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Mr David Styles
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Dear David,

Proposed Revision to the UK Stewardship Code

I am responding on behalf of KPMG LLP (KPMG), the UK member firm of the KPMG International network, to the Financial Reporting Council's (FRC) consultation on its proposed revisions to the UK Stewardship Code (the Code). We refer throughout to the existing Stewardship Code as the 2012 Code and the proposed Stewardship Code as the proposed 2019 Code.

Whilst KPMG does not itself undertake stewardship activities directly, as auditor to many listed and private companies we contribute to the effective operation of the capital markets and believe that all elements of governance - be it effective governance within companies by executive management and the Board, the audit process, investor stewardship or regulatory oversight - need to work in harmony to ensure the effectiveness and attractiveness of corporate Britain.

We agree with the FRC that effective stewardship is an important element of the overall corporate governance framework, with investors having a key role to play through challenging on material issues and thereby influencing decision making to improve the effectiveness of capital allocation in the economy. In general we support the proposed changes to the Code which reflect the extensive consultation already undertaken by the FRC. We believe the greater specificity in certain areas will complement growing experience and best practice.

I have set out our high-level views below, with our responses to the detailed questions in an Appendix. For convenience, we use the terms "investor" to cover all relevant types of organisation (asset owners, asset managers, service providers, etc) except where we believe differentiation is necessary. We also use throughout the FRC to include reference to its proposed successor, the Audit Reporting and Governance Authority (ARGA)).

Effective engagement

In our own engagement with companies and investors, we often hear from both sides that the other has been unwilling to engage. It is not clear to us why this would be the case, but might result from investor satisfaction with a company's management and performance and therefore the absence of a need to engage, or a lack of resources on the part of the investor, or some other reason. On the face of it, there is a desire on the part of both companies and investors for greater engagement and initiatives which promote this should be welcomed.

In so far as audit is concerned, this is undertaken on behalf of shareholders and in that sense is important in informing stewardship activities. It follows that there should also be effective engagement between investors and auditors. We have sought to increase the transparency of our work by going beyond the requirement for a binary audit opinion with the introduction of "graduated findings" in some of our audit opinions, but there is clearly more that could be achieved. Whilst the extent of direct auditor-investor engagement has increased in recent years, it is still relatively limited and subject to some challenges, for example in the form of auditor responsibility (to the body of shareholders as a whole), confidentiality obligations to audited entities, inside information considerations, etc. To an extent the subject of auditor-investor engagement may fall within the work of Sir Donald Brydon's review looking at the future of audit, but investors might also be encouraged to consider how they better interact with auditors.

Oversight and enforcement

As with all elements of the governance of Corporate Britain, effectiveness is likely to be improved by high quality transparent reporting and effective regulation. We agree with Sir John Kingman that at present oversight has largely been in the form of reviews of investor reports and tiering on the basis of these, with the surprising result that the majority of signatories are tiered in the highest category of performance.

The FRC should therefore extend its own engagement with investors - the quality of that engagement might itself inform its assessment of the quality of stewardship - as well as developing better mechanisms for assessing the effectiveness of individual investors' activities and the quality (and accuracy) of investor reporting.

Consideration also needs to be given to the adequacy of the powers that the FRC has to drive further improvement, and whether simply assessing performance through tiering is adequate.

Applicability of the Code to overseas investors

We note that application of the Code is largely confined to UK investors since, consistent with other aspects of UK financial services regulation, the UK regulatory framework does not apply to overseas investors in UK-issued assets (and accordingly the FCA's Conduct of Business Rules' requirement to produce a statement of commitment to the UK Stewardship Code or explain why it is not appropriate to their business model does not apply to such investors).

However, given the increasing proportion of ownership of UK assets by overseas investors, the benefits of the Code are diluted, as well as resulting in an uneven playing field for UK based institutions. We therefore welcome the joint FCA / FRC Discussion Paper (*Building a regulatory framework for effective stewardship*) which seeks views on whether there is more that should be done to incentivise international investors to exercise stewardship in a form consistent with the 2019 Code.

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Please do not hesitate to contact me should you have any questions in relation to our response.

