Institute of Business Ethics Response to the Financial Reporting Council consultation on Proposed Revision to the Stewardship Code

General Comments

The Institute of Business Ethics is an educational charity whose purpose is to promote high standards of business behaviour based on ethical values. We believe that governance and the investment process, supported by a strong and effective approach to stewardship, have an important role to play in delivering this objective, especially when stewardship favours a long term approach to business success as opposed to focus on short term results. We therefore welcome the opportunity to respond to this consultation.

We broadly support the primary definition of stewardship as set out in the Introduction to the new code. This is indeed to look after the assets of beneficiaries that have been entrusted to the care of others. The task must include addressing the social impact of investee companies because they cannot generate sustainable value for investors in the long term if they are harming society from which they derive their franchise.

We therefore agree with the references to environmental and social issues. However, institutional investors are there to look after the assets of their beneficiaries and we do not believe that the insertion of a social purpose is appropriate in the context of the Stewardship Code, especially since it might lead to conflicting objectives.

Moreover, **we are concerned that the revised Code places too much relative emphasis on environmental and social engagement at the expense of engagement focused on the financial, commercial and strategic health of the business**. It also continues to place heavy emphasis on reporting, which, as Sir John Kingman noted in his recent review of the FRC, can become an end in its own right.

With regard to the first point, we recall the original purpose for which the Stewardship Code was created, namely to address the apparent failure of institutional investors to challenge the business model of the banks in the run-up to the global financial crisis of 2008. Dealing with this type of challenge is significantly more difficult than monitoring and encouraging good environmental and social outcomes, important though these are. The investment community should not be too easily let off the hook. The immediate risk to beneficiary assets is large if governance opts out of financial, commercial and strategic issues, as the experience of Carillion and Patisserie Valerie shows.

We therefore need more clarity on what the stewardship obligations of investors actually are and what they understand by them. The code would be strengthened by specific reference under Principle One to the need for signatories to develop and disclose a clear understanding of their fiduciary duties, drawing on the freedoms and constraints set out in the Law Commission's report on The Fiduciary Duties of Investment Intermediaries of July 2014.

It is quite possible, for example, for a company to be delivering well on the environment and social welfare but to be running an unsustainable dividend policy which is not matched by cash generation. Were such a company to get into financial difficulties or even to fail, the social damage could be great as well as the loss to shareholders.

The code would therefore be enhanced if the need to develop and disclose a clear understanding of fiduciary duty were spelled out in the wording around Purpose in Principles A and B and the associated Provisions and Guidance. Moreover the requirement in Principle 3 of the existing code on investors to endeavour to identify at an early stage issues that may result in a significant loss of investment value should be reinstated. We do not understand why it has been deleted.

Our second main point is that the objective of the Stewardship Code should be improved execution by institutional investors of their fiduciary duties. High quality reporting is a necessary, but not sufficient pre-requisite for this. Together with the government and other regulators, investors should look at incentives towards better quality engagement.

This means looking at the contents of mandates awarded by asset owners to those that manage money on their behalf. These should aim to re-allocate resources away from dealing commissions towards stewardship. Together with their consultants, asset owners should do much more to scrutinise the quality of engagement.

That said, we are broadly supportive of the main changes to the Code, in particular the coverage of asset classes other than listed equity and the differentiation of roles played by asset owners, asset managers and service providers.

Specific answers

Question 1. Do the proposed Sections cover the core areas of stewardship responsibility? Please indicate what, if any, core stewardship responsibilities should be added or strengthened in the proposed Principles and Provisions.

See general comments above.

Question 2. Do the Principles set sufficiently high expectation of effective stewardship for all signatories to the Code?

See general comments above.

Question 3. Do you support 'apply and explain' for the Principles and 'comply-or-explain' for the Provisions?

Yes, but this is conditional on there being a real consensus around the Principles and the way in which they are expressed. The results of this consultation should confirm whether or not such consensus exists.

Question 4. How could the Guidance best support the Principles and Provisions? What else should be included?

The Guidance should not become a rule book. It should form a consensual basis for setting out best practice in support of a 'comply-or-explain' approach to the Provisions. We believe strongly that the FRC should not alter it without consultation.

If it does so, the 'comply-or-explain' approach will be harder to operate, especially since in Paragraph 60 of the document the FRC commits itself to "more clearly differentiating signatories based on the quality of reporting on their stewardship policies, objectives, activities and outcomes." It would therefore naturally tend to mark down investors who do not agree and therefore do not comply with guidance which it has itself introduced unilaterally.

