

FCA/FRC discussion paper: building a regulatory framework for effective stewardship

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 discussion paper. We include only those questions where we have chosen to respond.

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

Whilst superficially laudable, we disagree with the approach to the definition of stewardship as the concept of stewardship is more nuanced. The proposed 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 subsidiary to that duty and although likely to assist in fulfilling that legal duty, are not ends in themselves. The definition could perhaps be drafted conceptually along the lines of section 172 of the Companies Act 2006, with an overarching duty and an obligation to have regard to other relevant factors such as the fund's stated investment/policy approach or its investment timeframe or any stated sectoral or ethical goals.

We also have a concern to avoid confusion including any suggestion that the definition of stewardship, whether in the FRC Stewardship Code (the Code) or in anything that the FCA promulgates in its requirements or guidance as part of its stewardship oversight role, somehow overrides existing fiduciary or regulatory or contractual obligations that asset owners and managers have. In our response to the Code consultation, we therefore suggested that it might 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 suggested the Code should do the same, for example using a form of words such as –

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

We are not clear what the FCA intends to do following its consideration of the responses to this Discussion Paper, but if it will issue anything it should consider including the above statement.

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

We think it is important for the asset owner or asset manager to work out, for each investee company, what is important for that company – rather than seeking to prescribe that there must be a focus on particular areas.

Communication of what investors consider is important is also key. For effective stewardship, we consider that it is crucial that asset managers communicate clearly what their expectations are of companies, both individually and across sectors or whole industries, and also when those expectations change, both individually and across sectors or industries.

Q3(Part) To what extent do the proposed key attributes capture what constitutes effective stewardship?

We support the proposed key attributes, but have the following specific comments on Table 1.

No. 1, Column 2

"...and takes appropriate account of financially material ESG risks." This appears to suggest that ESG risks should be given particular focus and, as such, there is a risk that insufficient attention is given to other key risks such as having the wrong strategic focus, having too much debt etc..

Given the importance of investors considering, on a case by case basis, what are the critical areas of focus from a stewardship standpoint, we would propose the rewording of this as follows:

"... and take appropriate account of financially material risks, including ESG risks."

No. 2, Column 2, Table 1

We suggest that the first sentence here is amended as shown in red since communications and discussions should be a key part of effective stewardship:-

"Asset managers monitor closely issuer companies' strategies and engage actively with boards/management to communicate and discuss their views and where necessary exert influence".

We would also like to see the following addition and changes (see red), as a recognition of the importance of communication by asset managers or asset owners as appropriate with companies to achieve effective stewardship:-

"Asset managers clearly communicate their priorities to companies, both individually and across sectors/industries, and also when these change."

"Asset owners or asset managers on behalf of such owners should conduct appropriate due diligence on proxy advisers' voting recommendations where used: including seeking to ensure appropriate engagement takes place between the investee company and either the asset owner, the asset manager or their proxy adviser."

Q4 (Part) How can challenges associated with issues such as the coordination of stewardship activities across asset classes, or the exercise of effective stewardship across borders, be overcome?

As investment becomes more global, it is important that UK initiatives take account of initiatives outside the UK and seek to influence those in order to create greater alignment both as regards expectation and approach. We think challenges are best overcome by setting clear expectations as to the sorts of behaviours that are to be encouraged and by the UK working with others who are interested in this area (eg the UN and ICGN).

It would also be instructive to know how successful bodies such as the Investor Forum have been in encouraging a more coordinated approach among asset owners and managers.

Q6 (Part) What do you believe are the most significant challenges in achieving effective stewardship?

We think the significant challenges in achieving effective stewardship include:

- (i) asset owners being willing to pay asset managers sufficiently to enable them to employ more people to engage with investee companies and judging the asset managers on the basis of engagement as well as financial performance;
- (ii) asset managers better integrating their functions which review and decide on corporate governance issues in portfolio companies with their portfolio management activities to ensure a coherent and joined up approach, ensuring companies are not given conflicting views from the same investor;
- (iii) remuneration of asset managers not just on short term financial performance;
- (iv) proxy advisers being willing to engage constructively with companies before recommending a vote against the board's recommendation or an abstention;
- (v) creating a greater public awareness of the importance of stewardship, e.g. when someone chooses an ISA or other investment product. This could be achieved through enhanced disclosure in product literature/Key Facts documents; and
- (vi) creating a greater public awareness of difficulties related to voting where there is a pooled nominee somewhere in the chain. There should be an onus on investment managers to assist asset owners in relation to voting arrangements in such circumstances.

