

February 2018



**Response to FRC Stewardship Code
Pre-Consultation Questions**
Steering Group of The Purposeful Company

Submission context

This document sets out the response of the Steering Group of The Purposeful Company Taskforce to the pre-consultation questions on the Stewardship Code ('the Code'), issued by the Financial Reporting Council ('FRC') as part of its consultation on a revised UK Corporate Governance Code. These responses should be read in conjunction with our paper [FRC Review of the Stewardship Code: Thoughts for Change](#) ('Thoughts for Change') which sets out in detail our thoughts on a revised Stewardship Code.

In terms of terminology, in this paper we define:

- *Asset managers* as fund management companies (e.g. Fidelity).
- *Funds* as individual funds (e.g. Fidelity Special Situations).
- *Asset owners* or *savers* as ultimate owners (e.g. a university endowment or a retail investor).
- *Service providers* as investment consultants or proxy voting agencies (e.g. Aon Hewitt or ISS).

When talking about a generic actor in the investment chain, we use the term 'investment chain entity'.

Question responses

Question 17 – Should the Stewardship Code be more explicit about the expectations of those investing directly or indirectly and those advising them? Would separate codes or enhanced separate guidance for different categories of the investment chain help drive best practice?

We believe that it is essential that the Stewardship Code applies explicitly to all investment chain entities, including asset owners, asset managers, proxy advisors, and investment consultants. Creating a market for stewardship is likely to be significantly more effective than attempting to legislate stewardship through regulation, and requires the entire investment chain to take stewardship seriously. For example, asset managers may only perform the minimum level of stewardship required by regulation unless investment consultants and asset owners emphasise stewardship when awarding or recommending mandates. To improve stewardship quality, it is therefore important to consider how all participants in the chain act together to deliver stewardship. Simply improving standards in one part of the chain – for example asset managers – will deliver suboptimal results.

The current Code has, in our view, led to improvements in stewardship quality amongst asset managers, but it is overwhelmingly focused on that part of the investment chain. Only a minority of asset owners are signatories, and the Code does not focus on the aspects of stewardship most relevant to asset owners or service providers. We also believe that it is important that proxy advisors are brought under the remit of the Code more explicitly, and their role in the delivery of stewardship recognised. [Evidence from the US and UK](#) suggests that, for example, ISS voting recommendations have a causal impact on voting outcomes of 10% to 25% points, suggesting that some asset managers are outsourcing stewardship decisions to proxy advisors. Therefore, their operational models, analytical methods, and recommendation approaches should be subject to scrutiny and meaningful stewardship standards.

There is a view that service providers should not be elevated into having stewardship roles by including them under the Code. We understand this approach and are firm of the view that the Code should clearly and unambiguously attribute stewardship responsibilities to asset managers and asset owners. However, the reality of the market is that service providers of various types play a very material role in how stewardship is conducted. Therefore, including them within the Stewardship Code provides an opportunity to address in an integrated way their role in helping clients deliver stewardship.

The implementation of the EU Shareholder Rights Directive ('SRD') provides both an opportunity and risk. The SRD requires covered investment chain entities to make certain disclosures on a comply-or-explain basis and requires proxy advisors to follow a code of practice. The UK Government should set out in regulation that the Stewardship Code is the relevant code for all entities. This provides the opportunity to create a unified approach to encouraging better stewardship standards across the investment chain through an integrated Code, which can be a tool for continuous improvement in practices over time. The risk is that if this is not done, then different types of entity will apply different codes subject to reviews of different standards, which will substantially lessen the opportunity for driving up stewardship standards in an integrated way across the investment chain. In practice, the different codes would be reviewed according to varying criteria across different timeframes, and the quality of stewardship will depend on the weakest link in the chain. By creating an integrated Code as part of this review, the FRC will create the opportunity for the Government to use the SRD to encourage a step-change in stewardship quality, and a mechanism, through a single Code, for driving continuous improvement over time.

We would note that the decision to use an integrated Code is separate from the decision as to where regulatory oversight is located. Different regulators or legislation could all point to a single Code, overseen by the FRC. Therefore, code unification does not necessarily require unification of regulatory oversight, although there may be advantages to that.

Question 18 – Should the Stewardship Code focus on best practice expectations using a more traditional 'comply or explain' format? If so, are there any areas in which this would not be appropriate? How might we go about determining what best practice is?

As we describe in Thoughts for Change, there is a wide variety of investment styles, which implies different approaches to stewardship. For example, some may engage in activism, others may conduct detailed in-house research to guide their voting, and others still will analyse a firm's intangible assets and long-run growth prospects to base their retain versus sell decisions on these factors rather than short-term earnings. Therefore, care needs to be taken that use of "best practice expectations" does not have the unintended consequence of assuming a one-size-fits-all approach.

However, we do agree that the Code should move from an emphasis just on disclosure to the implementation of meaningful principles on an 'apply and explain' basis, supported by 'comply or explain' provisions. Those provisions should demonstrate that the principles are applied in a manner tailored to the entity's particular stewardship approach, rather than promoting a particular one-size-fits-all approach to stewardship.

We believe that a Code could have three principles, which have equal applicability across all investment chain entities regardless of their strategy.

Figure 1: Proposed principles

Principles	
Overarching principle	A signatory to the Code should be able to demonstrate how it implements, or help clients to implement an approach to investment that improves sustainable company performance.
A. Defining the approach to stewardship	An investment chain entity should clearly define the role of, and approach to, stewardship in meeting its purpose
B. Implementation of stewardship	An investment chain entity should establish governance, processes, and incentives to support its stated approach to stewardship, including identification and management of conflicts of interest
C. Reporting on the delivery of stewardship	An investment chain entity should clearly disclose its approach to stewardship and how it has been implemented in practice, including outcomes, in a manner that enables its clients and other stakeholders to judge the effectiveness of the approach in improving sustainable company performance.

The Code currently focuses on stewardship reporting. A revised Code should focus more stewardship delivery – on how stewardship is practically implemented within an organisation, through resourcing, integration into the investment process, aligning remuneration, and so on. This would help ensure that stewardship is not just a policy, but a practice.

Question 19 – Are there alternative ways in which the FRC could highlight best practice reporting other than the tiering exercise as it was undertaken in 2016?

Improving stewardship standards substantially requires the development of market demand for stewardship. This requires reform that goes beyond the Code, but the Code can play an important part of highlighting to all investment chain entities their stewardship responsibilities. Moreover, reporting provides an important mechanism to enable investment chain entities to hold each other to account. The focus of the FRC’s efforts in relation to reporting should, therefore, be to encourage reporting that facilitates a market for stewardship.

The FRC could make three contributions to support high-quality stewardship:

- Reviewing stewardship reports for coverage of required information, including a qualitative component linked to how well the reports demonstrate how the firm is fulfilling its stated stewardship approach. This could include random checking of fund documentation (see response to Q31).
- Producing an annual reporting review, including case studies of best practice stewardship reporting to provide aspirational examples.
- Developing frameworks for describing stewardship and supporting terminology for stewardship types and activities. This could be developed into standardised reporting templates enabling firms to describe their approach to stewardship in a way that is comparable and consistent across entities, to support market transparency for their clients and beneficiaries.

The FRC could consider focusing their review activity in two ways:

- Adopting a proportionality regime that tiers asset owners, asset managers, and service providers by reference to size and/or market share. Signatories in the highest tier could be subject to more pro-active review of reporting quality by the FRC.
- Rather than tiering all firms, the FRC could create a Tier status that firms must apply for, subject to fulfilling certain requirements in relation to transparency, quality of reporting, and independent review of the rigour with which stewardship has been embedded. Such an approach would lead to these high tiers having to be earned through exceptional practice, rather than being a default that is only lost through red flags. The FRC should also continue to emphasise that the Tier status is only certification of stewardship reporting, rather than stewardship delivery. There is anecdotal evidence that asset owners and investment consultants believe they can fulfil their stewardship responsibilities by simply selecting asset managers in Tier 1.

The FRC could also develop a series of market participant studies on stewardship quality. This could involve asking participants in the investment chain to assess each other on a series of engagement and stewardship quality criteria. Such '360-degree feedback', if carefully conducted, could provide a way to help identify issues and drive up standards across the investment chain. We note that there are risks with this approach. For example, corporate views of what constitutes good stewardship may differ from approaches that are in the interests of beneficiaries. Companies may rate dissenting investors as poor stewards, even if the investors have formed their opinion after extensive discussions with companies. Alternatively, asset managers may seek to deflect blame for stewardship deficiencies onto service providers. Therefore, we would recommend any such activity be carried out in a spirit of learning and improvement, which may in the first instance involve the FRC publishing general findings, while sharing specific findings with firms. This would also provide a basis on which the FRC could challenge firms as to their implementation of stewardship. Publication of findings could be considered by the FRC once market confidence had been built in the approach.

Question 20 – Are there elements of the revised UK Corporate Governance Code that we should mirror in the Stewardship Code?

Four aspects of the revised UK Corporate Governance Code could be reflected in the Stewardship Code:

- The principles-based approach, with an emphasis on explaining how the principles have been applied, with less emphasis on a tick-box list of comply-or-explain provisions.
- A strong focus on aligning corporate governance with purpose, strategy and culture.
- Increased emphasis on broader stakeholder considerations.
- Alignment of remuneration with strategy and culture, in particular, in relation to stewardship and investment approach.

Of course, those asset managers that are UK listed entities will be subject to the UK Corporate Governance Code directly, as well as potentially being signatories to the Stewardship Code.

We have already described the importance of an approach based on the delivery of stewardship, which emphasises the need for firms to set out clearly their approach to stewardship and how their

organisation, governance, and processes align with this. This is vital for the market for stewardship to operate effectively. It is easy to see how principles in the revised UK Corporate Governance Code under Section 1 – Leadership and purpose, and Section 2 – Remuneration, could be very relevant in this context, although they would require adaptation to be applicable to the Stewardship Code. Moreover, the way in which the Board Effectiveness Guidance has developed as a handbook to implementing the Code could also be a useful precedent for a similar document to help various investment chain entities think through how they could meet their Stewardship Code responsibilities.

