Financial Reporting Council (FRC) Consultation on Proposed Revision to the UK Stewardship Code (the Code)

Response of the City of London Law Society Company Law Committee

Overview

This response has been prepared on behalf of the CLLS by a working party comprising members of its Company Law Committee. The CLLS represents approximately 17,000 City lawyers through individual and corporate membership, including some of the largest international law firms in the world. These law firms advise a variety of clients from multinational companies and financial institutions to Government departments, often in relation to complex, multijurisdictional legal issues. The CLLS responds to a variety of consultations on issues of importance to its members through its 19 specialist committees.

We welcome the opportunity to comment on the FRC's consultation on the proposed Code. We include only those questions where we have chosen to respond.

We welcome the FRC's proposal to significantly revise the Code to ensure its effectiveness and differentiate excellence in stewardship.

A. Consultation questions

Q3 Do you support "apply and explain" for the Principles and "comply or explain" for the Provisions?

Yes, we support "apply and explain" for the Principles and "comply or explain" for the Provisions of the Code.

We would urge the FRC to only make changes to the Code guidance as part of a consultation, and only to change it without public consultation in extreme and urgent cases.

If there are urgent changes to guidance outside of a consulted on review of the Code, it should be clear on the face of the guidance, when the particular update starts to apply from. For example, if such changes are made halfway through a reporting period, a note should indicate for what period that update applies and for what period the previous text applied.

Q5, 1st part Do you support the proposed approach to introduce an annual Activities and Outcomes Report?

Yes, we are generally supportive of increased disclosure around engagement by investment managers by way of an annual Activities and Outcomes Report. However, we have a number of concerns around the need for disclosures to respect confidentiality and to be in context and proportionate, thus resulting in fair and balanced disclosures.

We have concerns about not only inside information but also confidential information and the extent of the disclosure. The guidance already states (Guidance 19) that "*Care should be taken when handling privileged material which could be considered as inside information*", but this does not address confidential information, nor the need for balance in reporting. It also does not give guidance as to the detail expected from disclosures. For example, is it enough to state the issue in relation to which engagement took place and whether the signatory was satisfied with the outcome of the engagement, without detailing the substance of the discussion? We think there is a risk that if signatories are expected to disclose too much information, that may discourage engagement, rather than encourage it.

There should be a legitimate expectation that confidentiality of information provided by the company in discussions will be respected unless specifically agreed to be waived. If annual Activity Reports may identify a company, or allow a company to be identified, we would like the guidance to remind

investors of the need to respect any confidential information provided (as well as any inside information).

We refer to the Investor Forum as a good example of collective stewardship where media comment and disclosures are kept to a minimum and non-specific, generic disclosures of engagements are made, the key priority seeming to be successful engagement, rather than publication at all stages *https://www.investorforum.org.uk/wp-content/uploads/2019/01/IF-Fatcsheet-Jan-2019.pdf]*

We also think it is important that the annual Activities and Outcomes Report requirement should not stipulate that reference always needs to be made to particular companies or the actions taken as there may be circumstances where the most effective stewardship is private guidance to the board.

Q.5, 2nd part. If so, what should signatories be expected to include in the report to enable the FRC to identify stewardship effectiveness?

Subject to the comments in Q5, 1st part and the suggestion below, we think the suggested contents for the annual Activities and Outcomes Report on page 4 of the CP seem sensible.

We also think it would be helpful for signatories to set out, not only their stewardship/engagement activities, but, by way of introduction, the criteria they use to decide when to engage with companies and which companies to engage with, so an additional second bullet along the following lines could be added –

- sets out the criteria they have used to decide when to engage with companies and which companies to engage with;

Q6 Do you agree with the proposed schedule for implementation of the 2019 Code and requirements to provide a Policy and Practice Statement, and an annual Activities and Outcomes Report?

We think the proposed schedule for implementation, the requirement for a Policy and Practice Statement and the annual Activities and Outcomes Report seem sensible.

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

Yes, we agree.

