

Mark Manning  
Financial Conduct Authority  
12 Endeavour Square  
London  
E20 1JN

By email: [dp19-01@fca.org.uk](mailto:dp19-01@fca.org.uk)

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Dear Mr Manning

**ICSA response to the Financial Conduct Authority/Financial Reporting Council Discussion Paper DP19-01 on Building a regulatory framework for effective stewardship**

We welcome the opportunity to comment on the FCA/FRC proposals to build a regulatory framework for effective stewardship.

ICSA: The Governance Institute is the professional body for governance. We have members in all sectors and our Royal Charter purpose is to lead 'effective governance and efficient administration of commerce, industry and public affairs'. With more than 125 years' experience, we work with regulators and policy makers to champion high standards of governance and provide qualifications, training and guidance. ICSA is the professional body that qualifies Chartered Secretaries, which includes company secretaries. Company secretaries have a key role in companies' governance arrangements, including shareholder engagement. Our members are therefore well placed to understand the proposals in the FCA/FRC discussion paper on building a regulatory framework for effective stewardship.

In preparing our response we have consulted, amongst others, with members of the ICSA Company Secretaries Forum, a group of company secretaries from more than 30 large UK listed companies from the FTSE 100 and FTSE 250. However, the views expressed in this response are not necessarily those of any individual members of any of this group, nor of the companies they represent.

We set out below our responses to the specific questions set out in the consultation paper. We have focussed on the questions covering areas where company secretaries have particular understanding. Where it is more appropriate for specific questions to be answered by investors, we have not attempted to answer those questions.



**Q1 Do you agree with the definition of stewardship set out? If not, what alternative definition would you suggest?**

No. The definition set out does reflect the dictionary meaning of the term 'stewardship' but this is very different from the meaning used in the previous stewardship code which said that "Stewardship aims to promote the long-term success of companies in such a way that the ultimate providers of capital also prosper. Effective stewardship benefits companies, investors and the economy as a whole". The new definition relates primarily to the responsibility of an intermediary for the stewardship of client investments; the way in which an asset manager deals with assets on behalf of its clients or, to put it simply, its fiduciary duty.

The previous definition focused much more on what is now defined as the 'stewardship activity' of 'engaging issuers and holding them to account on material issues'.

These are very different concepts and the conflation of them in the new stewardship code has created some confusion.

The new definition of stewardship is extremely broad and appears to be seeking to capture all types of investment, potentially leading to very long reports which include a lot of detail to help asset owners see how their investment is being managed. The original Stewardship Code led to significant improvements in voting by institutional investors, leading to a clearly differentiated approach and increased engagement. We therefore believe that an increased focus on the ownership aspect of stewardship would be more useful.

We would highlight two areas in which this conflation is particularly unhelpful:

**i) Increased scope of stewardship into other asset classes**

As far as the allocation and management of client capital is concerned, it makes absolute sense for other asset classes, and indeed investment classes, to be included within scope.

However, where we are considering engaging issuers and holding them to account on material issues, this extension causes us some concern. Investment in share capital constitutes ownership of the investee company, bringing with it control rights such as to vote at general meetings, including on the appointment of directors, to requisition meetings and to receive a share of profits. Bonds and other fixed income investments, by contrast, are loan capital, issued for a set period of time with a fixed interest rate payable to the bondholder and the return of investment capital at the end of the time period. As a debt, an investment in bonds also carries less risk and, in addition to a fixed rate of return, ranks ahead of ordinary shares for repayment of the debt (i.e. the capital invested) in the event the company becomes insolvent. Investment in bonds does not bring any of the control rights that apply to investment in shares. It carries neither voting rights nor a right to participation in profits. Shares and bonds are very different investment vehicles, which attract investors with entirely different investment objectives. Bondholding is a contractual relationship with the company, with the relationship and communications managed by the company's Treasury team. The company's relationship with shareholders involves a great deal more management and is carried out by the Investor Relations team.

We would also point out that the Discussion Paper makes clear the EU Shareholder Rights Directive II (SRDII) does not extend beyond equities. This is not surprising as the SRDII amends the first Shareholder Rights Directive as regards the encouragement of long-term shareholder engagement. As debt capital, investment in Bonds is usually a short-term investment. Bonds tend to be bought and sold quickly, whereas investment in shares tends to be for the longer term.

## ii) Additional focus of ESG factors

Again, from the perspective of the allocation and management of client capital, it makes absolute sense to include the consideration of ESG factors as these are a key consideration in an asset owners' risk assessment.

