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Corporate Governance and Stewardship
Financial Reporting Council
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By e mail stewardshipcode@frc.org.uk

Dear Sir/Madam

Proposed Revision to the UK Stewardship Code

Schroders manages or administers over £420 billion on behalf of institutional and retail investors, financial institutions and high net worth clients from around the world, invested in a broad range of asset classes across equities, fixed income, multi-asset and alternatives. We welcome the review of the Stewardship Code and the desire to drive more stewardship activity and greater disclosure of the outcomes.

We attach our responses to the questions raised but would like to make two general comments on the proposed Code related to the proposed new definition of stewardship and the new structure of the Code.

We are concerned that making the creation of “sustainable value for beneficiaries, the economy and society” an essential aim of stewardship activity, rather than a secondary outcome of a well-functioning stewardship market, could have some unintended outcomes. Our primary duty is to our clients, helping them achieve their investment aims. Stewardship activities are an integral part of this and we are happy to be held to account by our clients in this area. Creating sustainable value for the economy and society is an important outcome of effective stewardship, but it is vital that our primary focus is on our clients and their beneficiaries. We do not think the current definition makes this clear enough.

We also note that the first sentence of the revised definition, which refers to “allocation and management of capital” puts undue weight on transactional activity rather than monitoring and engagement activity once the initial allocation is made. We are surprised, given FCA’s concurrent consultation on shareholder engagement, the definition does not make a more explicit reference to engagement related activities. We would suggest that by including “oversight” alongside “allocation and management of capital” in the definition, this imbalance will be rectified.

Given the issues around short-termism identified in the Kay review, we are surprised with the removal of the words “long-term success” included in the previous definition. Whilst “sustainable” is similar, we would favour keeping the explicit wording around long-term.

We believe that our suggestions would align the definition of stewardship more closely with the UK Corporate Governance Code’s first principle which refers to “the long-term sustainable success” of a company in turn “generating value for shareholders and contributing to wider society.”

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In relation to the Code's overall structure, we have some concerns with its complexity and focus. The provisions and principles which focus on values and purpose, whilst doing no harm, send the wrong messages on the importance of action and reporting. Whilst we agree that stewardship covers the entire investment process we would rather the Code focus on enhancing those aspects of stewardship not covered by existing regulation. We consider that there is already a large amount of regulation on the buying or allocation process and more emphasis needs to be made on post investment monitoring, engagement, exercising rights and reporting activities. Our detailed response makes some suggestions on how to achieve this.

Yours faithfully,

Jessica Ground
Global Head of Stewardship

Responses to 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.

While stewardship covers the entire investment process, we would suggest that the particular focus of the Stewardship Code should be on enhancing the aspects of stewardship that are not covered by existing regulation. In our view, this should lead to a focus on post investment monitoring, engagement, exercising rights, and the reporting thereof.

As a result we are very concerned the principles begin with the need to “develop their organisation purpose and disclose how their purpose, strategy, values and culture enable them to fulfil their stewardship objectives”. We can envisage that many well crafted statements will emerge that will do little to drive the volume or quality of Stewardship.

Equally there is already a significant focus on institutional investors’ investment approaches by a number of regulators¹, and it is important that the Stewardship Code disclosure does not lead to a cut and paste of these existing practices, which would do little to drive improved activity. Recognising that the desire is to drive more and better quality activity, we suggest that Principle E and Section two entitled “Investment Approach” should be renamed “Investment Process”. An asset owner will view an investment approach as what best meet their liabilities, and an asset manager will view it as how they generate returns. As we have noted current activities largely focus on the buying or allocation process, and are typically well covered by existing regulation.

In our experience the bulk of stewardship activity happens after initial allocation decisions are made, and relate to the monitoring and engagement activity. These are often overlooked in many investment approaches, or are poorly articulated. By changing the principle to focus on process and monitoring, the message becomes clearer that this is an ongoing activity.

To overcome these concerns we suggest combining sections one and two, to achieve stronger linkages between purpose, objectives, governance and the investment approach (or as we would prefer) “process”. We believe that combining the first two principles (A and B) would also serve to link stewardship more closely to organisation’s fiduciary duty, which is more closely aligned to what is articulated in the second section on Investment Approach at present.

We also believe that Section 4 (“Constructive Engagement and Clear Communication”) should include an additional Principle on escalation, a component of the current code. We have found that outlining a clear articulation of how and when we elevate individual stewardship issues that have not been effectively addressed to be helpful to all stakeholders, in particular companies. The current phrasing of “constructive” engagement could be seen to imply that dialogue is valued over sanctions like selling or voting against management. In addition, given that the FRC is keen for asset managers to report any derivations from their existing policies, there is real merit to a prominent articulation of how engagements are escalated and what exceptions are made.

