

## **FRC Consultation on the Draft Stewardship Code January 2019**

### **PIRC Submission**

#### **Introduction**

PIRC welcomes the opportunity to respond to the consultation on the proposed UK Stewardship Code for institutional investors. PIRC has been an independent adviser to pension funds and other institutional investors for over 33 years. PIRC provides a variety of ESG research, advisory and data analysis services to institutional investors. These include research on ESG standards and compliance among listed companies, analysis of general meeting resolutions and proxy voting advice. PIRC also provides customised client templates and interpretation of client policies, outsourced vote execution, reporting on proxy voting activity and auditing of third-party actions. In addition, PIRC also provides a range of custom responsible investment policies and reports for clients in the UK and globally. PIRC is a regulated investment adviser. PIRC is regulated by the Financial Conduct Authority.

Since the inception of PIRC's Corporate Governance Service, PIRC has argued that corporate governance best practice has been an important element in reducing the risk of corporate failure and enhancing shareholder returns over the long-term. PIRC considers that investors have a responsibility to develop consistent, informed and fair corporate governance policies which are relevant to the particularities of the market and promote best practice at individual companies.

#### **Overall comments**

In addition to responding to the consultation questions, there are a number of additional points we believe should be considered.

#### Oversight of non-complying investors

We believe there is a regulatory black hole in the approach to stewardship in respect of non-signatories. For example, there are numerous hedge funds and activist funds that have a significant influence over the management, ownership, structure and finances of UK-listed companies. In recent cases such as the hostile takeover of GKN by Melrose Industries, or the failed refinancing of Interserve, such funds have played a pivotal role. However, they are able to simply "explain" non-compliance.

In addition, we are aware that many of the explanations that non-signatories provide merely utilise generic text that is repeated across dozens of different funds. This is the case with Elliott Advisors, a firm which has played a significant role at various UK companies including GKN and Whitbread most recently.

We believe that investors such as these are undertaking a form of stewardship and one which can have a dramatic impact on target companies. Currently they disclose nothing about how they approach these issues in terms of the Stewardship Code.

This is where there is an important divergence with the UK Corporate Governance Code. In the latter case, where companies choose to explain their non-compliance with some or all of the code it is clear that these explanations are monitored by investors and others. Where explanations are not felt to be satisfactory investors can and do challenge companies, often leading to change.

PIRC does not believe there is any equivalent market pressure at work with regards to the Stewardship Code. Having reviewed a number of non-compliance statements it is clear that many have been using the same statement for a number of years, so presumably have had little if any criticism as a result. In contrast those investors that do comply with the Code shoulder a significantly larger reporting burden, and are subject to greater scrutiny. This suggests a fundamental and critical imbalance in the oversight of stewardship.

#### Facilitating greater engagement

As we suggested in our response to the UK Corporate Governance Code consultation last year, it would be helpful if companies held an annual stakeholder engagement meeting with information and dialogue offered to all stakeholders and investors. This would save company and stakeholder/shareholder resources and would be a valuable conduit for company thinking ahead of the formal annual meeting timetable.

#### Non-standard market practices

We would strongly encourage further examination and disclosure of market practices that may work against effective and appropriate stewardship. Two areas we believe that might be of interest are the use of equity derivatives during merger and acquisition activity and the practice of 'divided washing'. In the former case, we are concerned that some investors may seek to influence the outcomes of bids whilst holding no shares, instead utilising equity derivatives. In the latter case we believe that stock-lending is potentially facilitating tax avoidance.

#### Importance of the workforce

We welcome the fact that there is a general intention to align the Stewardship Code with the UK Corporate Governance Code. With that in mind, PIRC notes that the revised UK Corporate Governance Code puts particular emphasis on workforce engagement and sets out various mechanisms for achieving this. PIRC believes that it would be helpful if the Stewardship Code made explicit reference to the benefits of investors engaging with the workforce as part of their stakeholder relationships.

## **Responses to specific issues: Consultation Questions**

*Q1. Views are sought on whether the core areas of the stewardship responsibility are covered?*

PIRC believes that the principle weakness of the draft is that it fails to adequately identify how code enforcement will be operationalised. In addition, it provides no scope to impact on foreign investor organisations that are playing an increasing role in UK corporate governance, such as overseas hedge funds. There are other areas where we believe further clarifications are required and these are detailed below.