Question 21 – How could an investor’s role in building a company’s long-term success be further encouraged through the Stewardship Code?

We believe that it is key for investment chain entities to understand that it is in their own interest to build up a company’s long-term success. Such an understanding will ensure that entities undertake stewardship through voluntary commitment, rather than compliance to a code. Yet the Code still has a major part to play in generating this commitment, through requiring entities to explain the role stewardship plays in their investment approach and to demonstrate how this is practically achieved. In particular, we are suggesting an overarching principle that a signatory to the Code should demonstrate how it implements, or help clients to implement an approach to investment that improves sustainable company performance. We are also suggesting a reorientation of the Code away from reporting of principles to demonstrating how these principles are applied, using a combination of apply-and-explain and comply-or explain. This, in turn, encourages entities to think through, and be transparent about their approach, and in this way create the opportunity for all investment chain entities to hold each other to account. This aim will also be supported by tailoring the Code to be relevant to the various types of investment chain entity.

In this context, we think it is helpful for firms to be encouraged to describe how they take longer-term factors, such as ESG criteria or intangible assets, into account in their investment approach. However, we do not believe that the Code should pre-suppose which factors asset owners or asset managers take into account, as this will be specific to the purpose of individual entities.

While generating a market demand for stewardship is the surest way to improve stewardship practice, aligning incentives is also very important. Even in an environment where the benefits of stewardship were understood, and high standards of stewardship were demanded, misaligned incentives could undermine stewardship – in particular, if they were based on short-term performance. Incentives operate both at the individual level, in terms of asset manager or asset owner pay, but also at the institutional level, in terms of fee arrangements for asset managers and service providers. We are proposing that alignment of incentives to stated approach to stewardship should be included as a requirement in the Code, and the FRC could helpfully develop guidance in this area to complement existing regulatory requirements under the EU Directives UCITSV and AIFMD.

Question 22 – Would it be appropriate to incorporate ‘wider stakeholders’ into the areas of suggested focus for monitoring and engagement by investors? Should the Stewardship Code more explicitly refer to ESG factors and broader social impact? If so, how should these be integrated and are there any specific areas of focus that should be addressed?

As set out in our approach to Q20, we believe it is appropriate for shareholders to set expectations for how they expect their investee companies to take into account wider stakeholder considerations as part

of fulfilling their section 172 obligations, and their view on how this contributes to business sustainability. This is, in part, because considering other stakeholders is important in the creation of long-term shareholder value. However, it should be down to individual investors how they set these expectations. The stakeholder considerations that are material will likely differ from company to company, and even within the same company over time.

Given the variety of stewardship approaches and investment styles, it would be dangerous to be prescriptive. For example, a requirement to use ESG factors in investment decision-making may result in tick-box usage of ESG-screening tools, rather than meaningful engagement.

Question 23 – How can the Stewardship Code encourage reporting on the way in which stewardship activities have been carried out? Are there ways in which the FRC or others could encourage this reporting, even if the encouragement falls outside of the Stewardship Code?

The principles should make it clear that reporting needs to explain how stewardship has been carried out and how the firm's governance and processes, including incentives, support its approach to stewardship. The Stewardship Code could provide reporting guidance to this effect. Our response to Q19 sets out ways in which the FRC could encourage this through its tiering and review activities, as well as through the development of reporting frameworks.

Given the range of investment styles, and hence stewardship approaches that may be adopted by different funds operated by a single asset manager, there is a danger that stewardship reporting at the asset manager level become generic or boiler plate. Asset owners buy funds, not asset managers. As we set out in Thoughts for Change, while overall stewardship reporting should continue to operate at the asset manager level, there should also be appropriate reporting at the fund level to show how stewardship supports that fund's investment objectives. This will create transparency to asset owners at the fund level. To minimise the reporting burden, the fund's stewardship approach can cross-reference the asset manager's overall approach.

We note that implementation of the Shareholder Rights Directive also creates the opportunity to create a regulatory underpinning to Code reporting requirements, and we recommend liaison with Department for Business, Energy & Industrial Strategy (BEIS) to try to ensure that the Code can form the single point where requirements for all investment chain entities are captured.

Question 24 – How could the Stewardship Code take account of some investors' wider view of responsible investment?

We believe that signatories to the Code should consider their stewardship approach across asset classes. For example, debt investors engage with companies, albeit without the voting rights of shareholders. Nonetheless, signatories to the Stewardship Code should consider how their stewardship responsibilities apply to debt holdings/funds. This is more complicated for engagement since debt investors benefit from downside protection rather than growth, innovation, and investment in intangible assets. However, a unified approach may be easier for monitoring – for example, consideration of ESG criteria may be applicable to both debt and equity investments. Multi-asset entities should consider their stewardship responsibilities in aggregate, in particular, how they apply for debt holdings and the extent to which they are similar to or different from their application to equity holdings.

Question 25 – Are there elements of international stewardship codes that should be included in the Stewardship Code?

We have not undertaken a comprehensive review of international stewardship codes. However, the Principles 1 and 7 of the Canadian Coalition for Good Governance stewardship code and Principles 1 and 6 of the International Corporate Governance Network (ICGN) stewardship code both contain useful themes in relation to:

- Establishing a stewardship approach;
- Aligning the firm's governance and processes (including remuneration) to the stated stewardship approach; and
- Encouraging a long-term approach to sustainable investment.

The ICGN principles also contain a section on the ecosystem of stewardship, which seeks to draw out some of the connections between different entities within the investment chain. We believe that this connectivity is an important part of any revised Code, and believe it should be developed to a greater level of specificity, as set out in Thoughts for Change.

As noted in the FRC's consultation document, the consultation on the Dutch Stewardship Code includes the use of stock lending. In Thoughts for Change, we recommend that entities disclose their stock lending policy. In The Purposeful Company Policy Report¹, we recommended that voting with borrowed stock be restricted to blockholders. However, we would suggest that such a provision would be better implemented through regulation than through the Code, else signatories felt they were being put at a commercial disadvantage.

Question 26 – What role should independent assurance play in revisions to the Stewardship Code? Are there ways in which independent assurance could be made more useful and effective?

Large firms subject to financial services banking regulation are required to undertake an independent review of their compliance with the regulation. The Stewardship Code could include a principle relating to the independent review. This could involve the use of internal audit or an independent third party periodically to review application of the firm's approach to stewardship and reporting, together with a statement as to when such a review was last undertaken and its findings. This could also be framed in a way similar to board effectiveness reviews under the UK Corporate Governance Code. We would suggest application of a proportionality threshold for this requirement, based for example on funds under management. As highlighted in our response to Q19, the FRC could adopt a highest Tier of signatory that operated by application – firms applying for the highest Tier would be required to undertake an independent evaluation of their implementation of stewardship and to report on this.

Question 27 – Would it be appropriate for the Stewardship Code to support disclosure of the approach to directed voting in pooled funds?

¹ http://www.biginnovationcentre.com/media/uploads/pdf/TPC_Policy%20Report.pdf

Yes. In general, the Stewardship Code should support initiatives to provide transparency on voting approaches, to enable all investment chain entities fully to understand how stewardship obligations are being fulfilled in voting.

Question 28 – Should board and executive pipeline diversity be included as an explicit expectation of investor engagement?

and

Question 29 – Should the Stewardship Code explicitly request that investors give consideration to company performance and reporting on adapting to climate change?

While there is evidence that considering other stakeholders ultimately improves long-run shareholder value, the stakeholder considerations that are material will differ significantly from company to company. As a result, we are cautious about mandating within the Code that entities include particular factors, such as diversity and climate change, in their approach. This runs the risk of assuming a one-size-fits-all approach to stewardship and could encourage a tick-box approach to disclosure. The emphasis should be on requiring entities to define what stewardship means for them and then to report against how they deliver it.

Indeed, if the Code revision were seen as a way to pursue wider public policy interests in a way that undermines saver interests (because they advocate the consideration of factors that reduce long-term returns in certain settings), this may be fatal to its credibility. If a majority of asset managers felt that measures were being imposed through the Code that were damaging to their interests, then the Code would immediately lose credibility. A situation where it became the norm for asset managers not to comply with several Code provisions would undermine its legitimacy. This would suggest that very specific quasi-regulatory provisions where there is neither evidence for their widespread efficacy nor asset manager or saver support should not be implemented via the Code.

However, as set out in response to Q19, there may be scope for developing a standards taxonomy of stewardship approaches and considerations, which could lead to standardized templates outlining stewardship approaches. If developed with care, and in a way that retains flexibility, such templates and taxonomy could be helpful to clients in assessing the approach to stewardship of different entities. Aspects such as diversity and ESG could be relevant within those taxonomies.

Question 30 – Should signatories to the Stewardship Code define the purpose of stewardship with respect to the role of their organisation and specific investment or other activities?

Yes. This is essential. As noted in our response to Q17, every investment chain entity should be required to define their approach to stewardship, organise in a way that supports that approach to stewardship, and report on how they have delivered stewardship in line with their stated approach. Starting first with purpose, and defining stewardship in the context of purpose, will help ensure that stewardship is undertaken out of intrinsic commitment rather than regulatory compliance.

Note that the word ‘purpose’ does not refer to any moral obligation, although a fund could have social or ethical objectives. Purpose reflects a broader notion than a fund’s ‘objective’, which typically contains only quantitative dimensions and/or is generic (e.g. ‘to generate long-term capital appreciation’) –

instead, purpose will describe how a fund intends to generate long-term capital appreciation and explain the role, if any, that stewardship plays in this.

A sample statement of purpose, and approach to stewardship, follow below. This aims to show how an approach to stewardship can be tightly linked to purpose, yet remain separate and so there is value in defining both:

Purpose: “To create long-term real returns over the long term with lower than average volatility by investing in companies with high-quality intangible assets generating high return on capital.”