Q10 Does the proposed Provision 1 provide sufficient transparency to clients and beneficiaries as to how stewardship practices may differ across funds? Should signatories be expected to list the extent to which the stewardship approach applies against all funds?

Yes, we consider Provision 1 is sufficient.

Yes, we consider that transparency as to how an entity's stewardship practices differ across its funds is important to existing and prospective clients and beneficiaries. Companies may also find this information useful to the extent they can ascertain which fund holds their shares. Regulators too may also be able to use this information to identify where there are gaps in stewardship from certain funds and then be able to consider how to tackle this. Consequently, we consider that signatories should list the extent to which the stewardship approach they describe applies to each of their funds (recognising that any differentiation can be set out in broad policy terms rather than any requirement to set out all instances of deviation).

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

Suggested enhancement of Provision 16 and guidance 16

We would like to see Provision 16 enhanced to go further than just monitoring and to encourage a regular dialogue between asset managers and service providers. This might read –

"Signatories should actively monitor and have a regular dialogue with their service providers (including providing periodic direct feedback to them) to ensure that their services enable effective stewardship".

We feel that a regular dialogue between asset managers and their service providers can only help improve stewardship and engagement. For example, it can help avoid instances where service providers recommend one thing in their report, when asset managers have said the opposite to a company, suggesting the two are perhaps not communicating as well as they could and are perhaps not wholly aligned. We also feel that where asset managers decide not to follow service providers recommendations, they should discuss this with the service provider to help evolve the relationship to better suit the stewardship stance of the asset manager going forward. To achieve the above, we would like to see the below enhancements to the first and third bullets of guidance 16:

Signatories should:

- disclose which services they procure to support their stewardship and from which providers;
- explain what types of actions they take to monitor service providers and how frequently;
- where appropriate and having regard to any confidentiality concerns, explain any dialogue that they have had with their service providers to evolve the relationship, for example to explain their view on an element of stewardship where they wish the service provider to take a different view or to explain why they have not followed a service provider recommendation and what that may mean for how the service provider should provide the service going forward;
- describe what actions, if any, they have taken because of monitoring

By way of explanation of the suggested changes to bullet 2 above, we are concerned that a requirement to describe specific actions may be too much and indeed is not necessary. Instead, we think, as regards monitoring service providers, that it would be helpful to require signatories to explain how often they take certain types of actions to monitor their service providers. So, we have added the words "types of" above to try and make it clear that a generic description of the action taken would be enough and that it is not necessary to list all cases where action was taken or exactly what action was taken.

Suggested new Provision

We also consider that asset managers should promote dialogue between their service providers and their investee companies to ensure that any voting recommendations are given in light of a correct appraisal of the facts. To achieve this, we would like to see an additional Provision along the following lines.

"Signatories should, in their contracts/mandates with service providers, require their service providers to engage with companies where companies request engagement and in particular should require their service providers to either engage with companies in advance of the service provider recommending a vote against or abstention on a resolution in its report or to notify the signatory in advance that they propose to vote against or abstain, so that the signatory can engage."

As this is a comply or explain Provision, those asset managers that that do not wish to require their proxy adviser to engage in this way are able to explain that approach, for example saying that they do not require this of their service provider as they themselves will do the engagement. We feel strongly, that an abstention, whilst not as definitive as a negative vote, still merits engagement with the company where it is proposed and should be included in the new Provision. Again, it open to signatories to explain non-compliance if they choose not to comply.

We mirror this in the Service Providers section from the service provider angle (see Q16 for more).

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

Yes, we support the phrase "collaborative engagement".

But we would note that, while the choice of wording is important, it is the spirit of compliance that is critical – this should be a truly collaborative exercise.

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

We consider that it is important to stress that first and foremost timely, company-specific engagement with the board, in particular with the chairman and the Senior Independent Director, is to be encouraged. The new UK Corporate Governance Code significantly elevates stakeholder engagement as a priority for companies and requires boards to engage with and understand the views of its various stakeholders, not least its shareholders (Principle D and Provisions 3 and 5) and the Stewardship Code should mirror this aim by encouraging shareholders to engage with companies.