However, where we are considering engaging issuers and holding them to account on material issues, this additional focus causes us some concern. ESG factors are enormously important to both companies and investors but investors have as many different views on ESG matters as they do on remuneration issues or on company strategy. There is no single, correct view of ESG issues. It is also important to remember that ESG factors do not reflect a comprehensive view of companies' activities. Indeed, the focus on ESG factors in isolation could be a serious distraction from important issues that might be going on in a company.

We are therefore concerned that the revised definition of stewardship appears to include consideration of ESG factors in isolation, rather than as a risk factor to be taken into account when considering the future financial and non-financial performance of the company, as envisaged by the SRDII. SRDII is intended to encourage long-term shareholder engagement and it is within that context that it says "Greater involvement of shareholders in corporate governance is one of the levers that can help improve the financial and non-financial performance of companies including as regards environmental, social and governance factors ..." (paragraph 14 – our emphasis). We support the view that consideration of material ESG risks to the company should be integrated into stewardship activities as they can impact the long-term sustainability of the company and be a cause of serious value destruction. However, the revised Stewardship Code is drafted in a way that requires ESG factors to be taken into account as a distinct issue in its own right, rather than being considered as a potential risk to the company's future performance. For example, Principle E states 'Signatories must integrate stewardship with their investment approach...' and then it goes on to say '...and demonstrate how they take into account material ESG factors, including climate change.' Likewise, Provision 11, the Guidance to provision 9, and the Guidance to provision 13 all treat ESG as a separate 'add on' to stewardship activities.

Paragraph 3 c. of the Introduction to the Stewardship Code, setting out the key changes in the 2019 Code, explains that 'the new Code makes explicit reference to ESG factors' and that 'signatories are expected to take into account material ESG factors, including climate change, when fulfilling their stewardship responsibilities'. Again, ESG is treated as a factor in its own right that signatories must take into account rather than as a potential risk that could impact the long-term financial and non-financial performance of the company – as envisaged by SRDII. The paragraph also refers to a number of recent publications to support this focus on ESG factors, yet these reports make clear that the most significant aspect of ESG factors is controlling risk and that ESG factors should be taken into account when they are 'financially relevant to the company'. These reports focus is on sustainability, delivering better long-term performance, and protection against value destruction. This emphasis on integrating ESG considerations into stewardship as potential risks to the sustainability and long-term performance of the company is not reflected in the wording of the revised Stewardship Code.

### **Our preferred definition of stewardship**

It is our view that the definition of stewardship for the purposes of the Stewardship Code should revert to the previous definition focused on 'engaging issuers and holding them to account on material issues', and should be restricted to assets held in companies that are subject to the UK Corporate Governance Code. These assets are listed equity shares only, which represent ownership of the company and

provide the control rights discussed above. This will afford clarity for investors and companies, with clear meaningful and substantive alignment between the Stewardship Code and the Corporate Governance Code, helping investors to hold companies and their management teams to account for compliance with the Corporate Governance Code.

**Q2 Are there any particular areas which you consider that investors' effective stewardship should focus on to help improve outcomes for the benefit of beneficiaries, the economy and society (e.g. ESG outcomes, innovative R&D, sustainability in operations, executive pay)?**

Yes. We believe that the draft Stewardship Code does not place sufficient emphasis on engagement with investee companies, which we believe to be the most important stewardship activity. The Stewardship Code appears to have broadened the definition of stewardship to cover a huge range of factors, rather than concentrating on this key aspect.

The Kingman review's criticisms of the Code focussed on differentiating excellence in stewardship and focusing on outcomes and effectiveness, rather than policy statements, and that this focus should be supported by increased powers. In our view, the revised Code should focus on identifying clear forms of engagement, setting out what is/should be required or expected. For example, we believe that the Code should require investors to actively engage with a company prior to voting against the board recommendation on any resolution at a General Meeting and explain in advance, in writing, their reasons for their decision. This will also support the company's compliance with its obligation to understand the reasons for shareholder dissent.

**Q3 To what extent do the proposed key attributes capture what constitutes effective stewardship? Which attributes do you consider to be most important? Are there other attributes that we should consider?**

We believe the most important feature of effective stewardship is engagement. As discussed in our responses to Questions 1, 2 and 4, we believe the attempt to broaden the definition of stewardship beyond listed equity to include all types of investment, and to include consideration of ESG factors outside those that are financially material risks to investee companies, will be detrimental to effective stewardship in terms of the oversight of management. We believe stewardship should focus on a requirement that investors engage with companies, in particular prior to voting against a board recommendation on any resolution at a General Meeting.