Approach to stewardship: “We believe that focus on short-term profit measures can discourage revenue investments (such as marketing, people, and innovation) and that drive long-term returns. We, therefore, focus on investing in companies with a strong record of sustaining high returns on capital with organic growth, through maintaining strong brands and other hard-to-replicate intangible assets. We engage actively with management teams to encourage focus on building intangible assets through revenue as well as capital investments, with a focus on organic rather than inorganic growth. We will exit investments where these principles cease to be followed and engagement with management fails to produce change.”

Question 31 – Should the Stewardship Code require asset managers to disclose a fund’s purpose and its specific approach to stewardship, and report against these approaches at a fund level? How might this best be achieved?

Yes. Different funds have different objectives and as a result, stewardship may play a very different role across funds within the same asset manager. Without appropriate transparency at the fund level, it will be very difficult for clients to hold funds to account on their stewardship obligations. However, to minimise the reporting burden, it should still be the asset manager that is the Stewardship Code signatory. The fund level documentation should then briefly set out particular aspects of how the firm-wide approach is applied at the fund level and any deviations from the firm-wide approach and processes.

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February 2018**

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February 2018



FRC's Review of the UK Stewardship Code
Thoughts for Change from the Steering Group
of The Purposeful Company

1. Submission Context

Central to the Government's agenda following the General Election is to 'forge an economy that works for everyone in every part of this country' and at the same time to address the productivity shortfall in the UK economy. The entire investment chain – asset managers, asset owners, and service providers (e.g. investment consultants and proxy advisors) – has a critical role to play in achieving these goals:

- **Asset managers**, through effective stewardship – both engagement and monitoring – can ensure that companies pursue long-term shareholder value rather than short-term profits. By doing so, asset managers can both fulfil their fiduciary duty to their clients – asset owners and savers – and improve the long-term performance of British companies.
- **Asset owners**, through holding asset managers to account on the delivery of their stated approach to stewardship, can ensure that stewardship is not simply a policy but a practice. Asset owners are the ultimate 'regulator' of asset managers by awarding mandates, and they are critical to encouraging asset managers to take stewardship seriously. A market for stewardship will be more effective than attempting to legislate stewardship through regulation.
- **Service providers** should similarly support asset managers in fulfilling their fiduciary duty to asset owners. For example, investment consultants should help asset owners evaluate asset managers on long-term investment performance and the delivery of stewardship.

There are currently widespread concerns that the UK investment management industry is failing to steward the companies it owns for the long-term, leading to perceptions that it has an excessively short-term focus and, as a result, that UK corporations are 'ownerless'. These concerns are serious and threaten the industry's legitimacy, in turn leading to calls to reduce shareholders' influence over firms in favour of employee or customer influence, or insulate management against shareholder oversight. Stewardship not only is central to the legitimacy of the UK investment management industry, but also can improve UK productivity, profitability, investment, and competitiveness – thereby transforming the UK into a 'country that works for everyone'.

A review of the FRC's Stewardship Code (the 'Code') is scheduled for 2018. This is a particularly opportune time to improve stewardship. Good stewardship underpins a key pillar of the Government's proposed Industrial Strategy, 'supporting businesses to start and grow'. A number of components of the stewardship ecosystem are already under review in light of the FCA Asset Management Market Review, the review of the Best Practice Principles for Providers of Shareholder Voting Research & Analysis, the required implementation of the EU Shareholder Rights Directive, and the Competition and Markets Authority Review of Investment Consultants. An integrated approach is required to achieve the best results, and so while the focus of this paper is the FRC's review of the Code, we also highlight connections to other areas of regulation or oversight of the investment chain.

A revised Code should be based on the most rigorous evidence. There is a huge range in the quality of evidence and it is almost always possible to find a study that supports a particular viewpoint. Thus, it is important to focus on the highest-quality evidence, published in the most rigorous peer-reviewed journals, and in many cases distinguishing causation from correlation. A consistent conclusion is that, in the long-run, there is no conflict between a model that seeks to maximise value for shareholders and one that creates value for all stakeholders.

The Purposeful Company is uniquely placed to provide input into this redraft. Its Taskforce has brought together businesses, investors, academics, consultants, and think tanks to develop policies to help transform British business with purposeful companies committed to creating long-term value through serving the needs of society. To reflect the heterogeneity of approaches to stewardship, we have sought the views of a wide range of investors and their representative bodies, pursuing different approaches to and levels of stewardship.

2. Defining Stewardship

Stewardship means different things to different people. For example, International Corporate Governance Network's Global Stewardship Principles¹ state that:

“Stewardship can be defined in general terms as the responsible management of something entrusted to one’s care. This suggests a fiduciary duty of care on the part of those agents entrusted with management responsibility to act on behalf of the end beneficiaries.”

The Canadian Coalition for Good Governance² argues:

“Stewardship for institutional investors means fulfilling their responsibilities as fiduciaries in meeting their obligations to their beneficiaries or clients. Stewardship is intended to enhance the long-term sustainable creation of value, so companies and their investors can prosper and, in the process, benefit the market and society as a whole.”

Similar sentiments are expressed by Tomorrow's Company³:

“The active and responsible management of entrusted resources now and in the longer term so as to hand them on in better condition.”

These definitions start with the role of stewardship as creating obligations to end beneficiaries. The UK Stewardship Code⁴ starts instead with the company and the role of stewardship in promoting its success:

“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. In publicly listed companies responsibility for stewardship is shared. The primary responsibility rest with the board of the company, which oversees the actions of its management. Investors in the company also play an important role in holding the board to account for the fulfilment of its responsibilities.”

The EU Shareholder Rights Directive⁵ also emphasises the role of stewardship in holding companies to account and improving their performance:

“Institutional investors and asset managers are often important shareholders of listed companies in the Union and can therefore play an important role in the corporate governance of those companies, but also more generally with regard to their strategy and long-term performance. However, the experience of the last years has shown that institutional investors and asset managers often do not engage with companies in which they hold shares and evidence shows that capital markets often exert pressure on companies to perform in the short term, which may jeopardise the long-term financial and non-financial performance of companies and may, among other negative consequences, lead to a suboptimal level of investments, for example in research and development, to the detriment of the long-term performance of both the companies and the investors.”

Despite their different starting points, there is substantial overlap between these definitions, because end beneficiaries gain from improving the long-term performance of investee companies. The beneficiary-focused definition arguably goes beyond the company-focused definition, as it encompasses activities such as choosing not to invest in companies with poor environmental, social,

¹ <https://www.icgn.org/sites/default/files/ICGNGlobalStewardshipPrinciples.pdf>

² https://admin.yourwebdepartment.com/site/ccgg/assets/pdf/stewardship_principles_public.pdf

³ <https://tomorrowcompany.com/publication/better-stewardship-an-agenda-for-concerted-action/>

⁴ <https://frc.org.uk/investors/uk-stewardship-code>

⁵ <http://www.consilium.europa.eu/en/press/press-releases/2017/04/03/shareholder-rights-eu-companies/>

and governance ('ESG') standards. On the other hand, the latter goes beyond the former in that it argues that stewardship is not simply implementing good investment practice, but can play an active role in improving the performance of investee companies.

A number of common themes come out of these definitions:

1. Stewardship must be seen in the context of creating benefits for ultimate beneficiaries.
2. Stewardship can improve the long-term performance of companies.
3. Stewardship may have spill-over benefits into society as a whole.

Point 1 is required, because without a benefit for ultimate beneficiaries, there is no case for asset owners or asset managers to devote resources to stewardship. Thus, no market for stewardship will develop, and stewardship may remain an activity undertaken for regulatory compliance rather than out of intrinsic commitment. The benefit can come from point 2, or from beneficiaries' non-financial goals. Point 3 creates a case for regulatory intervention to increase levels of stewardship above that naturally arising in the market. For example, stewardship by one shareholder generates benefits to all other shareholders, which the first shareholder does not capture.

The Code should focus, as today, on the interface between beneficiaries and companies, as intermediated by asset owners and asset managers, and facilitated by service providers. It is this interface, and the role that asset managers and asset owners have in improving long-term company performance, that lies at the heart of concerns about investor behaviour and is where confidence needs to be rebuilt. It is also the area of stewardship most relevant to promoting purposeful companies acting for the long-term to the benefit of the UK economy.

For the purposes of the Stewardship Code, we therefore define stewardship as follows:

For the purposes of the Code, stewardship involves an approach to investment that improves sustainable company performance.

Note that under this definition, not all investors undertake stewardship. Momentum or arbitrage investors, or index funds that undertake no engagement or voting activity, would not count as exercising stewardship. This does not mean that they serve no beneficial purpose in financial markets. On the contrary, they may aid liquidity, improve market efficiency, or provide savers with low-cost access to equity markets. Effective and efficient functioning of financial markets aids capital allocation and provides benefits to the economy overall. However, such investors do not engage in stewardship.

A separate advantage of this definition of stewardship is that it applies to debt as well as equity investors.

3. The Evidence for Stewardship

The advantage of our focused definition of stewardship is that it enables an evidence-based approach to design of the Stewardship Code. The Code should seek to promote approaches to investment that improve the long-term value of investee companies. Extensive evidence exists on how stewardship creates such value.

Stewardship may be “generalised”, applied on a standardised basis across companies, for example, such as engagement on ESG issues. Standardisation makes generalised stewardship relatively low-cost to implement. The risk is that it is subject to one-size-fits-all approaches and out-sourcing to proxy voting agencies or ESG index providers. As such, they can be a blunt instrument and not optimised to individual company circumstances. Indeed, this is one of the frustrations companies experience when faced with market-wide generalised approaches to stewardship. Alternatively, stewardship may be “specialised”, involving company-specific analysis or engagement.

Both generalised and specialised stewardship may be undertaken via engagement/voice, or monitoring/trading - the sale, threat of sale, or additional purchases. (Note that governance through “trading” is often referred to as governance through “exit”; we use “trading” here since it can involve buying as well as selling securities). The two mechanisms may be particularly powerful if used in tandem: the power of voice is enhanced by the threat of exit.