We believe that The Investors Forum provides such a mechanism already for investors to escalate concerns by coming together to put pressure on companies, without the need to construct a new mechanism.

If a different mechanism is envisaged, we are not clear what the purpose of such a mechanism is or to whom the escalation is to be made? Is it perhaps escalation of concerns to a regulator that is envisaged here in order to help prevent corporate failure? We feel that if this is to be taken further, more details and a further specific consultation, outside of this Stewardship Code consultation, would be more appropriate. With any such mechanism, we are concerned to ensure that it should not undermine the importance of engagement with the board.

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

We do not consider that there is a need for more detail or more specifics to be disclosed by signatories in respect of asset classes other than shares. We are concerned with a number of elements in this regard including:

- the risk of diverting attention and resources (eg people and time) away from what we perceive should be the main focus of attention, shareholder engagement with and stewardship of their investee companies; and
- the need for any requirements here to be proportionate.

Q16 Do the Service Provider Principles and Provisions set sufficiently high expectations of practice and reporting? How else could the Code encourage accurate and high-quality service provisions where issues currently exist?

We consider that there is now much influence in the hands of proxy advisers who play a significant role in informing investors' voting decisions. Whilst better resourced asset managers will carefully consider the voting recommendations of their proxy advisers and will be willing and able to engage with their investee companies before taking an informed view as to how they vote, other asset managers will routinely follow the advice of proxy advisers and may not have the resource to engage with investee companies. In the latter cases, the influence of proxy advisers is significantly enhanced. Indeed, unless such asset managers, as part of their mandate with their proxy adviser, require them to do the engagement role, there may be no engagement. Proxy advisers are therefore significant players in the stewardship arena in their own right and we believe that the Service Provider Principles and Provisions should be boosted in some key areas to reflect their significant

role. Key areas that we would like to see feature or be augmented include: willingness to engage with companies; conflicts of interest; and how account is taken of explanations of non-compliance. We would also like to understand better how any Code of Conduct will interact with the new Service Provider Principles and Provisions. We now look at each of these in turn.

Suggested new Provision - willingness of service providers, in particular voting advisory services, to engage. We consider that in the same way that asset managers and companies should engage on key matters to foster effective stewardship, so proxy advisers, particularly of those asset managers that are not able to engage themselves, should be prepared to engage where companies request it on key matters that are the subject of proxy advisers' reports, particularly when proxy advisers are going to recommend votes against company resolutions or abstentions on them. Therefore, as a mirror image to the new Provision that we have suggested for Section 3, namely that asset manager signatories require their service providers to engage with companies that request engagement in certain circumstances, we would like to see a new Provision in the Service Providers' section along the lines of the below –

"Voting advisory service signatories should inform a company and their client(s) before issuing a report that contains a recommendation to vote against or abstain on a resolution and should either engage with the company where the company requests engagement or inform their client(s) that the company has requested engagement."

As this is a comply or explain Provision, proxy advisers would be able to explain those circumstances where this Provision was not fulfilled. Guidance could elaborate on what an explanation of non-compliance in this regards could cover.

Finally on this point, we note the current guidance 1 under the Service Providers' section which states "Where service providers offer engagement services, they should set out an engagement policy and how this supports clients' stewardship." We do not consider the guidance sufficient, which is why we are suggesting the above Provision.

Suggested new Provision – how voting advisory services take account of explanations of non-compliance

We would also like to see a new Provision requiring voting advisory services to explain how they take account of companies' explanations of non-compliance. This would serve to encourage companies to think more carefully about the quality of their explanations of non-compliance and also voting advisory services to review them carefully on a case by case basis. This would be along the lines of –

"Voting advisory service signatories should explain how they take account of companies' explanations of non-compliance before deciding on a voting recommendation."

Conflicts of interest. We think that the Service Provider Principles and Provisions should require more detail on how service providers manage conflicts of interest – see specific comments in Part B of this response.