Question 5. Do you support the proposed approach to introduce an annual Activities and Outcomes Report? If so, what should signatories be expected to include in the report to enable the FRC to identify stewardship effectiveness?

Yes, this is a necessary prerequisite for effective stewardship. We need, however, to be clear that the primary purpose of such reporting should not be to enable the FRC as regulator to identify stewardship effectiveness but to enable the market in stewardship to function effectively, with business flowing to asset managers who are good stewards. The danger in tasking the FRC with 'policing' the Code is that signatories will become primarily concerned to please the FRC rather than to deliver value for money and effective stewardship. There are signs that this has happened with audit to the detriment of quality.

As stated in our general comments above, we consider that the FRC should work with government and other regulators to create more incentives for good quality engagement, and then encourage the market to make informed decisions.

Question 6. 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 have no comment as this is an operational question.

Question 7. Do the proposed revisions to the Code and reporting requirements address the Kingman Review recommendations? Does the FRC require further powers to make the Code effective and, if so, what should those be?

The concept of an outcomes report is a good one even if it is sometimes difficult to know exactly how to share the credit for a particular outcome when several investors have been involved. In the end, however, it is the market which should drive quality and differentiation.

There is room for some initiatives around this. When a company fails or experiences a crisis, there is too often a mad scramble, at times led by Parliamentary Committees, to investigate and apportion blame. While this approach is needed to allocate responsibility and ensure accountability, there is a separate need to learn the lessons for the future.

The market needs a safe space to undertake forensic work on a no-blame basis so as to establish whether and why shareholder engagement failed, to improve their practice and ensure that any general lessons are disseminated through the market. The Code could specifically encourage this and consideration should be given to allocating specific responsibility to the Investor Forum for facilitating such forensic work.

It is a remarkable failure of stewardship as well as of accounting and audit that Carillion was not successfully challenged on its failure to take an impairment charge on its permanently loss-making EAGA acquisition which was also valued in its books at more than it paid for it. Were major investors aware of this? If not, why not? If they were, why did the stewardship teams not engage?

Sir John Kingman's review noted that the FRC Investors Advisory Group consists largely of ESG specialists, not investment decision-makers. He recommended that the FRC needs to engage at more senior level in a much wider and deeper dialogue with UK investors. We believe that this is right if problems such as those which emerged at Carillion can be effectively addressed. A hook for such dialogue would be the requirement for the statement of purpose to be issued by executives at Chair or Chief Executive level (see answer to Question 8 below).

Question 8. Do you agree that signatories should be required to disclose, their organisational purpose, values, strategy and culture?

Yes, but this part of the disclosure should be made at the level of Chair or Chief executive and accompanied by a commitment to deliver on the purpose, values, strategy and culture. As discussed above, the statement should include a clear description of what the organisation understands by its fiduciary duties.

We noted that Paragraph 85 of the consultation document calls on institutions to invest in the workforce with the appropriate level of skills, experience and influence to engage appropriately. It stands to reason that only senior people deploying budgetary resources are able to make this commitment. They should then be held account for doing so.

Question 9. The draft 2019 Code incorporates stewardship beyond listed equity. Should the Provisions and Guidance be further expanded to better reflect other asset classes? If so, please indicate how?

It is probably early days to develop differentiated guidance for different asset classes. We consider that the present wording of the provisions and guidance is about right, except that we recommend that Provision 1 should refer to the need for disclosure about *how* the investor seeks to ensure consistency across all asset classes and (where relevant) funds.

Paragraph 83 of the consultation opens the agenda to systemic issues and the need to build a sustainable financial system. This is important but we are not yet at a stage where we understand properly what is meant by systemic issues. The IBE has admired some of the work done by shareholders in persuading oil and gas companies to consider the long term future of their businesses in the light of global warming.

Insofar as the purpose has been to deal with a systemic risk which ultimately threatens the value of beneficiaries' funds, then this is arguably entirely consistent with stewardship and the institutions' underlying fiduciary duty. However, these efforts are focused with a very clear strategic purpose. Introducing the concept of systemic risk without a clear understanding of what it means creates the risk that it will be used as an excuse for single-issue lobbyists to add policy issues to the stewardship agenda which are not clearly justified by institutional fiduciary duty.

Question 10. 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?