A brief summary of the evidence for the value of stewardship is as follows. The first three points focus more on generalised stewardship, the last three on specialised stewardship:

- Market-wide improvements in generalised stewardship, such as the passage of say-on-pay laws, laws that strengthen governance (such as Sarbanes-Oxley), and the implementation of superior governance practices by index funds, improves firm value and profitability.⁶
- Along the cross-section, firms with strong corporate governance - in particular, strong shareholder rights - outperform their peers.⁷
- Over the time series, improvements in corporate governance (such as strengthening shareholder rights and implementing long-term compensation) have a positive causal effect on long-term stock returns and profitability.⁸
- Blockholders are positively correlated with a number of measures of firm value, profitability, and investment, attributed to the role they play in specialised stewardship of those companies. In addition, trades of blocks between investors lead to significant increases in value, consistent

⁶ Correa, Ricardo and Ugur Lel (2016): ‘Say on Pay Laws, Executive Compensation, Pay Slice, and Firm Valuation Around the World’, *Journal of Financial Economics*; Chhaochharia, Vidhi and Yaniv Grinstein (2007): ‘Corporate Governance and Firm Value: The Impact of the 2002 Governance Rules’, *Journal of Finance*; Appel, Ian, Todd Gormley, and Donald Keim (2016): ‘Passive Investors, Not Passive Owners’, *Journal of Financial Economics*.

⁷ Gompers, Paul, Joy Ishii, and Andrew Metrick (2003): ‘Corporate Governance and Equity Prices’, *Quarterly Journal of Economics*; Masulis, Ronald, Cong Wang, and Fei Xie (2007): ‘Corporate Governance and Acquirer Returns’, *Journal of Finance*; Giroud, Xavier and Holger Mueller (2011): ‘Corporate Governance, Product Market Competition, and Equity Prices’, *Journal of Finance*; Bebchuk, Lucian, Alma Cohen, and Charles Wang (2013): ‘Learning and the Disappearing Association Between Governance and Returns’, *Journal of Financial Economics*. The final paper shows that corporate governance continued to be significantly correlated with firm value and operating performance in the 2000s, but the relationship with stock returns disappeared because investors now understand the value of governance and it became priced in.

⁸ Cuñat, Vicente, Mireia Gine, and Maria Guadalupe (2012): ‘The Vote is Cast: The Effect of Corporate Governance on Shareholder Value’, *Journal of Finance*; Flammer, Caroline and Pratima Bansal (2017): ‘Does a Long-Term Orientation Create Value? Evidence From a Regression Discontinuity’, *Strategic Management Journal*.

with stewardship by the right blockholder (e.g. with expertise in the firm's industry) adding value.⁹

- Engagement by activist investors improves firm value, productivity, and innovation, demonstrating the value of governance through voice. In addition, the presence of a large investor is associated with improved firm value and profitability, even if is not exercising control – consistent with governance through trading. Relatedly, mutual funds earn higher returns when they trade more, contrary to views that high turnover is an undesirable characteristic of a fund.¹⁰
- The evidence on governance through voice by other categories of investor is more mixed, and inconclusive as to whether widespread engagement of this type is effective. It may simply be that others investors' expertise does not lie in engagement, and so forcing all investors to engage may lead to unintended consequences (e.g. outsourcing to proxy agencies). Moreover, even for activist investors with expertise in engagement, the firm value improvement is higher when such engagement achieves a concrete outcome (such as a leadership change, change in strategy and so on) rather than less intentional engagement.

This evidence suggests that both engagement/voice and monitoring/trading, if used correctly, can significantly improve long-term firm value. In particular, blockholders, due to their large stakes, have incentives to bear the costs of engagement (overcoming the free-rider problem), and also gather information about a firm's long-term value to guide their trading decisions. Since UK shareholder structure is fragmented, methods for mimicking blockholders, perhaps through emphasising collective engagement, should be given high priority.

The research evidence gives rise to some important conclusions for the types of stewardship that should be promoted.

- Even if a blunt instrument, generalised stewardship that improves overall governance standards in the market is generally positive for value.
- Strong engagement by activist investors – often maligned for being short-term – can create beneficial long-term results.
- Blockholders help support firm value and profitability, suggesting that collective engagement mechanisms can be an important area of focus.
- Investors monitoring companies for long-term value considerations and providing discipline through exit (or threat of exit) and purchase (or prospect of purchase) are powerful instruments of good stewardship.
- However, there is little evidence that mere engagement 'activity' creates value, particularly if it is not intentional or if it is undertaken by investors who have little skin-in the game or expertise in engagement.¹¹

These results should not be surprising. Higher levels of engagement between investors and companies will not produce results unless it is coherent, intentional, and based on long-term value considerations. Stewardship should not be gauged by simple metrics that reward mere engagement activity, such as the number of meetings or voting levels (worse still, 'vote against' levels), but instead intentional, and

⁹ See Edmans, Alex and Clifford Holderness (2017): 'Blockholders: A Survey of Theory and Evidence', *Handbook of the Economics of Corporate Governance* for a summary of the evidence.

¹⁰ Pastor, Lubos, Robert Stambaugh and Lucian Taylor (2017): 'Do Funds Make More When They Trade More', *Journal of Finance*.

¹¹ Del Guercio, Diane and Jennifer Hawkins (1999): 'The Motivation and Impact of Pension Fund Activism', *Journal of Financial Economics*. Yermack, David (2010): 'Shareholder Voting and Corporate Governance', *Annual Review of Financial Economics*.

often collective, stewardship based on long-term factors. Moreover, the relevant metrics will differ across investors, depending on their stewardship expertise, and a high level of a given metric could constitute good stewardship for one investor and poor stewardship for another.

It should be noted that this is not entirely aligned with what companies themselves consider to be good stewardship, and here there may be an expectations gap to be bridged. Some companies may view good stewardship as agreeing with its strategy, and a dissenting investor as one who has not taken the time to understand its strategy. However, an investor may have engaged extensively with a company and simply agrees to disagree. High-quality stewardship will usually involve engagement with companies, but may not involve engagement on every issue the company wants to discuss, still less agreement. Indeed, the evidence is that confrontational activism – which is typically not welcomed by companies – creates long-run value. Discussions with companies and investors suggests the need for improved dialogue between corporates and investors to move to a set of realistic and productive shared expectations for stewardship.

While stewardship is often equated with engagement, the evidence highlights that monitoring/trading can also play a significant role in improving a firm's long-run value. For example, an investor who bases her investment decisions on a firm's long-term value rather than short-term earnings, and is willing to sell her stake (or not invest in) a company that is currently profitable, but has a poor long-term outlook due to short-termism, encourages companies to focus more on the long-term. Indeed, investors with concentrated portfolios devote substantial resources to deciding which firms to hold and which to avoid, and this in turn encourages companies to take actions to attract a given shareholder base. Indeed, having attracted the 'right' shareholder base is believed to be a key reason why Unilever was able to fend off Kraft's takeover approach in 2017.

In this context, the emphasis that most codes have stewardship through engagement, or engagement through voting, may be misguided. Investors will often have an area of specialism that would emphasise one dimension over another, and this should be recognised in the Code. The danger of applying blanket expectations is that investors will act in areas where they do not have expertise, or perhaps worse, outsource to proxy voting agencies. For example, a requirement for all investors to exercise their votes on all resolutions would almost certainly have the end result of increasing the influence of proxy voting agencies. The Code must acknowledge the different types of stewardship that can be undertaken.

4. Guiding Themes for Code Reform

This section outlines the guiding themes behind our suggestions for reform of the Code. In terms of terminology, in this paper we define:

- *Asset managers* as fund management companies (e.g. Fidelity).
- *Funds* as individual funds (e.g. Fidelity Special Situations).
- *Asset owners* or *savers* as ultimate owners (e.g. a university endowment or a retail investor).
- *Service providers* as investment consultants or proxy voting agencies (e.g. Aon Hewitt or ISS).

When talking about a generic actor in the investment chain, we use the term 'investment chain entity'.

(a) The Code should reinforce the criticality of an integrated approach to stewardship throughout the investment chain.

The entire investment chain – not just asset managers – has a critical role to play in effective stewardship of companies. For example, it is asset owners who are best placed to hold asset managers to account on actually delivering their stated approach to stewardship and reporting relevant metrics. Asset managers have a fiduciary duty to act in asset owners' interests, so asset owners being more explicit about their desire for stewardship is critical in encouraging asset managers to take stewardship seriously. Otherwise, asset managers might think that they are acting in clients' interests simply by prioritising cost efficiency. Indeed, the existing Code states that it applies not only to asset managers, but also to asset owners and service providers.¹² However, its current Principles were designed primarily for asset managers and are less relevant for other investment chain entities. For example, Principle 6 on voting activity is not relevant for service providers, who do not vote; Principles 3-5 on monitoring, escalation of engagement, and collective engagement are less relevant for asset owners (unless they are investing directly themselves) or service providers.

Therefore, perhaps unsurprisingly, while take-up amongst asset managers has been good (163 signatories as of July 2017), the Investment Association ('IA') found that under half of asset owners are signatories¹³, and only 59% strongly agreed that they had stewardship responsibilities; relatedly, only 31% of asset owners say that their investment consultants raise stewardship issues in discussions with them. The lower relevance of the Code to service providers may explain why all classified in Tier 1 and typically with uninformative disclosures; it is hard to downgrade service providers based on principles that are less relevant to them.

The Code should recognise the different stewardship roles played by different types of entity, and how they interact. It should set out clearly how its principles should be applied by different types of entity, with a stronger expectation that all types of entity should be signatories. Implementation of the Shareholder Rights Directive creates an opportunity to create, underpinned by regulation, a single Stewardship Code¹⁴ governing the stewardship activities of asset owners, asset managers, and service providers. This would establish a framework that would enable continuous improvement over time, recognising the interactions across the investment chain. If this opportunity is not taken through the redraft of the Stewardship Code, governance of stewardship will remain fragmented and future progress

¹² The current Code states that it 'is directed in the first instance to institutional investors, by which is meant asset owners and asset managers' and 'also applies, by extension, to service providers, e.g. proxy advisors and investment consultants'.

¹³ 'Stewardship in Practice: Asset Owners and Asset Managers', report by the Investment Association and the Pension and Lifetime Savings Association, September 2016.