Q2 Do the Principles set significantly high expectations of stewardship for all signatories to the Code?

We understand that the FRC is keen to drive a wider focus on stewardship by investment market participants and provide more transparency around these activities. The sheer volume of principles and provisions that focus on other issues, in particular on purpose and investment

¹ The FCA, TPR and DWP

approach, run the risk of sending a message that boilerplate disclosure trumps these two objectives.

Given the focus of both the FRC and the FCA to encourage more stewardship activity we suggest that the balance of Principles between articulation and action needs to be addressed (we view A-F as being about articulation and G-J about action). As we stated in response to question 1, we believe that combining the first two sections and a reduction in the principles under them would go some way to achieving this. We would also argue, in terms of the proposed principles that:

- There needs to be a better focus on collective engagement and escalation under Section 4 Principle H, (i.e. the reference to escalation in provision 19 is not enough) and
- Principle I should be expanded to include communicating clearly with investee companies or issuers.

We also have some suggestions on the proposed Provisions

Provision 2 calls for signatories to “explain what activities they undertake to interact with other stakeholders and exercise their role as stewards of the market.” We believe that it would be helpful to provide more clarity here and a possible separation of what we see as very distinctive activities. We take our activities as stewards of the market very seriously with extensive engagement with policymakers, auditors, listing authorities and the FRC itself trying to drive up standards. We already provide insights into our work in this area in our annual reporting which we believe also reflects the guidance relating to this provision.

However, the definition of “other stakeholders” could be interpreted in a much broader fashion. Given the revised definition of stewardship includes reference to “society” it is important that this is not interpreted as creating a need for institutional investors to interact with all stakeholders equally. For example, we often receive communications for individual disgruntled employees or customers raising issues, which we consider are of an immaterial nature. The new Stewardship Code needs to reinforce the primacy of the fiduciary duty that we owe to our clients and encourage interaction with material stakeholders on issues related to the creation of sustainable long-term value.

We welcome Provision 6, and believe that all mandates should examine stewardship issues, rather than just asking questions on ESG integration, as currently occurs.

We do not believe that Provision 13 relating to Asset Owners “Signatories should provide clear and actionable criteria for managers to assess assets against, including prior to investment, to ensure they are appropriate investments to make in accordance with their investment and stewardship strategy” is clear. We refer to our earlier comments that the Stewardship Code should not seek to replicate other regulations on investment decisions². In addition we feel that this could create an onerous burden for asset owners. We would argue for its removal.

We note a repetition between Provision 27: “Signatories should explain their policy on bond engagement, including the extent to which they engage pre-and post-issuance of bonds” and Provision 23. Provision 23 already requires asset managers and owners to explain how they exercise ownership rights across different markets and asset classes. It is not clear therefore why bond issuance has been singled out for explanation within this extra provision. Instead we would suggest Provision 27 is removed and the guidance should set out recommendations for how Provision 23 can be applied across distinct asset classes with different characteristics.

Q3 Do you support “apply and explain” for the Principles and “comply and explain” for the Provisions

² See for example FCA COBS 9A.2 (Assessing suitability: The obligations)

Yes

Q4 How can the Guidance best support the principles? What else could be included?

We currently find the combination of Sections, Principles, Provisions, and Guidance as an overwhelming one. We believe the current UK Code has been emulated around the world due to its simplicity. As a first step, a clearer illustration of which principles the provisions and corresponding guidance are designed to satisfy would be helpful.

In terms of other issue to include, the guidance on provision 19 lists examples of escalation, but exiting is not considered an example of escalation, nor the actions undertaken when choosing to exit.

Q5 Do you support the proposed approach to include 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?

We are supportive of this new recommendation. We believe it is important to introduce an evaluation of how well stewardship objectives have been met and the outcomes achieved. We have long sought to do this in our own reporting and in the work that we have supported the Investment Association when developing their Stewardship Reporting Framework.

We would welcome more clarity around the extent to which some aspects of reporting should be client specific or designed purely for public consumption. In particular, reporting against provision 21 and 22 may be challenging according to the variety of approaches undertaken on behalf of different clients as per clients' expectations. We currently provide both public and client stewardship reporting with varying degrees of detail.