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

Based on the experience of 'comply or explain' approach to effective stewardship, doubts exist on the ability of the investment industry to ensure that such a system works effectively. Though FRC has stated that the Code is not a rigid set of rules, PIRC is of the view that stewardship responsibilities should be the same for different asset owners, asset managers and investment consultants. However, a supporting guidance for signatories according to their role in the investment committee is important.

*Q3. Views are also sought on how to support the 'apply and explain' approach for the Principles and the 'Comply or explain' approach for the Provisions.*

The Code recognises the important and influential role that service providers such as investment consultants, institutional investors and proxy research providers play, and their efforts in supporting an effective investment market. PIRC agrees with separate principles and provisions for service providers that better reflect their role and responsibilities in the institutional investment community. Additionally, institutional investors, agents, other asset owners and managers should be encouraged to apply the code and also advised on what they should disclose, to whom and the monitoring arrangements that should be in place.

*Q4. Views are sought on how the Guidance would best support the Principles and Provisions and what else should be included.*

PIRC is of the view that the best way to ensure reasonable reporting is by ensuring that effective monitoring is in place. PIRC would draw attention to the significance of reporting and the lack of enforcement penalties that come in situations where an effective reporting system has not been in place. It is therefore vital that the FRC makes it clear from the onset that it will effectively monitor disclosures from all signatories and take the implementation of the Code seriously.

*Q5. Views are sought in support of the proposed approach to introduce an annual Activities and Outcome Report and what should be expected to be included in the report to enable the FRC to identify the effectiveness of stewardship.*

PIRC suggests that investors should generally apply the Code in its entirety since many activities and policies are inter-linked. Additionally, signatories that adhere to the Stewardship Code should be required to disclose an annual activities and outcomes report with links to other relevant documents or disclosures. Where necessary, PIRC believes that some degree of standardisation is required. Furthermore, additional emphasis should be laid on quantitative and qualitative disclosures in respect of the Code. Investors should be encouraged to provide some form of comparable data and examples of activities undertaken. Although there will be confidentiality concerns, PIRC believes that verifiable real-life accounts are more important than policy disclosures.

For example, we suggest that the annual Activities and Outcomes report should identify for each entity that has been engaged with, the following: name of entity engaged with; personnel (including status and responsibilities) met at engagement meetings; background to the decision to engage; whether preparatory material for the engagement is available for confidential client review; formal purposes for the engagement meeting; significant points raised in the engagement meeting; agreed outcomes of the engagement meeting; items where the entity did not/refused to discuss; perceived outcomes; agreed follow up and overall value of the engagement meeting. In addition, the signatory should make clear how the specific engagement reported on fits into the signatory's engagement strategy for the entity and the signatory.

*Q6. Views are sought whether to agree with the proposed schedule for the implementation of the 2019 Code and requirements to provide a policy and practice statement, and an annual activities and outcomes report.*

PIRC agrees with the proposed schedule for the implementation of the 2019 Code and requirements to provide a policy and practice statement and an annual activities and outcome report. However, we would suggest that the FRC undertake the first review after one financial year as there is likely to be certain areas that might require revision. Additionally, PIRC believes that some independent review and analysis of qualitative and quantitative reporting is undertaken of individual signatories' disclosures by the successor body to the FRC.

*Q7. Views are sought whether the proposed revisions to the Code and reporting requirements address the Kingman Review recommendations and whether FRC require further powers to make the Code effective and what those further powers should be.*

PIRC is of the view that the most pressing concern is to have a code in place and importantly monitor the impact.

PIRC agrees with the principle recommendation of the Kingman Review that the FRC is abolished and a new statutory based regulator is established accountable to Parliament. As stated above, a one-year review period would be welcome to understand how the signatories comply with the new provisions of the code and the reporting requirements. The information gathered would establish whether additional powers are required in order to ensure the effectiveness of the proposed revisions to the Code.

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

PIRC is of the view that all the signatories adhering to the Code should publicly disclose their organisational purpose, values, strategy and culture. It is noted that most listed companies complying with the UK Corporate Governance Code disclose these in their annual reports.

*Q9. Views are sought whether the draft 2019 Code incorporates stewardship beyond listed equity and whether the provisions and Guidance should be further expanded to better reflect other asset classes and how?*

PIRC agrees that the draft 2019 Code incorporates stewardship beyond listed equities to some certain degree. However, PIRC believes that the most pressing concern at the moment is to have a Code in place and then begin to monitor the impact of the Code. It could be very challenging to ascertain whether the draft 2019 Code sufficiently encompasses assets beyond listed equities and whether it should be expanded. Nevertheless, the emphasis should be on implementation now with revisions in the future where necessary.