¹⁴ Note that, even if the Government locates regulatory oversight for different types of entity in different places, all of those could point to the Stewardship Code as the single Code of practice governing all of them.

will be hard to achieve. This paper proposes an overarching framework for principles applicable to the entire investment chain, but with tailored principles applying to different types of entity.

There is a view that service providers should not be elevated into having stewardship roles by including them under the Code. We understand this approach, and are firmly of the view that the Code should clearly and unambiguously attribute stewardship responsibilities to asset managers and asset owners. However, the reality of the market is that service providers of various types play a very material role in how stewardship is conducted¹⁵. Therefore, including them within the Stewardship Code provides an opportunity to address in an integrated way their role in helping clients deliver stewardship.

(b) The Code should recognise the diverse role stewardship plays in the purpose of investment chain entities.

The current Code has been interpreted by some as implying a one-size-fits-all level of, and approach to, stewardship. For example, Principle 1, for investors to ‘publicly disclose their policy on how they will discharge their stewardship responsibilities’ may be interpreted as suggesting that all investment chain entities have the same level of stewardship responsibilities. However, as described in Section 3, asset managers and asset owners differ substantially in how they use stewardship in their investment approach. Moreover, even funds committed to stewardship may undertake it in many ways. Engagement can occur through a wide variety of forms (voting, meetings with company executives and directors, collective activism) and on a wide variety of issues (remuneration, strategy, culture). Different asset owners or managers may have particular areas of stewardship specialism. Stewardship can occur through not only engagement but also monitoring. It may not be cost effective, nor efficient for companies, for all investors to engage regardless of their size – small investors may have insufficient ‘skin-in-the-game’ to justify the cost, and companies not have capacity to meet every investor.

Far from leading to a reduction in the quality of stewardship, the recognition of heterogeneity should actually improve it. Holding funds to a one-size-fits-all benchmark may lead to them focusing on box-ticking to fulfil perceived obligations in areas where they do not have expertise; a revised Code could free them to deliver, and report on, the specific forms of stewardship that reflect their expertise and best serve their clients.

By the same token, the Code should reflect the role that service providers play in stewardship. They are not decision makers, and so the Code must reflect their role in supporting stewardship without suggesting that they act as principals like asset owners or managers.

(c) Investment chain entities should define their approach to stewardship as part of their purpose, including at the fund level.

The starting point for defining an investment chain entity’s approach to stewardship should be to first define its purpose, because a stewardship approach only makes sense within the context of purpose. Note that the word ‘purpose’ does not refer to any moral obligation – for example, a pension fund’s purpose will relate to the way in which it intends to meet its long-term liabilities. The statement of purpose should include the entity’s view of the role, if any, that it wants stewardship to play in how it operates. For a fund, purpose reflects a broader notion than a fund’s ‘objective’, which typically contains only quantitative dimensions and/or is generic (e.g. ‘to generate long-term capital appreciation’). Sample purposes are given in Section 6.1, and can range from index tracking, with stewardship being addressed on a generalised basis, to highly specialised activist investment strategies and engagement.

¹⁵ Malenko, N. and Shen, Y. (2016), ‘The Role of Proxy Advisory Firms: Evidence from a Regression Discontinuity Design’, *The Review of Financial Studies*, 29, 3394-3427; PwC (2018), ‘ISS: Friend or Foe to Stewardship’, Research Report, <https://www.pwc.co.uk/human-resource-services/assets/documents/iss-friend-or-foe-to-stewardship.pdf>

Having defined its purpose, an investment chain entity should then define its approach to stewardship, and explain how stewardship fits into its purpose. A sample statement of purpose, and approach to stewardship, follow below. This aims to show how an approach to stewardship can be tightly linked to purpose, yet remain separate and so there is value in defining both:

Purpose: “To create long-term real returns over the long term with lower than average volatility by investing in companies with high-quality intangible assets generating a high return on capital.”

Approach to stewardship: “We believe that focus on short-term profit measures can discourage revenue investments (such as marketing, people, and innovation) and that drive long-term returns. We, therefore, focus on investing in companies with a strong record of sustaining high returns on capital with organic growth, through maintaining strong brands and other hard-to-replicate intangible assets. We engage actively with management teams to encourage a focus on building intangible assets through revenue as well as capital investments, with a focus on organic rather than inorganic growth. We will exit investments where these principles cease to be followed and engagement with management fails to produce change.”

(d) The Code should cover not only stewardship policies but the actual delivery of stewardship, with processes, incentives, and reporting tightly linked to the stewardship approach to ensure genuine implementation.

While recognising that many types of investment manager play an important role in markets, not just those that exercise stewardship, the Code is designed for those firms that do undertake stewardship as defined in Section 2. Therefore, to enhance its credibility, the Code should demand that signatories demonstrate how their approach to investment improves sustainable company performance.

As discussed in theme (b), the Code should not evaluate all asset managers according a one-size-fits-all stewardship benchmark. But the Code should be very serious about holding funds to account according to their stated approach. Currently, there are widespread concerns that the Code’s tiering is based on the quality of a signatory’s Code statements, rather than outcomes. As a result, it evaluates stewardship policies rather than actual stewardship practice.

We believe that a revised Code should ensure that an entity’s policies and processes, including incentives, should be tightly linked to its stewardship approach. For example, asset managers with a policy to take stewardship seriously should ensure that it is fully integrated in the investment process, its incentives are aligned, and its use of proxy advisors is consistent with its stewardship approach. The current Code’s requirement to include a single contact person responsible for stewardship may contribute to stewardship being siloed in a ‘stewardship department’ rather than integrated, and so we recommend that it be removed.

Relatedly, the investment chain entity’s reporting should also be tightly linked to its stewardship approach. This will include, where possible, pre-specifying quantitative and qualitative metrics of stewardship that it will report, and supplementing them with case studies of effective stewardship.

(e) In implementing the Code, the FRC should liaise with regulators to maximise its impact.

As mentioned under theme (a), the Shareholder Rights Directive creates a requirement for proxy agencies to report their activities against a Code. This creates an opportunity for the FRC to design a Code that meets and aligns with the requirements of the Directive across the entire investment chain. If backed up by appropriate government regulation that points all investment chain entities to this revised Stewardship Code, this creates a unique opportunity to create a Code that allows an integrated view to be taken of stewardship responsibilities and provides a mechanism for continuous improvement across the investment chain in future. Furthermore, BEIS and the FRC should, in developing the Code, liaise with current holders of regulatory powers over asset managers and asset owners, in particular the FCA, DWP and The Pensions Regulator to influence how stewardship practices are enacted

throughout regulation. Examples include the Statement of Investment Principles and the Senior Managers and Certification Regime responsibilities of fund directors and fund management groups.

5. Components of a New Code

Guided by the above themes, this section discusses components of a potential new Code. The Code currently comprises seven Principles, which are well-established, and have achieved industry buy-in. However, they are very focused on asset managers, and as outlined above should be more tailored to different investment chain entities. Moreover, the Code could be strengthened by giving signatories an obligation to explain how they have applied the Principles ('apply-and-explain') to increase the likelihood of genuine adoption, rather than box-ticking, and allow greater transparency to stakeholders.

In addition, the Principles can be reinforced by Provisions and Guidance to provide clarity on how to apply them. While the Principles should recognise that the heterogeneity in approaches to stewardship, certain Provisions should be followed by most investment chain entities regardless of their approach to stewardship (e.g., for asset managers and asset owners, long-term compensation), and these should be applied on a comply-or-explain basis. Guidance would not form part of the comply-or-explain framework, but would provide entities with further explanation of how the principles should be applied.

Figure 1: Components of the new Code

Code component	Applicability	Example	Reporting mechanism
Principles	Any signatory to the code	Defining the approach to stewardship	Apply-and-explain
Provisions	Any signatory to the code	Disclosure of voting records	Comply-or-explain
Guidance	Some elements applicable to all entities, some tailored	Guidance on the use of proxy advisor recommendations	Supports practice and narrative reporting where relevant

We start with potential principles for a revised Code. We believe that a common set of over-arching stewardship principles should be employed across the entire investment chain, with sub-Principles to apply as appropriate for each investment chain entity.

Figure 2: Proposed principles

Principles	
Overarching principle	A signatory to the Code should be able to demonstrate how they implement, or help clients to implement an approach to investment that improves sustainable company performance.
A. Defining the approach to stewardship	An investment chain entity should clearly define the role of, and approach to, stewardship in meeting its purpose.
B. Implementation of stewardship	An investment chain entity should establish governance, processes, and incentives to support its stated approach to stewardship, including identification and management of conflicts of interest.
C. Reporting on the delivery of stewardship	An investment chain entity should clearly disclose its approach to stewardship and how it has been implemented in practice, including outcomes, in a manner that enables its clients and other stakeholders to judge the effectiveness of the approach in improving sustainable company performance.

The table overleaf illustrates how these principles could be translated for different types of entity.