An additional consideration is the timeframe that the report covers. In our experience of engagement, which we have tracked since 2000, it takes on average 2 years to effect change. The focus should be on a combination of both activities taken in the preceding 12 months, and outcomes achieved, which are likely to be the impact of earlier activities.

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 we agree with the proposed schedule for implementation.

Q7 Do the proposed revisions to the Code and the 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?

The Kingman review (Recommendation 42) was clear on the need for the FRC to improve their stewardship of the Stewardship Code. We have concerns that the revisions have created something overly complex. There is the real risk that evaluating which asset manager and asset owners are exercising their duties effectively becomes an impossible task given the sheer volume of Principles, Provisions and Guidance.

We would advocate simplifying the approach and our response points to areas how this might be achieved. For example, the amount of Principles, Provisions and focus on values, culture and purpose send the wrong messages on the relative importance of action and reporting.

In light of the uncertainty around the future of the FRC created by Kingman's recommendations, we are cautious about handing new powers to the FRC and argue that the organisation would need to build trust with investors before it could be trusted to use new powers effectively.

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

Please see our answer to question one, in which we argue that a focus on “purpose, values and culture” is a distraction and runs the risk of taking attention away from the important activity that stewardship is.

Q9 The draft 2019 Code incorporates stewardship beyond listed equities. Should the Provisions and Guidance be further expanded to better reflect other asset classes? If so, please indicate how.

We are happy to see stewardship responsibilities extend beyond listed equity, and they have formed part of our investment processes for many years. However, it is worth considering if any unintended consequences could be created, especially in the area of conflicts of interest. For example, a bond investor could legitimately focus on engaging companies in relation to issues that will impact the bond that they own, and its specific duration. This could lead to encouraging cash generation to be prioritised over making investments or tacking long-term issues like decarbonising a company.

The overall duration of the bond market gives rise to a significantly different time horizon than that of equities, given that the latter are permanent capital instruments. Further discussion on these potential conflicts of interest should be debated more fully with investors across asset classes.

Secondly an important driver of stewardship activity for other asset classes is the extent to which ownership of other assets have rights and responsibilities attached to them. We support the current approach in the proposed new Stewardship Code, which encourages asset managers to explain the approach they take to stewardship in different asset classes, rather than being prescriptive about these activities. As identified above, the suggested provisions with respect to bondholders may be too prescriptive.

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 to all funds?

The approach taken in the suggested code is proportionate – fund by fund disclosure would not be enlightening in general as most funds typically follow an institution level approach. Indeed it is by aggregating out holdings across funds that we are able to more fully exercise stewardship effectively.

However, there may be a role for reporting by exception - asset managers should be clear about where funds’ deviate from the reported approach and set out the rationale for this. For example, we have found in some M&A situations it has made sense for funds to vote differently on the same EGM resolution.

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 not supportive of this provision, as this is already well covered elsewhere in the investing process. There is a real risk that this just creates more boilerplate disclosure.

In our experience these are typically well articulated and an additional articulation in Stewardship Code disclosures will add little. Asset owners are required to set out their investment beliefs as a part of their statement of investment principles (SIPP), this can both help communicate to beneficiaries and help focus the owners’ investment strategy. Best practice would include an articulation of the asset owners’ beliefs about the role of stewardship.

Asset Managers are already required to articulate their investment beliefs in prospectuses.

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

We agree that it is helpful for asset managers to demonstrate that they are actively monitoring their stewardship service providers, in our case the proxy voting agency. We already disclose the services provided in our Stewardship Code Statement but could enhance this to explain the actions taken to monitor service providers, and describe the actions taken as a result of this.

However, it should be made clear that this is not an encouragement for voting to be reported against the recommendations of proxy advisors. Such activity only serves to create a perception that proxy voting agency recommendations are best practice, which in our experience is not the case.

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

We suggest that collective engagement is the more widely used term, and that there is little benefit in creating another term.

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

Our experience tells us that if you have significant concerns about a company that are being unaddressed it is important that you escalate them publicly. If things do go drastically wrong, you have a clear evidence trail of the action that you took. In contrast where we have raised concerns in a confidential manner we have not been provided any assurances that they have been addressed. Nor do we have unequivocal evidence that we were acting on our concerns.

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

In line with our answer to question 9, we suggest that there are a series of debates with investors in other asset classes to better understand their timeframes and priorities. Careful consideration needs to be given about the potential for a rise in conflicts of interest in stewardship activities as a result, and how this might be dealt with.

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 provisions where issues currently exist?

We have no comment on this question.