Let’s get engaged: Stewardship in the UK - FRC and FCA consult on revisions to the Stewardship Code and on the regulatory framework for effective stewardship

On 30 January 2019, the Financial Reporting Council (FRC) published a consultation on its proposed changes to the UK Stewardship Code. At the same time, the FCA and FRC jointly published a discussion paper, starting an examination of how effective stewardship can best be supported by the regulatory framework in the UK.

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Contact	Charles Mayo, Rosali Pretorius

Introduction

On 30 January 2019, the Financial Reporting Council (FRC) issued a consultation paper, “Proposed Revision to the UK Stewardship Code”. The FRC considers that its proposals would set “substantially higher expectations for investor stewardship policy and practice”. Comments on the consultation paper are invited to 29 March 2019.

At the same time, the FRC and the FCA jointly published discussion paper DP19/01, “Building a regulatory framework for effective stewardship” (DP), to “advance the discussion about what effective stewardship should look like, expectations for financial services firms, and how this can be best supported by the UK’s regulatory framework”. The consultation period for the DP closes on 30 April 2019.

Perspective

These papers need to be seen in the context of:

- perceptions that the UK Stewardship Code (Code) is not effective enough. Sir John Kingman said as much in his recent report on the FRC, “The Stewardship Code, whilst a major and well-intentioned intervention, is not effective in practice.” And, he noted that “Apart from some minor amendments in 2012, and the introduction of tiering in 2016, the Stewardship Code has not been significantly updated since first published in 2010”,

- the forthcoming revised Shareholder Rights Directive (SRD II), which mainly comes into effect in June 2019. SRD II is designed to promote transparency among investors about long-term investment and non-financial considerations, and

- increasing amounts of non-financial reporting, such as on directors' duties, supplier payment performance, gender and potentially ethnicity pay reporting, modern slavery, and the like.

FRC consultation paper on Proposed Revision to the UK Stewardship Code

Overview

In its consultation paper, the FRC puts forward changes to its 2012 Code, with a view to increasing demand for more effective stewardship and investment decision-making which is better aligned to the needs of institutional investors' clients and beneficiaries.

The consultation paper is accompanied by two Annexes:

- Annex A - Revised UK Stewardship Code and
- Annex B - Summary of Changes form 2012 Stewardship Code

The consultation follows the FRC's engagement with 170 members of the investment community and companies, including asset managers, pension funds, international investors and UK listed companies.

Comments on the questions included in the consultation paper are requested by 29 March 2019. These should be sent to stewardshipcode@frc.org.uk

Principal changes to the Stewardship Code

Defining stewardship' as "the responsible allocation and management of capital across the institutional investment community to create sustainable value for beneficiaries, the economy and society. Stewardship activities include monitoring assets and service providers, engaging issuers and holding them to account on material issues, and publicly reporting on the outcomes of these activities", the revised Code underlines the primary purpose of stewardship being to look after the assets of beneficiaries that have been entrusted to the care of others while broadening its scope to include investment decision-making and investment in assets other than listed equity.

The proposed main changes to the Code include:

<u>Purpose, values and culture</u>

Signatories to the Code would be asked to establish an organisational purpose, strategy, values and culture such that they are able to fulfil their stewardship objectives. This is directly aligned with the requirements of the 2018 UK Governance Code for listed companies.

These objectives must enable signatories to fulfil their obligations to their clients or beneficiaries.

The focus on purpose would bring the proposed revised Code into line with the UK Corporate Governance Code, ensuring that effective stewardship behaviours are embedded across the signatories' business. And, the draft revised Code would be structured to mirror the UK Corporate Governance Code, with numbered Sections, Principles and

Provisions accompanied by supporting Guidance.

Enhanced reporting requirements

Signatories would be required to make public disclosures about their stewardship activities and their assessment of how effectively they have achieved their stated objectives.

This reporting would be in two parts:

- a Policy and Practice Statement when signing the Code, and
- an annual Activities and Outcomes Report.