Figure 3: Example Code Principles for each investment chain entity to support the three over-arching Principles

Asset managers should...	Asset owners should...	Proxy advisors should*...	Investment consultants should*...
A. Clearly define the role of, and approach to, stewardship in meeting its purpose			
<p>define their approach to stewardship and their policy on how they will discharge their stewardship responsibilities in line with their purpose</p> <p>define the purpose of each fund including the approach to stewardship</p>	<p>define their approach to stewardship and their policy on how they will discharge their stewardship responsibilities in line with their purpose</p> <p>have a clear policy on how stewardship is built into asset management mandates</p>	<p>outline how services they offer help clients fulfil their stewardship responsibilities</p> <p>have a clear research methodology, and, if relevant, their 'house' voting policy</p> <p>avoid making recommendations based on strategic judgements that are the responsibility of their clients</p>	<p>include stewardship considerations when helping clients to develop an investment strategy</p> <p>help clients understand the value of stewardship and advise them on the stewardship obligations they should demand of their asset managers</p>
B. Establish governance, processes, and incentives to support its stated approach to stewardship, including identification and management of conflicts of interest			
<p>have a robust policy on managing conflicts of interest in relation to stewardship which should be publicly disclosed</p> <p>ensure that stewardship is incorporated into the investment process in a manner consistent with its stated approach</p> <p>embed the approach to stewardship in policies and processes, including ensuring incentives are aligned with the stated stewardship approach</p>	<p>implement the relevant principles for asset managers to the extent they manage investments directly (see left)</p> <p>have a process for monitoring the performance of asset management mandates that includes consideration of performance against the asset owner's stewardship objectives, and setting appropriate incentives for the asset manager</p> <p>ensure they receive appropriate training and advice on the role of stewardship in investment</p>	<p>have a robust policy on managing conflicts of interest in relation to stewardship which should be publicly disclosed</p> <p>develop a clear policy for communication and engagement with issuers to enable both issuers and clients to understand the approach taken</p> <p>subject any screening methodologies (ESG, pay-for-performance etc.) to appropriate independent review and validation</p>	<p>have a robust policy on managing conflicts of interest in relation to stewardship which should be publicly disclosed</p> <p>have a framework for helping clients to assess stewardship styles of asset managers</p> <p>have a methodology to include fulfilment of mandated stewardship obligations when helping clients monitor the performance of asset managers</p>
C. Clearly disclose its approach to stewardship and how it has been implemented in practice, including outcomes, in a manner that enables its clients and other stakeholders to judge the effectiveness of the approach in improving sustainable company performance			
<p>publicly disclose their approach to stewardship and associated policies, including at the fund level where appropriate</p> <p>disclose appropriate information on their voting policy and record, including in relation to stock lending</p> <p>report at least annually on their stewardship activities including at the fund level</p>	<p>publicly disclose their approach to stewardship and associated policies</p> <p>disclose appropriate information on their voting record</p> <p>report at least annually on their stewardship and voting activities</p>	<p>publicly disclose their research and screening methodologies (including any independent review and validation) and, if relevant, their 'house' voting policy, and their policies on communication and engagement</p>	<p>include appropriate consideration of stewardship considerations in their reporting to clients</p>

*Proxy agencies and investment consultants would also have separate Codes relating to service quality and professional standards

We set out below the key differences in these principles from the current Code.

Asset Managers

The principles for asset managers are very closely aligned with the current principles within the Code. Key changes are the requirements to:

- define purpose, including approach to stewardship, and report on this, at the fund level (potentially cross-referencing principles at the asset manager level);
- ensure that the approach to stewardship is incorporated into the investment process; and
- embed the approach to stewardship in policies and processes.

These changes are designed to ensure that the principles encourage effective and meaningful stewardship, as opposed to superficial or ‘window-dressing’ stewardship. We have also moved into Provisions the principles relating to escalation, collective engagement, and voting policy, as these are ways of evidencing the alignment of the organisation with the approach to stewardship, and may apply in different ways depending on the asset manager’s approach to stewardship.

One related question is whether the recommended principles should apply at the asset manager or individual fund level. The current Code applies at the asset manager level. However, approaches to stewardship differ at the fund level – for example, active and index funds within the same asset manager will have different purposes and commit to different levels of stewardship. Asset owners buy funds, not asset managers, and disclosure of an asset manager’s stewardship approach does not provide transparency at the fund level. This consideration might suggest that individual funds, rather than asset managers, should be signatories. This would allow funds competing on stewardship to sign the Code and funds competing on cost not to. However, we do not recommend this approach because the reporting requirements on each fund would be very high, and this might lead to boilerplate statements.

We thus recommend adherence to the Code and primary reporting responsibilities should remain at the asset manager level, with the asset manager developing its overall stewardship policy. However, just as fund objectives and fund performance are reported at the fund level, we proposed that each fund should report its purpose and stewardship approach. Such fund-level reporting need only be brief, since it can cross-reference the asset manager’s principles and briefly state how it fits with them. This proposed approach is similar to how ESG funds typically disclose their screening approach at a fund level, often cross-referencing ESG statements at the asset manager level. In light of the FCA’s desire already to improve definition of, and reporting on, objectives we do not view this as overly onerous. Indeed, if a common approach to stewardship were adopted across all of a firm’s funds, then each fund could simply cross-reference the firm-wide policy, creating no additional reporting burden.

Asset Owners

Asset owners generally follow the principles for asset managers, unless they delegate responsibility for asset management. In this case, key principles cover how they build stewardship requirements into mandates, establish appropriate incentives for the asset manager, monitor performance against these, and take action if asset manager performance is poor.

Proxy Advisors

The proposed principles extend the Best Practice Principles for Providers of Shareholder Voting Research and Analysis (‘BPP’) in two ways.

First, we add a principle that advisors should avoid making recommendations based on strategic judgements that are properly the responsibility of their clients. Proxy advisors can usefully process

information for clients in a way that adds to efficiency of stewardship. However, as emphasised in the BPP, the ultimate responsibility for voting judgements must remain with clients. If proxy advisors stray into making recommendations based on areas of strategic judgement, then this may result in investors out-sourcing judgement. In such cases they could highlight voting items as “For Strategic Judgement”.

Second, we add a principle that proxy agencies should subject screening methodologies to appropriate external review (for example by leading academics or other experts in the field) to ensure that they are robust in the context of available evidence. Otherwise, faulty screening methodologies may give rise to ineffective stewardship. An example is ISS’s pay-for-performance methodology, which is quite at odds in certain respects with well-established research methodologies.

Investment advisors

The principles for investment advisors aim to ensure that they build stewardship considerations into advice they provide to clients on investment strategy and mandate selection, and then the associated monitoring of mandate performance. This is essential to raise awareness of asset owners in relation to stewardship approaches and obligations – a current gap that was identified in the IA’s and PLSA’s Stewardship Report 2016.

Provisions

Comply-or-explain Provisions can support the implementation of each principle. Examples for asset managers are given below. Further examples where Provisions and Guidance could help interpret the Principles for each type of investment chain entity are given in Section 6.

Figure 4: Example of supporting Provisions

Principle: An asset manager should define the purpose of each fund including the approach to stewardship

Supporting Provisions:

- The fund board should consider the extent to which stewardship is a relevant factor to the fund’s purpose, and if so whether the approach to stewardship involves monitoring or engagement, and whether discipline is exerted through sale or voting.
- If the approach involves engagement, the board should consider its form, themes, frequency and scope and the approach to collective engagement.
- If the approach involves monitoring, the board should consider the dimensions covered (for example performance, strategy, ESG, short-term vs long-term orientation, and financial vs non-financial factors).

Principle: An asset manager should embed the approach to stewardship in policies and processes, including incentives

Supporting Provisions:

- Incentives should be aligned with the asset manager's or fund's stated purpose and approach to stewardship.
- Clear guidelines should be established for escalating stewardship activities.
- There should be mechanisms for engaging collectively where that is consistent with the approach to stewardship.
- There should be a clear policy on voting and use of proxy advisors.

Principle: An asset manager should report at least annually on their stewardship activities including at the fund level

Supporting Provisions:

- An asset manager should specify which quantitative and qualitative metrics it intends to report, and why it considers them material given its stated approach to stewardship. It should also note whether there are any material items it has decided not to report and, if so, why. An asset manager should supplement these metrics with case studies giving specific examples of engagement or monitoring (e.g. the analysis of long-term value that led to a divestment decision, or the analysis of long-term value that led to the asset manager holding onto a stake despite poor short-term performance).

6. Application of the Code to Different Entity Types

This section discusses the application of the overarching principles of Section 5 to different types of investment chain entity. We start with a discussion of both Principles and potential Provisions for asset managers. Asset owners will often delegate responsibilities to asset managers, and so Section 6.2 focuses on specific Provisions that may be most relevant to asset owners. We turn to Provisions for service providers in Section 6.3.

6.1 Asset Managers

This section discusses the application of the overarching principles of Section 5 to **asset managers** (and asset owners to the extent they manage assets directly themselves).

A. Defining the approach to stewardship

An investment chain entity should clearly define the role of, and approach to, stewardship in meeting its purpose

Purpose may differ widely across funds and may include, but not be limited to, some combination of the following:

- Benchmarking indices at low cost, thus providing cost-effective equity market exposure to savers – savers who might otherwise consider only savings accounts, given the fees associated with equity investing.
- Screening in (out) of certain socially responsible (irresponsible) stocks, for savers whose long-term interests include not only financial returns but a social mission.
- Regular engagement with companies, to improve their long-term performance.
- Activist investment – seeking undervalued companies with an opportunity to release value through change of strategy, leadership, or portfolio.
- Focusing on stock-picking – trading stocks according to their long-term growth prospects and intangible assets (rather than short-term earnings).
- Implementing a trading strategy based on statistical arbitrage, e.g. momentum (buying past winners and selling past losers), to give investors exposure to this strategy at lower cost than they could do to themselves.

Disclosing a broader purpose of the fund, including the approach to stewardship, creates greater transparency for asset owners, and accountability for following through on the advertised approach to stewardship.

A fund's purpose in turn provides guidance on its approach to stewardship – how it intends to improve the long-term performance of the companies that it engages in. Stewardship is not the same as purpose, and so it is useful to define purpose in addition to stewardship, since a fund's purpose may involve dimensions other than stewardship (e.g. the use of ESG screens), and indeed stewardship may not be central to some funds' purpose. However, stewardship should be tied to purpose – how a fund intends to improve the long-term performance of its investee companies should be tied to how the fund intends to generate long-term returns to savers. In turn, an investor can engage in stewardship through two main ways, engagement and monitoring. These are described in more detail on p63-64 of The Purposeful Company's [Policy Report](#), but are summarised briefly here.