Yours sincerely

David Matthews
Partner

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- 1 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.**
- 1.1 Yes, albeit this should be kept under review as practice develops.
- 2 Do the Principles set sufficiently high expectations of effective stewardship for all signatories to the Code?**
- 2.1 Yes, albeit this should be kept under review as practice develops.
- 3 Do you support ‘apply and explain’ for the Principles and ‘comply or explain’ for the Provisions?**
- 3.1 Yes. We believe that the equivalent approach has worked well with the UK Corporate Governance Code and provides appropriate flexibility given that a rigid approach will not necessarily be appropriate in all circumstances.
- 3.2 However, key to the success of such an approach is the quality of the explanations both of application of the Principles and compliance / non-compliance with the Provisions: we comment further on this in our response to Question 5 below.
- 4 How could the Guidance best support the Principles and Provisions? What else should be included?**
- 4.1 We consider that the Guidance has a valuable role to play in helping signatories (and other stakeholders) to better understand expectations and best practice. Recognising the desirability of having a framework of Principles and Provisions which is stable over time, the Guidance provides the opportunity for more timely updates to help signatories (and other stakeholders) without the formalities which may be required for updating the Principles and Provisions themselves.
- 4.2 Given that stewardship activities and in particular reporting thereof continues to develop, examples of best practice are likely to be valuable to help investors consider and compare their own approaches and the FRC should consider how it best identifies and promotes these.
- 4.3 In certain areas we note an inconsistency between the language of the Provisions which is compensated for in the Guidance. For example, Provisions 3 and 5 simply require that signatories “should have appropriate governance policies.....” and “should ensure their workforce has appropriate experience.....” respectively, but the “requirement” to explain (ie *disclose*) is included within the Guidance. This contrasts (again, for example) with Provisions 1, 2, 5, 6, and 8 which refer explicitly to *disclosure* of the relevant

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matters rather than just a requirement to undertake the relevant activities which are the subject of disclosure. In our view transparency in relation to Provisions 3 and 4 is important and should be strengthened by an explicit reference (as with other Provisions) for an explanation of how this is achieved.

5 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?

5.1 We support the introduction of an annual Activities and Outcomes Report.

5.2 We believe that in order to be valuable such a report needs to provide a balance between qualitative and quantitative information although we recognise that quantitative information in relation to “Outcomes” may be more difficult to identify and gather than for “Activities”. However, even quantitative measures relating to “Activities” - such as the number of resources involved in stewardship activities, the spend on such activities relative to investment portfolio, etc - may be valuable.

5.3 The content of such a report will no doubt continue to evolve over time and the most effective stewards will themselves innovate and drive market practice. To encourage such innovation and transparency, it is important that those demonstrating this are recognised for their achievements and the quality of reporting might be a separate matter reviewed by the FRC and benchmarked.

5.4 It is also important that the explanations reflect the views of leadership of the organisation (rather than simply those with stewardship responsibilities) and are fair, balanced and understandable. A requirement that all reporting should be approved by the Board of signatories is clear in (section 6 of) the preamble of the 2019 Code but there might also be benefit from being explicit on such a requirement as a specific Principle or Provision.

5.5 We believe that oversight from the FRC has an important role to play in ensuring this quality.

6 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?

6.1 Whilst the timing for implementation appears reasonable, we are not in a position to identify whether there will be particular challenges for institutions in submitting the information required in order to be considered as a signatory to the 2019 Code in Q1 of 2020.

6.2 The FRC should ensure that individual investors are aware of the rationale for their individual classifications on publication of the initial (and subsequent) lists

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in Q1 2020 and include in its Annual Review of Corporate Governance and Stewardship the bases driving such classifications and key areas which those in lower tiers need to address.

7 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?

- 7.1 The Kingman Review notes that 200 out of 278 signatories to the 2012 Stewardship Code are categorised as Tier 1 and notes that the FRC's focus is on checking the content of policy statements rather than actual effectiveness or outcomes.
- 7.2 Tiering is a helpful, but somewhat blunt, tool for demonstrating effectiveness of stewardship. To the extent tiering continues, consideration might be given to articulating the specific reasons for the categorisation of each investor. It would also seem inevitable that in an environment where constant improvement (and innovation) might be expected, merely "doing the same" year on year is unlikely to be sufficient to maintain a categorisation over time.
- 7.3 There are additional opportunities for highlighting best practice as a product of greater scrutiny of activity and reporting by the FRC through (a) referencing examples of best practice (both activities and disclosures) demonstrated by individual investors; (b) regular refreshing of the Guidance to reflect themes identified; and (c) providing a broader range of quantitative metrics to enable comparison.
- 7.4 More fundamentally, however, whilst we believe that more detailed, metric based and transparent reporting by investors may facilitate a better assessment of the extent and quality of stewardship activities by the FRC, review of reporting can only achieve so much. The FRC should therefore consider how it assesses the quality of the underlying activities and that they are fairly represented in investor reporting, as well as considering its own interaction with senior management, senior-decision makers and governance specialists within investors.
- 7.5 In relation to regulator / investor engagement, the Kingman Review also notes that the FRC's investor engagement activity largely focusses on ESG specialists rather than senior investment decision-makers. However, this requires willing engagement by those senior decision-makers which we recognise is difficult for the FRC to impose unilaterally. Boards of investors should encourage greater

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engagement of relevant senior executives with the FRC and this might form part of the disclosures in the annual Activities and Outcomes Report.