**Q4 What do you think is the appropriate institutional, geographical and asset class scope of stewardship? How can challenges associated with issues such as the coordination of stewardship activities across asset classes, or the exercise of effective stewardship across borders, be overcome?**

**Other asset classes**

As indicated in our response to earlier questions, we do not agree with the scope of stewardship being extended beyond listed equity when considering stewardship as the oversight of management. We understand the FRC's wish to include other asset classes but believe this stems from the confusion over the definition of stewardship noted above.

As discussed above under Q1, fixed interest investments such as bonds are a debt (loan capital) whereas equity is a share in ownership of the company (share capital). There are different investment

objectives associated with investment in debt versus equity. Bonds, as debt, are lower risk but with a lower return, whereas equity is much higher risk but with potentially higher returns. Stewardship is only relevant to listed equity. Holders of Bonds do not own a share in the company; they are not impacted by share price movements; they are paid a fixed rate of interest and their investment capital is returned to them at the end of a set period of time. They do not have the control rights that shareholders have, to take action against the company such as voting at the AGM, requisitioning General Meetings, submitting resolutions and speaking at General Meetings, or proposing a change to board membership.

If other asset classes are to be included in the scope of stewardship, exercising control rights would need to be carried out alongside engagement in relation to listed equity – and this could only be done if the Bondholder was also an equity investor. It would also be necessary to ensure a joined up approach to engagement, through their Corporate Governance teams, and subsequent reporting. Currently, this does not happen as the limited engagement required by Bondholders is carried out through the company's Treasury team.

### **Geographical scope**

We support the broader geographical scope of UK stewardship, reflecting increasingly diversified investment across other jurisdictions by UK investors. However, it is important that there is significant discretion over how this would be undertaken. Asset managers should not be expected to undertake the same level of stewardship across all markets, recognising the differences across various markets.

**Q5 We welcome examples of how firms with different objectives and investment strategies approach stewardship. In particular, we welcome input on how stewardship practices differ across active and index-tracker funds, in the following areas.**

**Q5i: how firms prioritise and conduct stewardship engagements**

**Q5ii: what investments firms have made in stewardship resources**

**Q5iii: how stewardship activity is integrated with investment decisions**

We have not attempted to answer the three questions set out above as we believe it is for investors to respond to these questions.

**Q6 To what extent do you agree with the key barriers to achieving effective stewardship identified in the DP? What do you believe are the most significant challenges in achieving effective stewardship? We would particularly welcome views on the investment required to embed effective stewardship in investment decision-making.**

We note the observation under 5.26 of the DP (and elsewhere in the DP) over the activities of key service providers, in particular the role of proxy advisers. We also note the requirements for additional disclosures by proxy advisors required under the SRD II. However we do not believe the SRDII or the proposals in the revised Stewardship Code are sufficient to address the significant challenge of proxy advisers' activities in relation to achieving effective stewardship. We believe it is essential there is transparency over the use of proxy advisers and we have addressed this in more detail in our response to Question 8.

We have not attempted to make other observations about key challenges to effective stewardship within investment firms, nor on embedding effective stewardship in investment decision-making, as we believe these questions should be answered by investors.

**Q7 To what extent do you consider that the proposed balance between regulatory rules and the Stewardship Code will raise stewardship standards and encourage a market for effective stewardship?**

We support the ‘apply and explain’, and the ‘comply or explain’ approach to the Principles and Provisions of the Stewardship Code. We agree with the proposed balance between regulatory rules and the Stewardship Code. Our concerns focus on the scope and content of the revised Stewardship Code. In particular, we believe it is essential for effective stewardship that the Stewardship Code requires investors to engage with investee companies, and focus on listed equity.

**Q8 To what extent are there issues with proxy advisers that are not adequately addressed by SRDII and proposed revisions to the Stewardship Code?**

We recognise that the principal issue here is not with proxy advisers *per se*, but with those investors who follow their advice or recommendations without further review or, more importantly, without discussing concerns with the company. That said, a number of our members have expressed concern about the activities of proxy advisers including the lack of willingness on the part of some to engage with companies, or even provide a method of contact. This is a particular challenge for companies outside the FTSE 100. The problem becomes extreme in situations when both issues combine – when investors automatically follow a proxy adviser’s views without question *and* when the proxy adviser is unwilling to engage with the company.

There is much anecdotal evidence of problems in this area including about possible conflicts of interest associated with proxy advisers’ other activities, such as consultancy. ICSA will be liaising with companies over the 2019 AGM season to offer concrete examples to the FRC Corporate Governance team.

Proxy advisers are in a position of having a great deal of power and there is a risk that the lack of competition in the market means there is little impetus for change.