The first stewardship mechanism is **engagement/voice**. This involves encouraging change in a firm's policies. In turn, engagement can differ according to the following (non-exhaustive) ways:

- **Form** of engagement. A fund may:
 - Vote for or against management.
 - Have private meetings with, or write private letters to, management or directors.
 - Act as an investor sounding board to management.
 - Engage publicly and in a potentially confrontational manner, e.g. call for management to divest certain assets.
- **Theme** of engagement. While the actual theme will depend on a company's particular circumstances, different funds may prioritise different general themes to engage along.
 - The IA's Stewardship Reporting Framework lists the following potential issues: Board and Director Related, Strategy, Remuneration, Capital Structure, Reorganisation (including M&A), Accounting and Audit, Environmental and Sustainability, and Social.
 - Complementary to some of the above, a fund might prioritise holding company directors accountable for delivering on their Section 172 responsibilities to stakeholders.
- **Frequency** of engagement
 - Some funds may engage only in 'intensive care' situations, where a company is in serious trouble.
 - Other funds may engage with companies routinely, as a matter of course.
- **Scope** of engagement. Some funds may engage alone, and with specific companies in isolation. Others may
 - Engage **collectively with other investors**. The Investor Forum currently has an established framework for collective engagement that addresses legal issues.
 - Engage at an **industry level**. This may involve several asset managers meeting with the main industry players and discussing long-term industry opportunities (risks) and how to capitalise on (address) them. Examples include BankingFutures and the Investor Forum's engagement with the apparel sector (which emerged from its collective engagement with Sports Direct in 2016).
 - Engage at an **economy level**. Investors may be active contributors to industry working groups, or engage with policymakers on how to promote superior stewardship.

As discussed earlier, the relevant engagement mechanisms will differ across funds, hence the importance of the revised Code allowing for a heterogeneity of different approaches. For example, collective and industry engagement may be particularly relevant for index funds due to their broad holdings. Active funds may have expertise in a particular area of engagement.

The second stewardship mechanism is **monitoring/trading**. This involves evaluating a company's long-term growth prospects and intangible assets, and selling a company if both are weak – potentially because the company is instead prioritising short-term earnings – or buying if both are strong. Trading is sometimes seen as the antithesis of stewardship, and a 'patient' investor who never sells is seen as the model one, but this is not supported by any evidence. A 'patient' investor who never sells – regardless of a company's delivery of long-term value – will not hold the company to account. Thus, the company can pursue short-term earnings to inflate the short-term share price, without fear of the investor selling. However, an investor who monitors the company's long-term prospects will sell its stake in a company that focuses on short-term earnings, lowering the stock price and thus deterring myopic behaviour in the first place. Conversely, investors acquiring shares in companies adopting an approach based on long-term value encourages such behaviour. For further detail, see the *Harvard Business Review* article ['The Answer to Short-Termism Isn't Asking Investors to Be Patient'](#).

Put differently, what matters is not an investor's *holding period* – whether it is long-term or short-term - but its *orientation* – whether it bases its sale decisions on long-term or short-term value. Thus, an investor who engages in stewardship through monitoring/trading should describe how it intends to ensure that it has information on long-term value, and the areas of long-term value where it considers

itself to have expertise. This may involve regular meetings with management, ensuring it has a large stake to make it worthwhile to monitor long-term value, and holding management accountable for reporting intangible assets (see our separate [Reporting submission](#)).

Finally, we should stress that having a clear approach to stewardship is in asset managers' interest, rather than a burden. It will help asset managers retain competitive differentiation in an industry that is becoming increasingly commoditised. Instead of competing on fees, asset managers will compete on stewardship. Indeed, as the trend towards index investing continues apace, the more sophisticated and deeper stewardship a truly active manager can bring, the more it will be able to maintain differentiation. Equally, index funds will retain legitimacy through strong levels of generalised stewardship on ESG matters and through participating in active engagement on specific stewardship matters.

B. Implementation of stewardship

An investment chain entity should establish governance, processes, and incentives to support its stated approach to stewardship, including identification and management of conflicts of interest

Stewardship must move beyond a policy to a practice. Principle B requires a fund to ensure that stewardship is incorporated in the investment process in a manner commensurate with its approach outlined in Principle A. There is a concern that stewardship is sometimes confined to the 'stewardship department' of an asset manager, and that this department may focus on generalised rather than specialised stewardship, be small, comprise mainly junior staff, and be seen principally as a cost centre.

If a fund has stated that stewardship is a priority, then it must ensure that it is embedded in the investment process. This is likely to involve stewardship being a central duty of the fund managers involved in stock selection, even if they are supported by a central team, and adequate resources being devoted to stewardship. Moreover, the specific nature of stewardship that the fund intends to pursue should be reflected in how it is organised. For example,

- If the fund has stated that it will engage collectively, then the asset manager should be part of the Investor Forum, or explain how it intends to engage collectively if not. This may include other 'clearing houses' for collective engagement, such as the UN Principles for Responsible Investment.
- If the fund intends to engage at an industry-level, then the asset manager should be actively involved in industry-wide consultations.
- If the fund has stated that voting is a key channel of engagement, it should disclose the providers of shareholder voting research that it uses, whether it takes recommendations from that provider, whether recommendations are standard or bespoke, and the extent to which it uses external versus in-house recommendations (including the frequency with which it goes against the provider's recommendations).
- If the fund has stated that it will use ESG criteria in its stock selection, it may choose to form an external advisory committee to provide independent input into its approach, particularly given the ambiguity in defining what constitutes good ESG (e.g. whether companies that make genetically modified crops satisfy the criteria). The minutes of such meetings could be made available to savers.
- If the fund has stated that it will meet with management regularly, it should ensure that it has the legal resources to ensure that fund managers understand what information can and cannot be shared in meetings (since, in the absence of clarity, they will default to a position of not receiving information).

Asset manager incentives should be clearly aligned with client interests, including reflection of the approach to stewardship. On our recommendation, Code signatories would be required to demonstrate

how their approach to investment improves sustainable company performance. In general, therefore, fund manager remuneration should be long-term and include investment in own funds as well as the asset manager's stock.

Asset managers should also have a clear policy on the use of proxy voting agencies, particularly those providing advisory recommendations. Where an agency recommends a vote against, investors who are not doing their own analysis should give companies a proper hearing and should consider finding out the views of other top shareholders in the company. Asset managers should also consider the quality as well as cost of advisory services and ensure that any approaches used are consistent with their own approach to stewardship.

C. Reporting on the delivery of stewardship

An investment chain entity should clearly disclose its approach to stewardship and how it has been implemented in practice, including outcomes, in a manner that enables its clients and other stakeholders to judge the effectiveness of the approach in improving sustainable company performance.

The fund's reporting should be tightly aligned to its stated approach to stewardship. To give an example of how such alignment might be achieved, a potential spectrum of fund approaches is in Figure 5 with the associated reporting metrics in Figure 6. Both are adapted from The Purposeful Company's [Policy Report](#); additional potential metrics are given in the IA's Stewardship Reporting Framework.

Figure 5: Spectrum of approaches to stewardship

Speculative	Index, passive	Active
<ul style="list-style-type: none"> Tactical shareholder 	<ul style="list-style-type: none"> Long-term shareholder 	<ul style="list-style-type: none"> Fundamentals-driven shareholder
<ul style="list-style-type: none"> Trading decisions driven by assessment of short-term stock returns 	<ul style="list-style-type: none"> Formulaic trading to minimise tracking error 	<ul style="list-style-type: none"> Trading decisions driven by assessment of long-term value. Ignore short-term stock returns or profits
<ul style="list-style-type: none"> Focused on predicting market sentiment and exploiting arbitrage opportunities 	<ul style="list-style-type: none"> Focused on providing savers with low-cost exposure to equities 	<ul style="list-style-type: none"> Focused on finding firms with long-term potential and helping them achieve it
<ul style="list-style-type: none"> Generally short-term holdings 	<ul style="list-style-type: none"> Only trade to maintain index weights 	<ul style="list-style-type: none"> Likely to have long-term holdings, but may not – key factor is trading decisions based on long-term value
<ul style="list-style-type: none"> Diversified positions to maximise liquidity 	<ul style="list-style-type: none"> Fully diversified 	<ul style="list-style-type: none"> Concentrated positions
<ul style="list-style-type: none"> Limited stewardship. Do not wish to receive inside information as this will restrict ability to trade 	<ul style="list-style-type: none"> Stewardship through voting. Activities likely to be general (board structures, pay norms) than company specific (strategy, leadership) 	<ul style="list-style-type: none"> Active engagement on specific issues (strategy, leadership). Willing to receive inside information if helps engagement. Monitors long-term value to drive trading decisions

Figure 6: Reporting metrics and link to stewardship approach

Metrics	Speculative	Active
Portfolio size	70-80	20-30
Portfolio concentration	Low	High

Tracking error / active share	Low	High
Benchmark	Market	Unconstrained
Turnover	High	Low
Interactions with management	Low	High
Resources devoted to stewardship	Low	High
Correlation of voting with proxy advisors	High	Moderate
Stock lending	Unconstrained	Constrained

There are three points to note:

- No single metric or set of metrics will adequately capture whether a company is delivering on stewardship. A narrow attention to specific metrics (e.g. low turnover) will encourage box-ticking to manipulate that metric.
- Even for metrics that are relevant to most funds, the same metric may be interpreted in different ways. For example, a short average holding period may be considered undesirable for a fund aiming to steward through long-term engagement, but not one who stewards through monitoring/trading. A high tracking error or active share is inconsistent with an index fund aiming to track a benchmark, but is consistent with active stock-picking.
- Some metrics should be reported not just quantitatively, but also qualitatively. For example:
 - The resources devoted to stewardship need not simply be headcount, but narrative discussion on their seniority and involvement in the investment process.
 - The voting record need not simply be the frequency of times that a fund votes with management, or with proxy advisor recommendations, but the extent to which the fund considers proxy advisor recommendations and the grounds for deviation, and the extent to which the fund engages with management prior to voting. The fund could also describe whether and why it signals its pre-AGM voting intentions, and whether and why (not) it discloses its votes and rationale for voting post-AGM.
 - Interactions with management should not only report the frequency of management meetings, but also the seniority of the individuals engaging (at both the fund and company) and also the theme of engagement. The latter should then be evaluated versus the fund's stated priorities. The IA's 2014 report on 'Adherence to the FRC's Stewardship Code' found that remuneration was the main theme of actual engagement, even though it only ranked fifth in asset managers' stated priorities.
 - A fund that intends to engage collectively could provide qualitative details on its engagement with other investors in specific company situations or general Stewardship and Strategy Meetings (recommended by the Investor Forum), collaboration with industry associations, and contributions to industry consultations.