*Q10. Views are sought whether the proposed Provision 1 sufficiently provides transparency to clients and beneficiaries as to how stewardship practices may differ across funds and whether signatories should be expected to list the extent to which the stewardship approach applies to all funds.*

*Q11. Views are sought on whether it is appropriate to ask asset owners and asset managers to disclose their investment beliefs and whether this will provide meaningful insight to beneficiaries, clients or prospective clients.*

PIRC is of the view that asset managers and asset owners should disclose their investment beliefs. Some listed companies are already disclosing their stewardship activities and PIRC believes such disclosures provide meaningful insight for asset owner beneficiaries and clients and has no objection to such reporting in line with the Stewardship Code.

*Q12. Views are sought whether Section 3 set a sufficient expectation on signatories to monitor the agents that operate on their behalf.*

PIRC is of the opinion that signatories should monitor the agents that operate on their behalf. Signatories should be mandated to establish an engagement policy and explain how they integrate it into their investment strategy as well as methods of engagement and escalation.

PIRC urges the successor to the FRC to establish standardised, centralised disclosure of voting records. The current approach is essentially designed around the way asset managers want to disclose, not how a user might want to access the data. In order to compare the voting stances adopted a user must visit multiple websites and utilise different disclosure formats (searchable/non-searchable, monthly vs quarterly updates etc). In contrast US mutual funds make one annual disclosure of their record with the SEC and all records are held in one place. Whilst we consider that the US model lacks timeliness (since it may take a year for votes to be disclosed after being executed) the centralised nature of the data makes collection and analysis easier.

A number of PIRC clients continue to express exasperation that asset managers will not allow them to exercise their own voting policy when investing through pooled funds. It is important to have clarity on a number of facts in relation to this issue. First, it is clearly technically possible for split voting to be facilitated in pooled funds, as asset managers have acknowledged. Therefore, this is a question of willingness to accept client requests. Second, there is no difference in principle between asset managers voting their holdings in segregated or pooled accounts. If the successor body to the FRC accepts that it is desirable for asset owners to adopt and exercise their own voting policy, then the failure of asset managers to facilitate this in pooled funds should be of concern. It effectively inhibits stewardship.

Thirdly, since a growing proportion of asset owners' pooled fund investments are managed passively it this makes the argument for facilitating split voting stronger. If asset owners are simply holding a stock because it is a constituent of a given index, rather than because the asset manager has selected it there is no reason why the asset manager need be involved in voting.

Finally, there will inevitably be situations where asset owners have a beneficiary base with distinctive views (for example the pension fund of a charity or trade union). If the asset manager does not permit split voting on resolutions where it is clear beneficiaries would have a strong view that is in conflict with that of the asset manager (for example executive pay). Therefore, this would result in the known views of the beneficiaries being overridden, even though it would be technically possible to give them expression. This does not sit easily with trustees' fiduciary duties.

Therefore, asset managers must be required to facilitate split voting in pooled funds and such a requirement should be considered for legislation. As an interim measure, the FRC (or its successor body) should support split fund voting in the Stewardship Code.

*Q14. What might be the benefits of having a mechanism where investors could escalate concerns in confidence about an investee company?*

It depends on whether such a mechanism is secret or transparent. Reproducing the secrecy of the Investor Forum would be duplication. For example, PIRC would be concerned if a group of the largest asset managers, privately discussed views on particular companies and then agreed to use their votes in the same way, without consulting clients, or enabling their underlying asset owner clients to exercise their own voting decisions where requested. Such a practice would not be acceptable.

PIRC also notes that there is scope in such activity for a significant conflict with other stakeholders' interests. For example, in the case of the hostile takeover of GKN it is clear that a number of groups were opposed to the Melrose takeover, including GKN employee representatives. It would be interesting to establish the extent of private engagement around the bid by asset managers and, in contrast, the extent to which (if at all) they sought to engage with the workforce.

*Q16. Views are sought on whether the Service Provider Principles and Provisions have set sufficiently high expectations of practice and reporting and how else the code could encourage accurate and high-quality service provision where issues currently exist.*

PIRC currently adheres to the Best Practice Principles of Proxy Research Providers. We believe that they provide an adequate basis for its clients to hold PIRC to account for disclosure purposes.

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