Code of conduct. It is not clear to us what the FRC intends the interaction between the Service Providers' section and the code of conduct to be.

Ideally, any code of conduct should be complementary to the Code and be one that is recognised throughout the service provider industry.

Boosting service providers' guidance.

We would like to boost the Service Providers guidance as follows: -

"Voting advisory service signatories should indicate the percentage of clients for whom they use their standard, publically available, voting guidelines and the percentage for whom they use bespoke guidelines."

B. Specific comments on revised Code

Definition of stewardship (section 1 after Introduction)

Whilst superficially laudable, we see a number of issues with the definition of stewardship and feel that the concept of stewardship is more nuanced. We feel that the definition overstates the duty of asset owners since it rates as equal the need for them to create sustainable benefit for beneficiaries, the economy and society. We consider that their legal duty is to their beneficiaries/clients and that it should be clear that other ideals or benefits are separate from the duty. The definition could perhaps be drafted along the lines of section 172 for directors, with an overarching duty and an obligation to have regard to other relevant factors.

We also have a concern to avoid confusion including any suggestion that the Code somehow overrides existing fiduciary or regulatory or contractual obligations that asset owners and managers have. It might therefore be worth confirming in a preamble to the Code that whatever is written in the Code is not intended to change fiduciary duties or regulatory or contractual obligations. The UK Corporate Governance Code recognises the difference between directors' legal duties and what is thought to be best practice. We suggest the Code should do the same, for example -

"Nothing in this Code overrides or is intended as an interpretation of the fiduciary duties or regulatory or contractual obligations of signatories."

1. Purpose, Objectives and Governance

Principle D says the policies to manage conflicts must put the interests of beneficiaries and/or clients first. Whilst we think it is correct that the interests of beneficiaries or clients should be put first as against the interests of the signatory, we also think that policies to manage conflicts of interest deal with situations where there may be conflicts of interest between different clients. In such cases, the requirement to put the interests of beneficiaries and/or clients first does not help. The policy will normally work to separate those taking decisions for one client from those taking decisions for another client. We think either the Principle needs to make it clear it is only dealing with conflicts between beneficiaries/clients on the one hand and the signatory on the other hand or to be recast to deal also with cases where there are conflicts between clients.

Provision 5. We are concerned that the word "incentive" might suggest this is purely to do with monetary incentives. Perhaps this can be changed to add the following words after "incentives" – "(either financial or non-financial)" to remove any doubt.

2. Investment approach

Provision 10. We feel that it is not appropriate for asset managers to have to state an investment time horizon as that is a matter between them and their clients and will be set by their client's mandate. It may be different for different mandates and may change.

Provision 11. For asset managers we think this should refer to the client's mandate as well as the client's investment time horizon.
Provision 12. We are also concerned whether it is appropriate for an asset manager to disclose an investment belief, as we believe this will vary from one client to another.

4. Constructive engagement and clear communication

Principle H does not say who signatories must engage with and should do so. We think this should say –

"Signatories must undertake constructive engagement with companies in which they invest either directly or by engaging another to do so on their behalf to maintain or enhance the value of assets."

We have suggested changes to make it clear that the engagement is with investee companies and that a signatory may engage by using another (eg an asset owner using an asset manager to do this).

Provision 19. We consider Provision 19 should require signatories to say how they decide when to engage and how to engage. Investors cannot (given their resources) engage with all the investee companies on everything – so what is important is how they decide when to engage and how to engage. It would be helpful for them to describe the approach they adopt. We suggest that Provision 19 be amended as follows –

"Signatories should describe: how they decide when to engage; how they decide what method to use for the engagement; and what methods they have used for engagement, and escalation if required, to enhance the value of assets. "

5. Exercise rights and responsibilities

Elevation and extension of guidance 24 to replace Provision 24. As drafted, the second sentence of guidance 24 is exactly the same as Provision 24 and it is not clear to us what is intended as between Provision 24 and guidance 24. We would like to suggest the following -

We suggest that guidance 24 should become a Provision and be slightly boosted as regards voting advisory services, as we consider that this information would be useful to both asset owners, companies and regulators and allow them to see the growing influence of service providers and to better understand how their advice/information is used by signatories to further stewardship. The new Provision 24 would read –

"Signatories should describe the services they procure, if any, from voting advisory services: including identifying the providers, the scope of services (including whether the voting advisory service uses its standard, publically available, voting guidelines or bespoke guidelines agreed by the signatory) and the extent to which they follow voting recommendations made by such services.

