and how the investment industry responds to the apparent hardening of view among certain parts of society on its acceptability as an investment given its carbon intensity. This consideration does not just apply to excluding certain sectors – for example, clients might not want to be exposed to companies involved in certain behaviours such as poor labour practices or bribery regardless of the potential financial or operational risk and could expect their investment managers to take them into account.

We would therefore see value in the Code being explicit that materiality can refer both to what an investor believes to be relevant to the value of investee companies and also topics that are important to their clients and beneficiaries within the context of their expectations of how their investments should be managed on their behalf.

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

Yes, we think this is important in raising the overall expectations and ambitions of the Code.

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

Practically, it would be helpful to have the guidance as a separate document, so that if it is updated the Code doesn't need to be. This is also a helpful message that the Code is designed to be an enduring document whereas the guidance will be regularly updated as good practice continues to evolve. It would be helpful to clarify in the preamble that the guidance is expected to evolve with practice, and that adherence to the guidance alone is not to be taken as good reporting – indeed, the more freely firms report the more likely it is that they will produce meaningful and innovative disclosures and avoid defaulting to box-ticking.

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 see this as very helpful as it will allow greater validation of the policies in action, and requires investors to give proof the extent to which their policies have an impact.

Importantly however, we do not think that the Code should be particularly prescriptive about what should end up in the report, other than emphasising that it is an opportunity to demonstrate the extent to which stewardship practices add value for clients and beneficiaries and policies are followed. We worry that excessive requirements will just encourage box-ticking in order to comply or, worse, greenwashing as firms exaggerate about their activities and capabilities.

Our view is that the main focus should be on encouraging firms to produce disclosures that help clients get under the skin of the processes and deliver honest, credible reporting. The measure should be the credibility and the insights, rather than on the number of pages. Our own research shows that our clients find shorter, incisive documents that they can consume easily and that lift the lid such that they can get comfortable that we take these issues seriously are the most compelling; we strongly suspect the door stop reports that are sometimes produced are rarely read, if even opened, by clients. Indeed, we would strongly encourage making explicit that honesty and openness are key criteria of good reports; an investor signatory should be able to be comfortable in saying where they think they can improve, or where things had not gone as they had hoped, and that this transparency would be seen as good reporting. In this light, we think it would be helpful for Principle I to read "Signatories must communicate clearly *and honestly* with clients and beneficiaries."

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?

If the idea is that Stewardship Code reporting should become the foundation documents for signatories' stewardship reporting and the deadline for signing is 31st December 2019, we do not think it sensible to require an implementation report exactly one year from signing the Code. Many firms use a calendar year as the basis for the reporting cycle, and so will more likely produce their reports early in the following year. While some signatories might chose to release their first activities and outcomes report under the new Code sooner than January 2021, we think it would more helpful to require signatories to set out in their policies how their reporting cycles operate and allow them to produce at least annual implementation reports accordingly.

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 agree that the new Code represents enhanced ambition in the UK Stewardship regime, which ought to address many of the related concerns expressed by Kingman. However, as we have highlighted previously we believe that ultimately the Code will need to be judged on how it encourages behaviours that deliver outcomes in clients' interests and meets their expectations.

Currently we do not believe that the FRC would require further powers to make the Code more effective. Client demand is likely to be more effective as a carrot than a regulatory stick to promote good practice, which an enhanced tiering, monitoring and oversight regime by the FRC should further enable.

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

Yes. We believe that this offers real opportunity for a firm to explain *and demonstrate* how it sees its role and delivers for key stakeholders, and how the organisational culture and values support that role, having been entrusted with the long-term savings of others. Alignment with the language and intentions of the UK Corporate Governance Code is very helpful in highlighting the commonality of purpose between company boards and investors in their respective stewardship roles.

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?

While we are fully supportive of the idea to expand the Code to cover any asset classes where the investor deems that stewardship might be relevant, we do not think referencing specific approaches to specific asset classes would be the right approach.

We do not find the reference to bond engagement helpful in Section 5, which is more related to voting rights, and would favour the removal of the Provision 27 entirely. Should reference to asset classes in the body of the Code be made it would probably be more helpful in Sections 3 and 4, which are likely to be more applicable to a wider set of asset classes. If this approach is to be taken we do not think it helpful to reference bonds specifically, but make clear that investors should consider monitoring and engagement approaches in the manner most relevant for the asset class.

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 is sufficiently clear in our minds. However, we think it would be more helpful to allow firms additional flexibility in the units of analysis by which they might choose to disclose different practices and policies. For example, different investment *desks* comprising multiple funds all investing in the same asset class might adopt different approaches. Similarly, some houses will manage both active and passive funds, which will naturally have different approaches to stewardship and integration.

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 concerned that there is no common definition of investment belief, at least for asset managers, which would be necessary to make these disclosures insightful. It is also unclear to what extent a firm's investment beliefs would be expected to impact the day to day fund management processes, risking bland statements that lack credibility. If our understanding of it is correct – i.e. an investor's view on the world and what is important to its clients - we also suspect that many aspects of it would emerge from other disclosures, including around Principle A and Provision 10, should client focus requirements be enhanced.