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

We support the proposed balance.

It seems to be likely that a two tier approach will result, those that do the minimum per SRD11 and those that follow the enhanced Code standard. The minimum will be better than nothing, and the revamped Code should hopefully achieve more than it did before. This should also ensure that asset owners have greater choice in terms of selecting an asset manager whose stewardship approach is aligned with the preferences and/or requirements of the asset owner.

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

We consider that there is now very considerable influence concentrated in the hands of proxy advisers who play an increasingly 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 perform the engagement role with the investee company, there may be no engagement. Proxy advisers are therefore significant players

in the stewardship arena in their own right and we consider that more should be expected of them and their asset manager clients.

Accordingly, in our response to the Code consultation we have suggested that a number of areas should be boosted, in some instances by new provisions and in other areas by augmented guidance. These include the need for (i) regular dialogue between asset managers and their proxy advisers to ensure the latter's services appropriately address the needs of the asset manager and to enable effective engagement to take place; and (ii) engagement between companies and either proxy advisers or their client asset managers in certain circumstances (eg in advance of recommendations to vote against or abstain on board-sponsored resolutions).

Q9 iii Feedback on whether there is a role for UK regulators in encouraging overseas investors to engage in stewardship for their asset holdings in the UK

We think there is a role for UK regulators to encourage overseas investors to engage in stewardship for their asset holdings in the UK – and also for the UK regulators to engage with regulators elsewhere to try to steer expectations outside the UK in a similar direction.

iv Feedback on the extent to which additional rules might be necessary either to improve stewardship quality or prevent behaviours that might not be conducive to effective stewardship

We consider that additional rules are not needed at the moment (beyond the proposed changes to the Code).

vi Feedback on whether the FCA's proposed rules to implement certain provisions of SRD II should apply on a mandatory, rather than 'comply or explain', basis

We support a comply or explain approach.

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

We do not consider that there is a need to change the LRs etc. But we do think the FCA and the FRC have not been as effective as they could have been in policing the requirement for listed companies to provide an appropriate and meaningful explanation where they do not comply. Equally, the Stewardship Code has not always been effective in ensuring that investors respond appropriately to good explanations of non-compliance.

Other miscellaneous points

Para 1.16 – We are not clear what will result in practice from the FCA considering whether a firm that claims to engage in stewardship is doing it appropriately? Will the FCA perhaps report on the upshot of its considerations and issue guidance following an initial period – possibly through the equivalent of "Dear CEO" letters?

Para 3.17 – "where permitted by its mandate, an asset manager may seek to exit an investment if engagement is unsuccessful". We have a concern with the above words as they may be read as meaning that an asset manager may only exit after there has been engagement. In some cases, an asset manager (mindful of its contractual relationship with its client), may feel it should exit without engagement and this should be permitted. If the words are intended to deal with the position of an index fund which cannot exit, that should be made clearer.

Para 3.26 – The Company Law Committee would be keen to be involved in any FCA study/work on information flows supporting the functioning of the markets such as the management and disclosure of inside information.

General points:

- (1) **Disclosure of investment time horizons.** We agree that if a manager chooses to state its investment time horizon, it should also clearly communicate how its exercise of ownership rights is consistent with that hold period. However, we do not believe it would be appropriate that asset managers be required to state an investment time horizon: 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.

- (2) **The problem of free-riding.** Whilst we acknowledge the problem of free-riding that the discussion paper mentions in a number of places, we do not consider that it is capable of elimination. The discussion paper seems to envisage the possibility of further regulatory intervention leading to a situation where all investors are equally engaged, but we believe this will remain elusive and if pushed too far would result in an overly prescriptive regime that could be counter-productive. Raising standards should be pursued, for example by boosting the Stewardship Code and by sharing good practice and good outcomes with a view to bringing more (but not necessarily all) investors up to the required standards of stewardship.

29 April 2019