Signatories should indicate which, if any, proxy voting adviser(s) they use, the scope of services procured and how advice/information received is used as part of the signatories' stewardship activities."

Service Providers

See comments on Q16 above.

On the **Guidance,**

Page 14, Guidance 9: We think “may wish to indicate” should be replaced with "should".

Guidance 10 says “in most cases a long-term perspective is required”. We query whether this is this case, and wonder, as mentioned before whether this will depend on the client mandate? Also, what is long –term?
Guidance 11 for asset managers refers to “beneficiaries” in line 3. We think this should refer to clients.

Page 15, Guidance 15. We consider that the concept of providing an "explanation of significant votes" is unclear and would ask for clarification of what is meant by "significant". Is it significant by type of vote; significance of the underlying issue to the investee company's business (if so, how is that to be assessed?); or significance of the investment in the context of the investor's portfolio or the voting capital of the investee company in question? Some non-exhaustive examples would be helpful in this regard.

Page 16, **Guidance 19**.

We suggest that the below element of guidance 19 be elevated to be a Provision and boosted as follows –

"Signatories should seek to engage with companies (or arrange for others to do so on their behalf) before casting any votes against or abstaining from management-sponsored resolutions, ideally leaving enough time for meaningful engagement. "

It is not clear what counts as a "major shareholder" (under listed equity assets). Is this determined by reference to the size of the shareholding in comparison to the size of others' shareholdings or in some other way? It is also not clear whether the guidance means divesting all the holding or whether divesting some of the holding or more than half would be enough for the guidance to apply. We think this needs clarifying.

We think that the guidance for bondholders is not sufficiently strong. We think it would be desirable for there to be guidance that bondholders should also monitor whether an issuer is meeting its covenants or not, and if it is not and this gives rise to concerns, to engage with the issuer.

Page 17 In **Guidance 20,** we think the obligations should apply where a signatory has said it is willing to undertake collaborative engagements (whether it does so or not). If it has not undertaken collaborative engagements, it should explain why not.

Page 18 In **Guidance 23**, we consider that this should also include wording to make it clear this applies where a signatory gives others a mandate to use their ownership rights.

In **Guidance 25**, we suggest it would be helpful to have information on whether the asset owner/manager uses voting processors or not.

On "empty voting" this can also occur where derivatives are used, so the guidance should refer to this too. We wonder whether a more detailed explanation may be needed in the guidance.

In **Guidance 27**, the sentence "Examples may include working equity with portfolio managers" does not seem to make sense.

Page 19, service providers guidance – see comments above on Q16.

C. Miscellaneous comments

- **Communicating investor expectations to companies**

Principle E requires that signatories must integrate stewardship with their investment approach and demonstrate how they take into account materials ESG factors, including climate change. For effective stewardship and engagement, we consider that it is also key for signatories to make clear what their expectations are of companies and also when they change, particularly across different industries.

- **Oversight of compliance / reporting against the Code**

We consider that to maintain pressure for compliance as well as to drive up standards of best practice in stewardship and stewardship reporting, the FRC or its successor should do an annual monitoring report on the Stewardship Code and the reporting done pursuant to it.

- **Reporting by signatories**

Requiring all signatories to the Code to provide more detailed reporting on their stewardship activities and how effective they have been in achieving their stated objectives is a laudable aim,

but it will only achieve real change if signatories to the Code ensure that they have both the time and resource to engage properly with investee companies as part of the discharge of their stewardship activities and provide meaningful disclosure that can assist the investee company and the wider market to understand the approach being taken by the investor.

29 March 2019