Additionally, and for transparency this applies to us, some firms might elect *not* to have an overall investment belief. We have deliberately chosen a no-CIO structure to encourage a range of views across our business, which we embrace as a virtue for our company and clients. We do not therefore see this Provision as additive, and would favour using other Principles and Provisions to reach the intended reporting in other ways, or to be clearer on what is meant by an investment belief if this can be reconciled with

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

We think that aspects of Provision 15 could be merged with Provision 22, or at least moved forward in line with Provision 22 as part of increasing the emphasis on client focus. For asset managers looking after retail investors' savings it is also important to reference client expectations, as they are unlikely to have their own investment and stewardship policies.

We also think that Provision 16 could be amended to reflect that the benefit of monitoring should be that service providers best enable the signatory's approach to stewardship, rather than enabling effective stewardship overall.

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

We do not have strong views.

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

There are already a number of escalation mechanisms available to investors, not least through direct engagement with the board. Where engagement with the chair is deemed to be lacking, investors can ask to speak to the SID. Collective engagement of course is another option, which can be pursued informally through connections or in a more structured manner via the Investor Forum. Of course, there comes a point at which, if engagement is unsuccessful, a broader investment decision is necessary. In many ways, adding more layers between engagement and the subsequent investment discussion about what would need to happen if engagement is unsuccessful is likely to be less helpful for integrating stewardship and investment.

However, depending on how the director oversight regime recommendations from Kingman progress we can see significant value in introducing a confidential escalation mechanism to alert the ARGA when an investor deems that a director might be in breach of their duty.

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

Please refer to our response to question 9.

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?

While we understand that SRD II includes service providers, and the Code very helpfully looks to align with the requirements of the Directive we continue to think it counter-productive to include references to service providers in the Code. They have no fiduciary duties, and are all too often used as a way of absolving investors of their own responsibilities. Indeed, we suspect that by removing service providers from the Code their services would likely be better used by investors in pursuit of their own stewardship objectives by shining the light back on the choices and activities of the investor.

Additional comments

Definition of stewardship: Our main duty as investors is to our clients. However, it is clear that stewardship and investment activities fully in their interests should also result in a more sustainable economy and society. In order to clarify that our duty is to our clients, but also to highlight the important corollary outcomes, we wonder whether the definition could be slightly tweaked to say "...to create sustainable value for beneficiaries and clients, in turn supporting a sustainable economy and society."

ESG integration: throughout the Code where ESG is mentioned climate change is singled out as a topic. It is not clear to us why this is the case and we would favour the removal of the regular references, particularly in Principle E, so as not to provide unintended signalling that the Code sees one issue as more important than others.

Provision 6: It is unclear to us how this applies to asset managers.

Provision 9: Investment decision-making should also be factored into stewardship activities, so we would favour "and vice versa" included at the end.

Provision 10: It would be helpful to provide some additional discussion on whether this is more of a philosophical view on investment time horizons, or whether the desired disclosure is based on portfolio turnover. We would prefer the former, and that this be disclosed at the same level as disclosures under Provision 1.

Provision 11: In line with having different stewardship approaches across the firm, it will be helpful to emphasise that this also applies to taking ESG issues into account and again will most credibly be disclosed at the same level as the disclosures under Provision 1. The Provision should also include the word "material" before ESG.

Provision 18: In order to be fully integrated into an investment process, investors need to be clear on what they would need to do should engagement not be successful. It is unhelpful for engagement to be seen as an activity that can deter indefinitely divestment decisions, even when considered pragmatically engagement will not be successful. We would therefore suggest adding to the end of the Provision "including how they consider the consequences for their investments when engagement is unsuccessful."

Principle J and Provision 23: It would be helpful to highlight that the most effective way of exercising these rights and responsibilities is by using them to support the investment and stewardship approach. Too often proxy voting is seen as a compliance exercise, following a box-ticking approach. This might be appropriate for some investment strategies that invest in a large number of stocks such as quantitative or passive funds. However for others it is clearly misaligned with the investment process, and can be a source of frustration that the governance and investment teams present different views on the same issue to a company.

Additionally, we wonder whether this section could be further strengthened by making explicit reference to the fact that signatories should be willing and ready to hold management, directors and auditors to account for performance through voting. Voting is most powerful when it is used as a tool in an engagement strategy, and is a very helpful "last resort" when an engagement isn't going to plan or a strong message needs to be sent to a company. Highlighting this will be particularly helpful to ensure that voting remains as effective as possible given the intention to bring stewardship closer to the investment process.

Guidance 5: We wonder whether for asset managers this should read "Signatories should disclose *how* they are incentivised to align investment strategy etc."

Guidance 8: We are not sure that guiding for international standards to be used if using an internal audit process is needed. Indeed, for us the real benefits is having an independent check that we are following our own policies and processes as set out in our stewardship documents, rather than ticking boxes against an assurance standard designed to be applicable to a wide range of investment styles and approaches.

Guidance 19: While we understand that it is helpful for a company to know why a large investor is selling, it is in reality quite challenging to implement. For example, some investors might not sell all their holding immediately, or indeed might trim their unit size and then buy more later when the valuation is more appealing. Quantitative funds could end up taking large stakes and subsequently selling, but are unlikely to communicate with investee companies every time they sell. If this guidance is to be retained, it might help to include "where practicable".

However, we would favour removing guidance related to asset classes altogether. It risks being seen as a tick list, and it is not clear why other asset classes have not been included. For brevity and to encourage innovation, we suspect it would be better to remove the text from "For listed equity assets" onwards. The guidance could always reference other repositories, such as PRI, as useful resources.