Corporate Governance and Stewardship
Financial Reporting Council
8th Floor
125 London Wall
London
EC2Y 5AS

29 March 2019

<u>IoD Response to Proposed Revision to the UK Stewardship Code</u>

Thank you for giving the Institute of Directors (IoD) the opportunity to respond to the FRC's Proposed Revision to the UK Stewardship Code.

About the IoD

The IoD was founded in 1903 and obtained a Royal Charter in 1906. It is an independent, non-party political organisation of approximately 30,000 members. Its aim is to serve, support, represent and set standards for directors to enable them to fulfil their leadership responsibilities in creating wealth for the benefit of business and society as a whole. The membership is drawn from right across the business spectrum, with 70% consisting of directors from small and medium-sized enterprises (SMEs).

The IoD has long been an advocate of high standards of corporate governance, including investor stewardship. According to our Royal Charter, one of the IoD's key objectives is "to promote the study, research and development of the law and practice of corporate governance, and to share findings." We strongly believe that an effective system of corporate governance is a key underpinning of UK economic performance and business legitimacy.

<u>Summary of our view</u>

Effective stewardship of listed companies by institutional investors is a key component of the UK's corporate governance system. Investors exert significant influence over corporate behaviour and decision making, particularly with regard to listed companies, and represent an important source of accountability for boards of directors.

Our overall perception of the stewardship performance of UK asset managers, owners and advisers is mixed. Some market participants use their equity ownership and advisory powers in an enlightened manner, and encourage the adoption of a long-term, purpose-oriented approach to business. In this segment of the market, ESG (environmental, social, governance) factors are becoming increasingly important investment criteria, and this exerts a positive impact on corporate behaviour.

However, there is also a significant proportion of the industry that places a low priority on fulfilling a stewardship role – either as a matter of investment policy or due to insufficient internal resources dedicated to stewardship and its integration with investment decision-making. In other cases, investors may claim to be engaged stewards of their corporate assets, but fail to follow through in terms of their actual investment behaviour.

Furthermore, in a small but influential segment of the investment industry, some fund managers primarily view their rights as shareholders as a means through which they can extract short-term financial returns rather than pursue enlightened stewardship. In some instances, such returns may be acquired at the expense of other important company stakeholders, e.g. employees, suppliers, pension fund beneficiaries, with implications for the long-term prospects of the enterprise. Such short-sighted investor demands and expectations may diminish the ability of boards to pursue strategies focused on long-term investment, innovation and the development of human capital.

In our view, the UK Stewardship Code has a valid role to play in encouraging a more enlightened approach to investor stewardship. Although its impact so far on investor behaviour has been somewhat limited, **it nonetheless provides a clear articulation of what an enlightened stewardship policy should look like**. It encourages institutional investors to be transparent about their approach to corporate engagement and emphasizes the economic and social responsibilities that are associated with corporate ownership.

However, our underlying concern about the effectiveness of the Stewardship Code relates to the strength of the underlying business incentives faced by many investment industry participants. These incentives are not necessarily aligned with a long-term stewardship approach. **Hence we remain sceptical about the ability of the Code – despite its good intentions – to significantly influence the stewardship behaviour of many institutional investors.**

For example, in circumstances where active fund managers are faced with the dilemma of pursuing long-term engagement with an investee company or demanding more immediate financial returns through M&A activity or share buybacks - which could strongly boost the share price in the short term - which are they more likely to choose? Short-term investment outperformance greatly enhances the ability of asset managers to attract and retain investment mandates, which are the ultimate determinants of their commercial success.

In the case of passive investment funds – which are the most rapidly growing segment of the investment industry – the costs involved in pursuing a meaningful engagement strategy with investee companies may be seen as prohibitive. We note with concern both the job cuts and relentless downward pressure on management fees that the passive sector has been experiencing during the last 6 months. Although the major players in the passive sector claim to be adding capacity to their corporate governance teams, it is challenging for them to apply a meaningful stewardship approach to the thousands of investee companies that make up their global index-based portfolios.

