ShareAction»

16 Crucifix Lane
London, UK
SE1 3JW
+44 (0) 20 7403 7800

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

Sent by email to dp19-01@fca.org.uk

Dear Sir or Madam,

3rd May 2019

FCA and FRC: Building a regulatory framework for effective stewardship

I am writing to respond to the discussion paper on building a regulatory framework for effective stewardship on behalf of ShareAction, a registered charity established to promote transparency and responsible investment practices, including stewardship, by pension funds and other institutional investors. We are a member organisation and count amongst our members well-known NGOs and charitable foundations, as well as over 26,000 individual supporters.

We work with institutional investors to promote stewardship and engagement. We conduct annual industry-wide surveys to rank them on these activities. We have ranked asset owners and asset managers on compliance with key elements of the Stewardship Code since its inception, and published these rankings. We have extensive experience of research and policy development on barriers to long-termism, and fed into the 2012 Kay Review, the related BIS Select Committee inquiry, both Law Commission reviews of trustees' fiduciary duty and the BEIS Select Committee inquiry on corporate governance.

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

We would like to see an amendment to the definition of stewardship, adding 'the environment' to 'beneficiaries, the economy and society'. While we understand that the term 'society' could be read as including 'the environment', we think it is important to state this explicitly. Some investors may not read 'society' in this way and this could cause them to give less weight to environmental concerns. We would argue that the inherent value of the natural environment goes beyond the needs of human societies. In addition, many investors are still getting to grips with taking into account financially material environmental and social factors following new investment rules from the Department for Work and Pensions, and the FCA has proposed similar measures for contract-based schemes. To include social factors and not environmental factors in this definition could cause confusion amongst investors that the regulations were intended to avoid.

We understand there has been pushback from some stakeholders on this definition of stewardship, on the basis that it is not compatible with their fiduciary duties. Our view is that the definition is compatible with investors' fiduciary duties. The Law Commission has twice confirmed that ESG factors should be considered by fiduciaries where financially material to investments and may be considered where not financially material (subject to a two-part test

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based on beneficiaries' likely views). This has since been reflected in regulatory clarification by the Department of Work and Pensions and we anticipate similar provisions for contract-based schemes to be introduced by the FCA this summer.

Creating sustainable value for beneficiaries and society are not mutually incompatible aims. For example, if an investor engages with a company to improve their workforce practices, both beneficiaries (through better long-term returns, increased goodwill and reputation for the company, and improved quality of life in a more equal society) and wider society should benefit. This is recognised by Larry Fink (CEO and Chairman of BlackRock) in his 2018 'Dear CEO' letter[1] in which he said that to "prosper over time, every company must not only deliver financial performance, but also show how it makes a positive contribution to society. Companies must benefit all of their stakeholders, including shareholders, employees, customers, and the communities in which they operate". While it is positive Blackrock (and others) take this position, the role of the FRC and FCA is to ensure all investors adequately consider the extent to which their investments consider wider stakeholders.

Moreover, Section 172 of the Companies Act 2006 requires company directors to have regard to the longer-term and wider consequences of their decisions on the community and environment. Under the non-financial reporting regime, companies must annually publish a strategic report on their impact on the environment, the company's employees, and social, community and human rights issues. Amending the definition of stewardship to include societal and environmental concerns would therefore only be an expectation that investors engage with companies about issues on which they already receive information.

The Corporate Governance Code's first principle is: "A successful company is led by an effective and entrepreneurial board, whose role is to promote the long-term sustainable success of the company, generating value for shareholders and contributing to wider society" [our emphasis]. A fiduciary investor's role is to provide the appropriate support and impetus for directors to ensure they are carrying out these responsibilities, so it is entirely appropriate that their stewardship responsibilities include consideration of wider society.

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 (eg ESG outcomes, innovative R&D, sustainability in operations, executive pay)?

