

## **High Pay Centre response to the FRC Stewardship Code consultation**

### **Background**

The High Pay Centre is an independent, non-partisan think tank focused on the causes and consequences of economic inequality, with a particular interest in top pay and corporate governance. We run a programme of research, events and policy analysis involving business, trade unions, investors and civil society focused on achieving an approach to business that enjoys the confidence of all stakeholders.

Our interest in stewardship in relates to the role that investment intermediaries play in shaping pay distribution, governance standards and responsible business practices, with a particular focus on pay distribution. We have conducted extensive opinion polling, expert research interviews and analysis of the relevant research on these topics, informing our consultation response.

For more information visit [highpaycentre.org](https://highpaycentre.org).

### **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.**

There are many positive developments in the latest iteration of the code. In particular, we welcome

- the specific emphasis on the consideration of ESG factors in investment and stewardship practices;
- the specific provisions and guidance for different types of investment professionals (asset owners, asset managers and service providers);
- the increased scope of the code in terms of asset classes beyond listed equities;
- the inclusion of provisions relating to engagement with the ultimate beneficiaries of investments;
- the emphasis on organisational culture;
- and the responsibility for signatories to deliver sustainable value for wider society.

This latter clause is critical to rebuilding/retaining public trust in the investment and financial services industry.

To this end, we would recommend supplementing the reference to ESG investing in Principle 2, provision 11 to include a reference to environmental/societal impact. The term 'ESG' is generally taken to mean environmental, social and governance factors that are material to investment returns. This is important to emphasise in the code, but ought to be taken into account by investors in any case.

It will sometimes be the case where an investment will generate a positive return, despite negative environmental or social consequences, and stakeholders have an interest in knowing how asset owners, managers and service providers act in such case. The rise of so-called 'impact investing' suggests that many beneficiaries – from informed ultra high net worth individuals, to ordinary pension savers – want to see their money invested in a manner that has a positive impact on society, and would rather not make investments with a social or environmental cost. The UN Sustainable Development Goals, already being used by many investors, provide a framework for measuring impact.

Obviously, this approach is to be welcomed from a broader socio-economic perspective and can be supported by asking code signatories to explain how (or if) they measure their environmental and social impact, and whether or not this is a factor in their investment decisions and stewardship practices. Their customers/beneficiaries can then make more informed decisions about where to put their money.

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

Yes, we think the principles cover the key themes of stewardship activity.

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

The twin approach of 'apply and explain' and 'comply or explain' is sensible for the principles and provisions respectively, given that the general principles ought to be universally applicable to all investment industry participants, whereas the more specific provisions may not be relevant to everyone.

However, it is critical that disclosures of applicance/compliance are properly enforced. This requires prominent, accessible publication, where disclosures can be subject to independent scrutiny. It also requires proper scrutiny on part of the FRC backed by effective sanction – for example, demotion to a lower tier of signatory.

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

The lay-out of the draft guidance is hard to read. It would be better to place each guidance point adjacent to the relevant text in the actual code, rather than at the end of the document.

In terms of specific provisions, we think that the guidance on engagement, for example, could cover asset classes beyond listed equities and bonds. Investors in property, infrastructure, private equity, commodities and other asset classes also have critical stewardship responsibilities.

As with our response to question 1, we would support guidance on principle 2, provision 11 advising of the importance of measuring the environmental and social impact of investment decisions, and communicating this to stakeholders.

Guidance on provision 5 could note that incentives relate not just to the structure of pay packages but the total value. Pay levels in the investment industry are very high by the standards of the wider economy. This has an important impact on the culture of investment industry firms and the motivation of people attracted to work in the sector. It is therefore significant information in relation to stewardship practices. As such, the guidance should advise disclosure of pay practices and pay levels in this provision. The major UK-listed banks details how their staff are distributed across different pay bands (for example the number earning £0-£25k, £50k, £75k, £100k, £250k, £500k, £1m, £2m etc). This is a good template for investors and could be included in the ‘activities and outcomes report.’)

Guidance (and indeed, the provisions) in relation to service providers could be much more specific – we discuss this in more detail in response to Q16.

**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, this is an effective way of ‘explaining’ application of the principles and compliance or otherwise of the provisions.

Scrutiny of the reports by the regulator and by independent analysts will incentivise the highest standards of stewardship.

As in question 1, we would like to see signatories discuss the social and environmental impact of their investment decisions in the report. We would also like to see external verification included, in order to ensure that reports can be trusted

More generally, we think it is vital that reports contain broad characteristics of good reporting, such as balance (noting areas for improvement as appropriate); clarity; an evidence-base (with reference to data on interventions, voting practices and resources dedicated to stewardship, for example); and depth (covering disaggregated information on different funds operated by the parent asset manager, for example). When the regulator assesses reports and considers potential responses, criteria such as these should inform its next steps.

**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, the timetable allows several months for existing signatories to produce a policy and practice statement, and over a year to publish their first activities and outcomes report. This is plenty of time, and no-one could reasonably argue that they need longer.

**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?**

Stewardship Code validation informs decisions to award business worth hundreds of millions of pounds. Therefore, the standards set out in the code need to be rigorous and rigorously enforced.

The Kingman Review argued that the new code should focus more on outcomes and effectiveness than policy statements. The more specific provisions in the code on, for example, explaining how ESG factors are considered in investment decisions; monitoring how assets are managed; and communicating to clients/beneficiaries and understanding their views on investments are a significant improvement in this respect.