Hence, although it is important to differentiate between individual market participants, **we remain concerned that the Stewardship Code exerts, as yet, insufficient influence over a critical mass of institutional investor incentives and behaviour.**

However, **this scepticism does not lead us to suggest that the Stewardship Code should potentially be abolished** – in contrast to the view expressed in the recently published Kingman

Review on the future of the Financial Reporting Council[1]. Although investor stewardship remains a work in progress, **it is important to have a vehicle through which societal expectations for investor stewardship are made explicit**. Even though stewardship practice may not yet match stewardship aspiration, this is still a valuable role for the Stewardship Code to play.

Hence the IoD has always been supportive of the concept of the Code, both prior to and after its launch in 2010. Furthermore, its valid societal role has been reflected in the proliferation of stewardship codes in more than 20 countries around the world.

Our final major concern relating to the UK Stewardship Code is not explicitly addressed in the consultation document**. It relates to the future location of the Stewardship Code (and the UK Corporate Governance Code) in the UK regulatory architecture** that will be established following the replacement of the FRC with ARGA – the Audit, Reporting and Governance Authority. According to the recommendations of the Kingman Review, most of which have been endorsed by the Government, responsibility for oversight of the Stewardship and Governance Codes will pass from the FRC to ARGA.

However**, we are not persuaded that a robust statutory audit regulator like ARGA would be an appropriate home for either code.** Both codes operate according to a 'soft law' regulatory philosophy – rather than on the basis of prescriptive enforcement - and have developed by means of a collaborative partnership between the government, business and investor communities. We doubt that ARGA would be the right place to oversee this kind of regulatory approach.

One option might be to establish **a dedicated Corporate Governance Commission**, a framework that is utilised in other European jurisdictions (e.g. Germany). This could embed a high level of involvement by relevant business and civil society stakeholders. In comparison with a statutory regulator, it would also be an appropriate place to ensure that the best practices articulated in the codes reflect the practical needs and experiences of market participants as well as regulatory perspectives.

Comments on specific changes to the Code

We are broadly supportive of the detailed changes to the UK Stewardship Code which are proposed in the current consultation.

The Code's new definition of stewardship as "the responsible allocation and management of capital across the institutional investment community, to create sustainable value for beneficiaries, the economy and society" reflects a more holistic view of the role of investors in corporate governance, and is consistent with recent changes to the UK Corporate Governance Code. **We support the more wide ranging scope of this new definition,** which emphasizes the role that investor stewardship can play in the overall economic system and wider society.

We also find it useful for the Stewardship Code to follow a similar format and structure to the UK Corporate Governance Code – consisting of Principles and Provisions, and accompanied by supporting Guidance.

We are particularly supportive of the Code's new requirement for signatories to develop their organisational purpose and disclose their stewardship objectives and governance. We agree that a well-defined purpose should help signatories to better articulate their role in the institutional investment community and demonstrate how the alignment of purpose, values, strategy and culture enables them to fulfil their stewardship objectives.

[1] In his recent Independent Review of the Financial Reporting Council, Sir John Kingman argued that "If the Code remains simply a driver of boilerplate reporting, serious consideration should be given to its abolition" (page 46).

We also think **it is appropriate to widen the scope of the Code to include investment decision-making and investment in assets other than listed equity**. Increasingly, institutional investors are investing directly in unlisted equity and alternative asset classes – although the details of how stewardship is applied by each asset class may vary, the underlying stewardship philosophy should be consistent.

Furthermore, as has been observed in some recent high profile cases (e.g. Interserve, Debenhams, Carillion), a variety of investors other than equity fund managers (e.g. creditors or distressed debt investors) may exert influence over companies in particular circumstances, and it is important to ensure that there is a common understanding amongst them of the meaning of good stewardship.

There is one aspect of the new Code structure where we have concerns. For understandable reasons, the new Code attempts to better differentiate between the stewardship roles of asset owners, asset managers and service providers (e.g. proxy advisors and investment consultants). **However, the effect of splitting up the Code to reflect their differing roles serves to make the Code more cluttered and complex.**

The contrast in terms of length and complexity between the proposed new version of the code and the original 2010 version is now significant. We would prefer to see the stewardship role of different institutions addressed by tailored, specific codes for each of these three categories of market participant.

***

I hope you have found our comments helpful. If you require further information about our views, please do get in touch.

Kind regards,

Dr. Roger Barker
Head of Corporate Governance
Institute of Directors
Tel: +44 (0)7814 386 130
Email: roger.barker@iod.com