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

8.1 In principle we agree, but there needs to be appropriate balance and linkage between these features (purpose, values, strategy and culture) are relevant to, and lead to the enhancement of, effective stewardship.

9 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?

9.1 We agree that stewardship can and should be exercised in respect of different asset classes and that there is value in understanding how this is achieved.

9.2 Of particular importance may be providers of capital to unlisted companies which may themselves be of significance to society. Where such providers of capital are signatories to the Code (also being investors in listed equity) disclosure might be required to the extent to which the principles applied for investment in listed equity are also applied for investment in unlisted equity (or other instruments). However, this will not cover investors with only unlisted instruments, and further thought might be given to transparency of stewardship activities for such investors.

9.3 In addition, the Code does not appear to address short positions or investment in derivatives. Signatories to the Code should be required to explain their strategies for such investment and how these are consistent with the spirit of the Code.

10 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?

10.1 We agree that disclosure at a fund level would be unnecessarily burdensome and that a description of deviations from the organisational norm for individual funds (or groups of funds) is an appropriate compromise. Such description

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might include a statement as to why a deviation is appropriate and any processes required by the relevant organisation to approve such a deviation.

11 *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?*

11.1 We consider that “investment philosophy” may be a better term than “investment beliefs” (which, in our experience, is not commonly used). This would capture, for example, firms that characterise themselves as stock pickers with concentrated portfolios, compared to others that adopt an indexed approach or perhaps a greater than normal focus on sustainability. However, the intended clients may be best placed to comment on whether this is additional meaningful insight.

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

12.1 We agree that responsibility for stewardship cannot be delegated but note that whilst section 3 is clear on the need for monitoring it is implicit, rather than explicit, that the responsibilities of asset owners and asset managers cannot be delegated by outsourcing. We would suggest that this retention of responsibility is made explicit.

12.2 However, we also note smaller investors may be more dependent on outsourcing of certain activities than larger investors and may also have less “influence” over those service providers. It is therefore important that these service providers are themselves held to high standards in the activities they perform and in their governance as well as being transparent through reporting. In our response to Question 16 we comment that the requirements in relation to service providers appear “light” and make suggestions for enhancement.

12.3 As with other areas, the Guidance for service providers might be expanded and examples of best practice be identified over time which would be helpful for signatories and other stakeholders. For example, expected standards for reporting by service providers might be developed and / or, particularly where the extent of outsourced activities is extensive, it might be appropriate to go

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beyond monitoring and seek some form of assurance with regard to the extent of activities undertaken.

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

13.1 We have no strong view on this, although acknowledge that “collaborative” suggests a more positive form of engagement focussed on success. We are therefore supportive of using this term.

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

14.1 Effective engagement between investors and issuers provides a mechanism for investors to raise concerns which may be enhanced when in the form of collaborative engagement or when those concerns are shared and communicated by other investors (and other stakeholders).

14.2 However, at present there are few options for investors when concerns are ignored by issuers, other than (i) a referral to the Investor Forum (which typically only deals with a small number of cases each year) or (ii) for equity holders to vote against specific matters (when such matters are subject to shareholder votes) or (iii) to divest of the investment (albeit the latter is primarily an option for active managers rather than for investors in tracker (or equivalent) investments).

14.3 Further, effective stewardship has benefits for stakeholders other than the ultimate beneficiaries of asset ownership. Arguably that carries with it responsibilities for sharing fundamental concerns which are not otherwise known and when actions might be possible to protect other stakeholders and society more generally.

14.4 The question is how such a mechanism might best be achieved. The Kingman Review has recommended that the ARGAs develop a market intelligence capability (as well as be given enhanced powers to investigate areas of concern) and the raising of areas of concern by investors on a confidential basis would be a valuable contribution to this.

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

15.1 Yes. Given that there are well established mechanisms as to how equity investors exercise effective stewardship, investors in other asset classes for

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which stewardship practices are not so well developed are likely to benefit from Guidance and examples of best practices specific to different asset classes.

16 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?

- 16.1 Notwithstanding that ultimate responsibility for effective stewardship is retained by asset owners and managers, service providers play an important role in the investment supply chain given their influence on the actions of others. The governance, processes, resources and remuneration, as well as the extent and quality of engagement by service providers is therefore essential if advice is to be provided on an informed basis rather than simply based on generic criteria.
- 16.2 In that context, the supporting Provisions and Guidance for service providers in the Proposed 2019 Code appear to be relatively “light” compared with those for asset owners and asset managers. To ensure consistency, it might be more appropriate to replicate in the Provisions for service providers the relevant specific Provisions under each of the Principles and the associated Guidance.