However, the language in some of the provisions still runs the risk of the policy statements and reports turning into unsubstantiated PR exercises for the companies in question. 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...' Giving the guidance greater prominence alongside provisions rather than at the end of the document (see Q4) would also help in this respect.

In addition, we believe that the regulator should actively address poor quality reporting against the code, and not be afraid to demote signatories to a lower tiering level or suspend signatures. They should also have the power to conduct random stewardship audits, comparing the reality of stewardship practices with the narrative set out in reports. This would greatly incentivise signatories to report accurately and to embed stewardship practices into their every day operations.

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

Yes, good stewardship often relates to the application of values (for example, holding investee companies to account over unethical practices). Stewardship Code validation informs major investment allocations from individual and institutional investors. If certification is to mean anything, companies need to demonstrate that they have the culture, values and integrity to uphold high stewardship standards. Demonstrating the link between stewardship and purpose/strategy will enable clients/beneficiaries to understand how deeply stewardship is integrated into a signatory's operations.

To this end, we think that provision 4 discussing the 'experience, qualifications and/or oversight' of the signatory's the workforce, should also include a reference to character or integrity. Many of the people the investment industry ultimately serves have a particular interest in seeing their money invested ethically. A number of scandals affecting the financial services industry in recent years – doing immense damage to the sector – have related to the values and conduct of people working in the industry, rather than their competence.

Therefore, in order to fully comply with both the letter and the spirit of the code, it is vital that the staff of signatory organisations are imbued with the appropriate values and integrity.

**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?**

The increased emphasis on asset classes beyond listed equity is a welcome addition to the new version of the code. This most relates to guidance for bondholders. It could be noted that for example, oversight of labour standards and environmental performance of property/infrastructure investments, or in private equity projects also requires the same diligent stewardship as ownership of shares in listed equity.

**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?**

Signatories should state and report on stewardship policy, practices and outcomes at individual funds, if they differ from the approach at group level.

**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?**

Yes – an investment philosophy ought to include a view on factors such as the quality of management and governance of an asset; the importance of ESG issues in investment decisions; or the strategy and culture of an investee company. In these cases – which are applicable across most asset classes – the signatory would make a decision to invest, but the characteristics are not permanently defined. Therefore, ensuring that – for example – an asset maintains good quality governance, an outstanding ESG record and a positive strategy and culture is an ongoing task.

Equally, the decision to divest from an asset will be taken as a result of ongoing oversight of the investment. So stewardship activities immediately follow from investment decisions and derive from a particular investment philosophy, and divestment decisions are a result of stewardship practices. So it is impossible to understand a signatory’s approach to stewardship without detailing their investment beliefs.

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

The requirement to take responsibility for oversight of outsourced stewardship activities and set clear expectations to third parties is vital, however the consultation refers to asset owners monitoring investment consultants. Very often, it will be the consultants who will advise asset owners on their responsibilities (in terms of legal and regulatory obligations, as well as societal expectations). This should be made clear in the code. As currently formulated, it could be interpreted as absolving consultants of responsibility for stewardship oversight, despite the fact that they very often bear responsibility for asset owners activities rather than vice versa.

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

Yes, collaborative is a slightly broader and more meaningful term that should encourage co-operation on stewardship activities. Collective implies formal engagements conducted en masse (which maybe necessary at times) whereas collaborative also encompasses more informal, day-to-day co-operation and support, of the kind that is of great value in engaging with investments.

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

Yes, investors are well-placed to identify issues with a company where legal/regulatory involvement maybe appropriate alongside or instead of representations to the directors. Enabling some kind of formal and confidential mechanism for reporting these concerns would give investors greater confidence for doing so, and would therefore increase the likelihood of identifying issues at an earlier stage.

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

Yes – see 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?**

This section is currently too vague and risks creating the impression that vital investment intermediaries are something of an afterthought with regard to stewardship.

In particular, we are concerned about the very general terms in which the outsized influence of investment consultants and proxy advisers is discussed.

Investment consultants play a critical role in advising asset owners on their stewardship activities. The FCA's recent inquiry into the asset management industry (also covering investment consultants) and The Pensions Regulator's work on the 21<sup>st</sup> century trustee noted that many pension fund trustees are lack financial/investment literacy and are highly dependent on consultants.

As such, there are good grounds for arguing that specific guidance should be directed at consultants in the revised code, as is currently the case for asset owners and asset managers. At the very least, the provisions and guidance for service providers should specifically mandate consultants to show how they:

- consider stewardship practices, including approaches to ESG and environmental and social impact, when advising asset owners on investment decisions;
- advise asset owners on both their legal/regulatory duties in relation to stewardship practices, and of wider societal expectations;
- advise asset owners on how to solicit member views on stewardship and report back to members on stewardship activities;
- ensure that the culture, values and integrity of their own employees supports responsible stewardship along the investment chain.

Similarly, the voting advice provided by proxy advisers has a huge influence on stewardship, particularly on the issue of pay, but also on wider corporate conduct regarding the re-election of company directors. The provisions and guidance for this section for proxy advisers should be much more direct in terms of requiring proxy advisers to explain how they reach their voting recommendations.

In particular, advisers should be required to explain how they consider social/environmental impact and the interests of wider society when considering how to vote. On Directors' re-elections, for example, UK company directors are required by company law to have regard for the interests of all stakeholders, including their workforce, customers, the environment and community, when exercising their responsibilities, so the extent to which they have done this ought to be a stated factor in determining their re-election.