We understand the difficulty of ensuring that the broad approach to stewardship applies across the board, when in some houses portfolio managers take a bespoke approach. However, insofar as the code is designed to improve the ability of asset owners to make informed choices, it does seem desirable that asset managers should at least disclose when particular funds are not covered by their stewardship activities. We consider that such disclosure be required under a comply-or-explain basis.

Question 11. Is it appropriate to ask asset owners and asset manager to disclose their investment beliefs? Will this provide meaningful insight to beneficiaries, clients or prospective clients?

Yes, provided the statement is made at a senior leadership level.

Question 12. Does Section 3 set a sufficient expectation on signatories to monitor the agents that operate on their behalf?

Given our belief in the need to monitor financial, commercial and strategic issues, we are concerned at the deletion of the previous Principle 3 Guidance paragraph exhorting signatories to monitor and engage on developments that may result in a loss of investment value. Indeed we are surprised that such a deletion has been introduced without it being the subject of a question, when the original purpose of this paragraph was to encourage institutions to get to grips at an early stage with flawed business models and financial practices.

As to the monitoring of service providers, we are generally content, although we believe more needs to be done collectively to ensure that Proxy Advisers meet the required standard.

Question 13. Do you support the Code's use of 'collaborative engagement' rather than the term 'collective engagement'? If not, please give your reasons.

We are wary of this change of language because, as indicated in Paragraph 99 of the consultation document, it appears to open the door to interference in the engagement process by outside stakeholders with no particular accountability. It needs to be clear that institutional investors may collaborate with non-investor stakeholders provided that this is consistent with the fiduciary duty towards their beneficiaries, but they are not compelled to when this is not the case. Provision 20 should be reworded accordingly.

Question 14. Should there be a mechanism for investors to escalate concerns about an investee company in confidence? What might the benefits be?

We see no immediate requirement for additional powers of escalation. Investors are already able to talk to boards in confidence and to vote against directors where they perceive problems. They should, however, establish better dialogue with Audit Committees and be more willing to challenge auditors.

Looking ahead, however, we note that Recommendations 47 to 50 of Sir John Kingman's Independent Review of the Financial Reporting Council would give the FRC or its successor body powers to intervene in troubled companies including the right to commission and publish independent reports, a review of dividend policy and the replacement of the auditor. One reading of the reasons for this is that the FRC is being asked to accept this obligation because shareholders have consistently over the years failed to do so effectively.

This criticism is not entirely fair. Some institutional investors were perfectly aware of the difficulties facing Carillion and sold out accordingly, which was almost certainly the best decision for their beneficiaries. If they do have serious concerns, shareholders have strong existing powers including the right to dismiss the board. Their ability to use these powers effectively is sometimes limited because of the fragmented nature of market ownership and because of the growing prevalence of passive investment where investors are locked in and cannot sell. If there is a new mechanism it needs to address this last point in particular.

An effective sanction against companies that persistently and wilfully display poor governance is that they should be excluded from the index. Then everybody, including passive funds would be free to sell.

We do not agree with all the detail of the Kingman proposals on intervention, but we do agree with the broad thrust that the FRC or its successor should have powers to engage more with companies where it perceives a problem or where a problem has been drawn to its attention. The ultimate sanction should be the power to issue a recommendation to the index providers on the basis that it was no longer safe to compel passive funds to hold the company.

Arguably, by the time this stage was reached, the share price would have fallen and much value would have been lost. However, the threat of such a sanction might be enough to concentrate minds and prompt earlier action, especially if the initial intervention by the FRC, or its successor was on a confidential basis. To be effective in this role the FRC, or its successor should be able to rely on confidential expressions of concern from investors, auditors and others. All this, however, depends on implementation of the Kingman proposals.

Meanwhile, investors who are largely focused on passive funds should be clear that, where they cannot sell because of concerns, they will use their voting rights to vote against director re-election.

Question 15 Should Section 5 be more specific about how signatories may demonstrate effective stewardship in asset classes other than listed equity?

Paragraph 27 of the Guidance should refer to asset classes other than bonds. For example, much of the Stewardship Code is relevant to investments in private equity. Investment in property carries a large potential stewardship obligation.

As part of its continuing maintenance of the code the FRC, or its succesor should convene workshops, exploring practical ways of how investors in various asset classes can deliver effective stewardship. This would be a prelude to expanding the guidance at a later stage.

Question 16. 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 provision where issues currently exist?

Yes, generally. However, on a separate yet related track, much more work needs to be done to raise confidence in the work of Proxy Advisers.