One way of dealing with these problems, and to ensure transparency, would be for investors who use proxy advisers to be required to disclose this. They should also make clear the basis on which they use their services, such as whether it is on an advisory basis or adoption of proxy advisors recommendations is a default position. In both cases, it is also important that the mechanism for going against proxy adviser recommendations is also disclosed.

It would also be helpful if proxy advisers were required to be explicit about their engagement policy and publish the results. We are aware that the separate FCA consultation on proposals to improve shareholder engagement includes a proposal for disclosure on the use of proxy advisers but we believe these proposals are too vague.

**Q9 We welcome views on:**

**Q9i: Whether and to what extent the FCA’s proposed rules for asset owners should be extended to SIPP operators?**

As this question deals with the internal operations of investment firms, we have not attempted to provide an answer.

**Q9ii: The case for regulatory rules to expand the reach of stewardship beyond listed equity**

As indicated in our response to earlier questions, we do not agree with the scope of stewardship being extended beyond listed equity when considering stewardship as the oversight of management. We understand the FRC's wish to include other asset classes but believe this stems from the confusion over the definition of stewardship – it is entirely appropriate to do so when considering stewardship as the allocation of client assets.

As discussed above, holders of Bonds and other fixed-interest assets are not owners of the investee company and, therefore, do not have control rights. They are paid a fixed rate of interest and their investment capital is returned to them at the end of a set period of time. They do not have the same rights as shareholders to take action, such as by voting at the AGM, requisitioning General Meetings, submitting resolutions and speaking at General Meetings, or proposing a change to board membership. There are different investment objectives associated with investment in debt versus equity. Bonds, as debt, are lower risk but with a lower return, whereas equity is much higher risk but with potentially higher returns.

**Q9iii: Whether there is a role for UK regulators in encouraging overseas investors to engage in stewardship for their asset holdings in the UK**

Where other jurisdictions apply their own stewardship code, we do not believe it would be appropriate to attempt to apply the UK regulatory framework to overseas investors in UK-issued assets. Overseas investors should apply their own stewardship codes. However, in jurisdiction where no stewardship code exists, we believe it would be helpful for overseas investors to be encouraged to follow the UK Stewardship Code in relation to their stewardship of UK listed companies. We would also encourage an alignment of codes across all jurisdictions, including the US and Japan, to provide for common standards across all jurisdictions.

**Q9iv: The extent to which additional rules might be necessary either to improve stewardship quality or prevent behaviours that might not be conducive to effective stewardship**

We support the 'apply and explain' and 'comply or explain' approach to stewardship in the revised Stewardship Code, and believe this is preferable to implementing additional rules. However, we believe investment firms are best placed to comment on any rules that regulate the internal operations or behaviours of investment firms.

**Q9v: For differences between active and index-tracker strategies in the practice of stewardship, whether there are particular regulatory actions we should consider to address any perceived harms.**

Again, this question deals with the internal operations of investment firms, so we have not attempted to provide an answer.

**Q9vi: Whether the FCA's proposed rules to implement certain provisions of SRDII should apply on a mandatory, rather than 'comply or explain', basis.**

We support the approach of rules to implement the baseline regulatory requirements of SRDII, with other areas being effected on a 'comply or explain' basis through the Stewardship Code. However, we have concerns over areas of the Stewardship Code that go beyond the requirements of SRDII such as the inclusion of other asset classes, in addition to listed equity, and the additional emphasis on ESG factors to be considered in isolation, rather than as an element of financial and non-financial risks to the company as envisaged by SRDII.

**Q10 We welcome feedback on whether, to support effective stewardship, we should consider amendments to other aspects of the regulatory framework that affect how investors and issuers interact (such as the LRs, PRs and DTRs)?**

We believe the Stewardship Code, underpinned by a 'comply or explain' provision for certain financial services firms in the FCA's Conduct of Business Rules, is the best framework to support effective stewardship. However, the definition of stewardship, and the content and scope of the Stewardship Code is key to achieving this. As discussed in Question 1 above, one of the most important aspects of effective stewardship is engagement, and the expectations on engagement set out in the revised Stewardship Code are too low. It is important that there is alignment of scope and responsibilities between the Stewardship Code and the UK Corporate Governance Code, so that investors can hold companies to account for compliance with the Corporate Governance Code. Our concern is that, as currently drafted, and with the revised definition of stewardship, the Stewardship Code will increasingly diverge from the Corporate Governance Code, rendering compliance with the Stewardship Code less helpful in terms of holding companies to account for their governance arrangements.

We hope you find our comments helpful and would be happy to expand on any of these points should you wish to discuss them further.

Yours sincerely

**Peter Swabey**  
**Policy & Research Director**  
pswabey@icsa.org.uk