Moreover, the set of metrics that will be considered material will differ across funds. For standard metrics that a fund considers not material, and chooses not to report, it should explain why.

- A fund that intends to steward through monitoring/trading may choose not to report turnover, since there is no clear 'target' level of turnover. Realised turnover will depend on how companies behave - if most companies end up focusing on the long-term (short-term), an effective monitoring strategy will involve low (high) turnover. Instead, the fund might report qualitatively on the process by which it obtains information on a firm's long-term value and ensures that any divestment decisions are driven by these considerations rather than short-term profit. Such reporting would be less relevant for a fund that stewards through long-term engagement, or an index fund.

These qualitative and quantitative metrics should be supplemented by case studies of both engagement and monitoring. The IA's Stewardship Reporting Framework suggests that case studies of engagement include the name of the company (where possible), a summary of the issue, who instigated the engagement, the objectives of the engagement, the process of the dialogue, and the outcome of the engagement (including progress against the objectives). In addition, case studies of effective monitoring could also be reported. This may involve reporting on (potentially anonymised) cases in which a fund divested the holding, and an explanation of the analysis of long-term value that led to this decision. Conversely, it may involve reporting on cases in which the fund held onto a stake, despite poor-short term performance, due to its analysis of long-term value.

6.2 Asset Owners

Many of the principles for asset owners would apply in a similar way as for asset managers. In this section we consider specific aspects to be considered as potential Provisions for **asset owners**:

- The Statement of Investment Principles should be specific about asset owners' stewardship expectations, such as the degree to which they wish stewardship to be exercised, time horizons, and benchmarks, and basis of incentives (e.g. a balance of fixed fees and incentives linked to long-term performance). It could also include the criteria on which the asset owner will evaluate the asset manager and potentially switch to a competitor, and the bases on which it will not (e.g. short-term performance).
- Asset owners could have a 'covenant' (informal, not a legal document) of how they will structure and govern mandates. For example, the Environmental Agency Pension Fund's covenant states what they expect of asset managers, and what asset managers should expect from them.
- Asset owners should consider how they ensure, through fee arrangements and remuneration, that asset manager incentives are aligned with the asset owner's investment policy and approach to stewardship.
- Asset owners should ensure that they receive appropriate training and advice on the role that stewardship plays in the approach to investment.
- The Risk Register for pension funds should be broadened. Currently, it contains issues such as interest rate projections (which may affect optimal stock-bond allocation), but could extend to other items relevant to stewardship, such as the risk of climate change, ageing population, technology changes etc.
- Imposing reporting requirements on asset owners (e.g. approach to stewardship and how this is fulfilled) will create demand for such information from asset managers.
- Asset owners could disclose which investment consultants they use, and the role they play in defining and monitoring mandates. Such disclosure would mirror asset managers' disclosure of their use of proxy advisors.

A key class of asset owner is pension funds, and the FRC could work with The Pensions Regulator, Pensions and Lifetime Savings Association, and the Association of Member Nominated Trustees to develop appropriate principles.

Note that the development of principles for asset ownership will likely be more effective if accompanied by a regulatory underpin for asset owners. Currently, FCA Conduct of Business Rule 2.2.12 requires asset managers to either sign the Code or explain their approach to stewardship if they do not), but there is no analogous requirement for asset owners. This can be addressed through the implementation of the Shareholder Rights Directive.

6.3 Service Providers

This section discusses the application of the overarching framework of Section 3 to service providers,

specifically looking at some Provisions that could be developed to support the overarching principles.

Turning to service providers, different principles apply to investment consultants and proxy advisors. **Investment consultants** play a critical role in helping asset owners choose asset managers. However, there is a widespread concern that they choose mandates based on short-term performance and pay insufficient attention to stewardship. Potential provisions follow below:

- Investment consultants should establish a process to help their clients develop stewardship principles and appropriate measurements to factor into investment mandates.
- Investment consultants should put practices in place to ensure that they monitor funds' long-term performance and delivery of stewardship versus their client's stated approach, and report on how they have done this. They should also ensure that their stewardship assessment is incorporated into their recommendation, either as a separate criterion or as part of the overall rating.
- Investment consultants should ensure that the stated stewardship approach of the fund matches the preferences of the asset owner, and report on how they have done this.
- Investment consultants should disclose how they are paid (e.g. whether it is on the long-term performance of the funds they recommend), and how they manage potential conflicts of interest.

Proxy advisors are increasingly influential, with evidence showing that their recommendations have a causal effect on voting outcomes.¹⁶ They can play a valuable role in facilitating cost-effective fulfilment of stewardship activities, and their usage should be encouraged as one of many inputs into a voting decision. However, they may be misused if asset managers simply follow proxy advisors' recommendations. Being spread over thousands of companies, proxy advisors may issue 'one-size-fits-all' recommendations – particularly given concerns that they are under-resourced (particularly at the senior level) to cover so many companies. Anecdotal market evidence suggests that proxy advisors are not well equipped to apply rules in a situation that requires strategic judgement. A good example is executive pay, where design of the pay system should be linked to strategy, and non-standard features may be appropriate in certain circumstances. Thus, if investors are over-reliant on proxy agency recommendations, innovation in corporate governance may be stifled, and judgement may in effect be outsourced. A separate concern is that proxy advisors may be biased towards companies they offer consulting services to.¹⁷

The industry's own voluntary Best Practice Principles, where (similar to the Code) signatories publish statements on their compliance with the principles, does not address the role of proxy advisors in the stewardship chain. The Shareholder Rights Directive is recommending greater transparency for proxy advisors, but only on the main information sources and methodologies applied to lead to their recommendation. This is unlikely to go far enough.

Arguably, concerns about proxy advisors' role should be addressed to asset managers, and the way they use advisor recommendations. However, advisors also need to acknowledge and address the role they play in stewardship, particularly when they are issuing voting recommendations. Potential Principles or Provisions for proxy advisors follow below. Some of these mirror the Proxy Advisory Firm

¹⁶ Malenko, Nadya and Yao Shen (2016): 'The Role of Proxy Advisory Firms: Evidence From a Regression Discontinuity Design', *Review of Financial Studies*. Summarised at <http://alexedmans.com/how-proxy-advisors-influence-voting-outcomes/>. See also a UK perspective at: <https://www.pwc.co.uk/human-resource-services/assets/documents/iss-friend-or-foe-to-stewardship.pdf>.

¹⁷ Li, Tao (2017): 'Outsourcing Corporate Governance: Conflicts of Interest Within the Proxy Advisory Industry', *Management Science*. Summarised at <http://alexedmans.com/conflicts-of-interest-among-proxy-advisors/>.

Reform Act, introduced in the U.S. House of Representatives in May 2016¹⁸:

- Firms issuing a recommendation-based service should be prepared to give clear indications during consultation with companies where there is a strong possibility of a negative voting recommendation arising, and should provide a reasonable period for fact-checking, particularly where a “Vote Against” recommendation is issued.
- Where one or more of a company’s Top 10 shareholders has expressed an intention to support the proposal, the advisor should, at the request of the shareholder and company, be prepared to include this in their report.
- Proxy advisors should disclose
 - Their consulting activities with companies (potentially including their top clients by revenue), and how they manage potential conflicts that may arise.
 - The nature and extent of the independent review to which they have subjected screening and quantitative analysis methodologies.
 - Information and cases studies on their approach to voting on current topical issues.
 - The policies that underpin their voting recommendations.
 - The seniority of the staff who have either made or reviewed the recommendations.
- Where an assessment of strategic context is essential to determining support for a proposal, this should be clearly highlighted by the proxy advisor to avoid a one-size-fits-all approach, separate from simple “Vote For” or “Vote Against” recommendations.

It is important to maintain a competitive market for advisory services, and in some cases regulation could simply be a barrier to entry. Some of the negative impacts of proxy advisors on stewardship can arise when scale is combined with the practice of giving black-and-white voting recommendations. Therefore, a proportionality provision could also be applied so that certain Code provisions applied only to firms carrying out certain types of activity above a given scale.

¹⁸ See <https://corpgov.law.harvard.edu/2016/05/31/holding-activists-and-proxy-advisory-firms-accountable/> for a summary of the Act.

7. Next Steps

The FRC is at an early stage of reviewing the UK Stewardship Code. We have set out our thoughts for change in this document, and continue to engage with market participants on its contents. Although we set out a meaningful and detailed position, based on evidence, for how the new Code should be framed, including some key Guiding Themes for reform, there is much further work to do on the detail. As the content evolves, we shall continue to share this stakeholders. Particular areas for future focus include:

- Reviewing in detail how the Code fits in with other market developments such as the FCA Asset Management Market Review and the implementation of the Shareholder Rights Directive.
- Stakeholder testing: convening a review constituency drawing on the Purposeful Company Taskforce members, with particular emphasis on getting feedback from a wide range of investors on the practicalities of the new framework and its potential impact on investor behaviour, but also from companies on what will improve their own experience of stewardship.
- Review of existing Code comply-or-explain Provisions: which should be retained, which should be removed, and how they should be organised against the new Principles.
- Development of provisions and guidance on how the Code would be applied, in particular, to asset owners and service providers.
- Reviewing codes in other territories to maximise international alignment.

We would welcome any feedback from market participants on the contents of this document. In the first instance please send any feedback to Alex Edmans (aedmans@london.edu), Tom Gosling (tgosling@london.edu), and Will Hutton (will.hutton@hertford.ox.ac.uk).

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February 2018

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Launched in September 2011, Big Innovation Centre is a hub of innovative companies and organisations, thought leaders, universities and 'what works' open innovators. Together we test and realise our commercial and public-purpose ideas to promote company and national innovative capabilities in a non-competitive and neutral environment. We act as catalysts in co-shaping innovation and business model strategies that are both practical and intellectually grounded. Our vision is to help make the UK a Global Open Innovation and Investment Hub by 2025, and to build similar initiatives internationally. For further details, please visit www.biginnovationcentre.com

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