The factors listed in this question are all potentially relevant for investors' stewardship activities (depending, of course, on the asset in question). However, these factors should be placed in their wider context and investors should focus on the areas that will have the most net-positive impact for beneficiaries' long-term financial outcomes, society and the environment. For example, it is important that a bank should aim to reduce the carbon footprint of its offices. However, the impact of this measure will pale in comparison to the impact it can have by scrutinising its lending policies and reducing its carbon exposure.

Successive AGM seasons have shown that excessive executive pay is an important issue for investors in their voting and wider stewardship activities. This is wholly reasonable, given that 2016 research from Lancaster University found that the correlation between high executive pay and good performance was "negligible", with boards receiving pay rises of

[1] https://www.blackrock.com/corporate/investor-relations/2018-larry-fink-ceo-letter

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more than 80% over a decade, while performance as measured by economic returns on invested capital was less than 1 per cent over the period.[2]

However, it is vital that executive pay is also placed within its wider context, for example the impact it has on staff productivity and turnover within organisations. On average, FTSE 100 CEOs are paid around 190 times what the average employee receives. Investors should consider the pay ratios in the investee organisation and look at whether it is paying workers a living wage (as determined by the Living Wage Foundation) at the lower end of the scale. From a financial performance perspective, a survey of 800 businesses that pay the Living Wage Foundation's Living Wage found that 93% reported benefits including greater productivity and reduced turnover as a result.[3]

From a broader societal perspective, spiralling pay ratios contribute to spiralling inequality across wider society. Research from the Equality Trust indicates that high inequality is not good for anyone, wherever they sit on the income ladder: less equal societies have less stable economies, less social mobility and lower educational scores, as well as higher property crime and violent crime. They have populations that are more likely to have serious health problems and are less likely to trust each other, less likely to engage in social or civic participation, and less likely to say they're happy.[4] Research for the High Pay Centre found that 80% of respondents want the government to reduce the gap between rich and poor.[5] Therefore, income inequality should be a key consideration not only for investors in stewarding investments on behalf of their beneficiaries but also to the Government and regulators, who should give serious consideration to its societal impacts. This was recognised in the Department for Work and Pensions' recent consultation on ESG factors in pension investment.[6]

Investors should also consider what corporate activities are incentivised by the executive pay structures in question. For example, if an investee energy company rewards its executives for exploiting new oil and gas reserves, the investor should look at how far the company's strategy is compliant with the Paris Agreement objectives. Where it is not yet compliant, the investor should engage with the company to ensure it is taking clear, decisive steps to become so, and vote against remuneration packages that are inconsistent with this.

Q3. To what extent do the proposed key attributes capture what constitutes effective stewardship? Which attributes do you consider to be most important? Are there other attributes that we should consider? If so, please describe.

We broadly agree with the proposed key attributes and example activities. However, to reflect the law on pension investments more accurately, we would recommend inserting the following wording: '(and, where appropriate, beneficiaries' wider ethical and quality of life concerns)' after each mention of 'beneficiaries' financial interests' in points 1, 2, 3 and 4.

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[2] https://www.ft.com/content/abc7085e-c857-11e6-9043-7e34c07b46ef
[3] https://www.livingwage.org.uk/good-for-business
[4] https://www.equalitytrust.org.uk/about-inequality/impacts
[5] http://highpaycentre.org/pubs/reform-agenda-how-to-make-top-pay-fairer
[6] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/716949/consultation-clarifying-and-strengthening-trustees-investment-duties.pdf, p8

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

Stewardship should be applicable across all investment actors, jurisdictions and asset classes because:

- All actors within the investment chain (asset owners, asset managers, advisors) play an important role in determining investment and stewardship policies, and should report transparently on how they are doing so.
- Effective stewardship of companies listed outside the UK is no less important to the ultimate beneficiaries than it is for UK companies. Indeed, given the lower levels of regulation in some markets (for example, in relation to worker rights and protections), it may be more so. There are also countless ESG risks and opportunities that have a reach beyond national boundaries, such as climate change and water pollution.
- We think it would be worthwhile for the FCA to explore how overseas investors can be held to account for exercising stewardship in relation to UK assets. 1.1% of UK businesses receive direct overseas investment and they employ approximately 4 million people in the UK.[7] Just as an overseas company employing UK workers are subject to UK employment law, overseas investors should be required to show how they are demonstrating good stewardship. Otherwise, UK businesses may be subjected to pressures to generate short-term profits by, for example, cutting wages and treating the lowest-paid workers poorly: this would impact negatively on both the long-term sustainability of the business (due to decreased motivation levels and increased staff turnover) and wider UK society (increasing poverty, dependence on food banks, mental health issues etc).
- Investors should use the resources, rights and influence available to them to exercise stewardship, no matter how capital is invested. As noted in this discussion paper, a large proportion of UK asset managers' portfolios are allocated to bonds. Our recent report, *Sleeping Giants: Are Bond Investors Ready to Act on Climate Change?,* found that bond investors' engagement practice still falls short of what is required for climate change mitigation.

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7 https://www.ons.gov.uk/economy/nationalaccounts/balanceofpayments/articles/ukforeigndirectinvestmenttrendsandanalysis/july2018#contributions-of-businesses-engaged-in-foreign-direct-investment-to-the-uk-economy

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

i: how firms prioritise and conduct stewardship engagements

ii: what investments firms have made in stewardship resources

iii: how stewardship activity is integrated with investment decisions.

Not answered.

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

We agree that the problems identified present significant barriers to effective stewardship: in particular, misaligned incentives, poor transparency and the free rider problem.

We believe the misaligned incentives in the investment chain are wide ranging and cause significant problems for the effective functioning of capital markets. We would recommend that the FCA and FRC work with the Government to conduct a cross-departmental review of how these incentives can be realigned.

Professor Kay addressed the free rider problem in his 2012 review: "Even if the benefits of analysis and engagement would be large, for both companies and beneficiaries, the incentives for any individual fund manager to pursue these benefits are weak, since although the individual fund manager bears all the costs most of the additional return will accrue to people who are not his clients and most of the business benefits will accrue to other firms."[8] His recommendation for addressing this problem was setting up an investors' forum with the aim of facilitating collective stewardship activities among asset managers. The Investor Forum was established in 2014 off the back of this recommendation. While the Investor Forum seems to have undertaken numerous successful engagement activities since then, we note that it is focused primarily on governance and managerial execution, rather than (for example) environmental crises that will require collective action. We would recommend that the review suggested in the above paragraph includes an exploration of how the FCA and FRC can encourage collective engagement on environmental and social factors as well.

Enhancing transparency in the investment chain by making voting mandatory could be a powerful driver for better stewardship. This would allow asset owners, beneficiaries and consumer groups to conduct meaningful comparisons of voting patterns among asset managers, asking for justifications and holding asset managers accountable where necessary. We discuss this in more detail in Q9(vi).

8 https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/253454/bis-12-917-kay-review-of-equity-markets-final-report.pdf

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The new requirements on defined contribution pension schemes to report publicly on how their ESG and stewardship policies are being implemented in practice could also have a significant effect on raising standards of stewardship. This should reinforce demand for stewardship and ESG-focused investment from asset owners, clarify how this is being done in practice and generally realign incentives along the investment chain.

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 broadly feel that the two-tier system should work well to ensure a baseline minimum standard of stewardship across the board, while encouraging driving higher standards for the firms that are well placed to demonstrate best practice. However, this is dependent on two factors that we do not yet see in the proposed new rules and Code:

- Mandatory voting disclosure in COBS (we discuss this in more detail in Q9(vi)).
- Clear carrot-and-stick-based consequences for Stewardship Code signatories who do not comply or exhibit high standards of stewardship. We discuss this in more detail in Q7 of our response to the recent FRC consultation but, in brief, we think this should include:
    - Public recognition of signatories who have shown high standards of stewardship (for example, a starred status).
    - Constructively dealing with signatories who fail to comply, firstly via private engagement and then via public notices and suspension of signatory status.
    - Increased investigative powers and capacity to conduct random audits.