The more rigorous reporting obligations would be subject to increased oversight by the FRC.

Stewardship beyond listed equity

Given the significant growth in investment in assets other than listed equity, such as fixed-income bonds and infrastructure equity, the revised Code would require signatories to use the resources, rights and influence available to them in the UK and beyond, to exercise stewardship regardless of how capital is invested.

Integration of stewardship and investment approach

The draft revised Code would set higher standards for asset owners and asset managers about how stewardship responsibilities are integrated into their investment processes - this would include investment decision-making and mandate design as well as additional activities.

Recognising the importance of environmental, social and governance (ESG) factors

The draft revised Code makes explicit reference to ESG factors, with signatories expected to take such factors into account when fulfilling their stewardship responsibilities. The revised Code is also intended to encourage greater demand for an engaged approach to stewardship and investment decision-making, aligned to beneficiaries' investment time horizons.

Clear expectations of different entities in the investment chain

To tailor the Code more clearly to the role of different entities in the investment community, the proposed revisions would provide more detailed Provisions and Guidance, written for asset owners, asset managers and entities providing services to the institutional investment community (such as investment consultants, proxy advisers and other service providers) wishing to demonstrate their commitment to effective stewardship.

FRC and FCA joint Discussion Paper DP19/01 on Building a regulatory framework for effective stewardship

The DP, published jointly by the FCA and the FRC, invites comments about how stewardship can best be strengthened within the existing structure of UK capital markets, given the role it has to play across a variety of investment strategies and approaches.

Responses to the DP should be submitted by 30 April 2019 either through the FCA's online response form, by email (to dp19-01@fca.org.uk) or in writing (to Mark Manning, Financial Conduct Authority, 12 Endeavour Square London E20 1JN).

Noting that poor corporate governance and a lack of shareholder engagement can contribute to a culture of short-termism and to high-profile corporate failures, a key focus of the DP is the role of stewardship in investment strategies that aim to meet investors' financial interests over a long-term investment time horizon, including those managed on behalf of consumers in pension funds and life insurance policies.

In this, the DP takes into account the forthcoming SRD II, which mainly comes into effect in June 2019.

The DP considers, among other things:

What does effective stewardship look like?

Among the attributes that constitute effective stewardship by asset owners and asset managers, the DP puts forward the following:

- a clear understanding of the scope, role and purpose of stewardship
- good communication across the institutional investment community to align stewardship objectives
- active monitoring of assets, constructive dialogue with issuers, exercise of ownership rights, and the integration of stewardship and investment decisions
- institutional culture and structures (such as remuneration, performance measurement and asset manager selection) that support investment strategies
- stewardship activities consistent with clients' and beneficiaries' financial interests over their investment time horizon
- reporting and disclosures across the institutional investment community to demonstrate that stewardship activities reflect the financial interests of clients and beneficiaries over their investment time horizon.

Key challenges

While progress has been made towards effective stewardship in the UK, the DP recognises that some challenges that remain to be dealt with.

These include making adequate investment in people and processes to ensure effective stewardship. The DP considers that, although the cost of such investments may "reasonably be expected to be outweighed by the benefits", some of these benefits - such as higher long-term investment returns - accrue not only to the firm that bears the cost of exercising stewardship, but to all other investors. These, then may not invest as fully as they otherwise might but rather 'free-ride' on the stewardship of others.

SRD II will introduce new rules to enhance transparency around how equity investors exercise stewardship, thereby encouraging a long-term perspective in investment strategy, non-financial considerations and corporate governance. The DP, though, seeks views on whether the UK regulatory framework should go further than the provisions of SRD II.

Balancing regulation and the Stewardship Code

In light of the FRC's proposed revisions to the Stewardship Code (see above), the FCA is keen to gather views on how far the balance between regulation and the Stewardship Code would deliver an effective regulatory framework for stewardship - in particular, how best to deal with specific issues in the design of the regulatory framework, including its institutional, asset-class and geographical scope.

elexica Limited, CityPoint, One Ropemaker Street, London EC2Y 9SS