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

The Stewardship Code should explicitly state that service providers must “demonstrate how they take into account material ESG issues, including climate change” in the Service Provider Principles and Provisions. We have concerns about the extent to which proxy advisors are applying ESG factors to their decisions, especially given how much reliance is put on their advice.

We support the PRI’s recommendation that the Guidance to Provision 2 in the Stewardship Code should be amended to encourage signatories to publish details and statistics of errors made in their service provision. Proxy advisors play a powerful role in influencing voting decisions and they have received a great deal of criticism for making factual errors in AGM season.

Q9: We welcome feedback on other specific aspects of the regulatory framework described above. In particular, we are interested in views on:

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

Yes, we believe it is wholly appropriate to extend the proposed rules for asset owners to SIPP operators. While SIPPs offer consumers more choice around investment option than a normal personal pension does, they are still a consumer product and therefore in need of close regulatory attention. The providers of SIPPs have ownership rights over the assets within the funds and should use their influence available to exercise stewardship on behalf of consumers. SIPPs have been the focus of the FCA's attention for some years now, following large numbers of claims against providers and advisors for making unsuitable, unregulated investments within SIPPs vehicles. We see no reason why SIPPs should be excluded from these rules.

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

As we commented above, investors should use the resources, rights and influence available to them to exercise stewardship, no matter how capital is invested. It would be helpful for the amendments to COBS to reflect this explicitly, as the Stewardship Code now does, as there is still a preconception among investors that stewardship is only relevant to equities.

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

As discussed in Q4, we think it would be worthwhile for the FCA to explore how overseas investors can be held to account for exercising stewardship in relation assets managed in the UK.

iv: 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 are concerned that firms may not take their duties under the new rules seriously without a clear sense of oversight or enforcement. **The FCA should undertake a review of the effectiveness of these rules in two years' time, in conjunction with the new regulatory body replacing the FRC**. If there is evidence that firms are not meeting the requirements of the rules (for example, if they say they are complying but are not doing so, or their explanations are insufficient), the FCA should take a more active approach to scrutinising and enforcement compliance with these rules, as it does in other areas.

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

Not answered.

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

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As we have previously commented in our response to the FCA's consultation on proposals to improve shareholder engagement, we strongly recommend that voting disclosure under the UK's implementation of SRDII should be on a mandatory rather than on a comply-or-explain basis. The Government already has the necessary powers to make voting disclosure mandatory (s1277, Companies Act 2006). The FCA should require asset managers to publish voting decisions (including rationales for votes against management and for votes with management where a significant number of shareholders voted against). There should not be an option to 'explain' noncompliance with disclosure. Furthermore, asset owners should be required to publish this information or provide links to it on their own websites, regardless of whether they exercise their own votes or delegate to managers.

ShareAction's position for many years has been that asset managers should be required to publish their voting decisions. This would better enable asset owners, pension scheme members, retail investors and other stakeholders to evaluate the quality of stewardship undertaken by asset managers. Transparency is a pre-requisite of a healthy and well-functioning 'market for stewardship'. Your consultation paper on SRDII makes the point that "Developing a market for stewardship would improve competition in consumers' interests by encouraging firms to compete to deliver high-quality investment decisions, oversight of assets and engagement with, and challenge of, companies' boards and management." The Investment Association has also said it supports the development of a stronger market for stewardship. In practice, it's hard to envisage a more effective market emerging unless those who purchase asset management services can compare how different asset managers in the marketplace are voting.

We appreciate that time is short before the SRDII implementation deadline of 10th June. Clearly, we would be happy to see a reasonable time period in which regulated firms could prepare to disclose their votes. Many firms already disclose, albeit disclosures are made in many different formats which impedes their practical value in making the stewardship marketplace more competitive. Currently, voting disclosures are often opaque and inaccessible, listing resolutions by number without setting out the actual resolution text, and lacking explanations of controversial votes. Managers disclose in different ways and at different times: there can be a significant time-lag between the votes happening and disclosures being made. We therefore also suggest that the FCA invites industry to work together to develop a common template for voting disclosures.

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)?

Not answered.