THE INVESTOR FORUM

Mark Manning
Financial Conduct Authority
12 Endeavour Square
London EC20 1JN

30th April 2019

Dear Mark,

Discussion Paper on Building a regulatory framework for effective stewardship

We welcome this Discussion Paper (DP) and the FCA's appetite to advance the debate on what effective stewardship entails, the standards that the UK should aspire to, and how these might best be achieved.

The FCA's recognition of the value that effective stewardship can bring, and the appetite to align new proposals with its own purpose and objectives, is a clear positive. We agree with the FCA's view that those who work in financial services must embrace the principles of responsibility and accountability. Encouraging effective investor stewardship represents a significant opportunity to ensure that the financial services industry delivers benefits to consumer and the real economy.

The UK is at the forefront of developing stewardship practices, yet expectations are rising and much more remains to be done – both by practitioners, and the creation of a cohesive regulatory and supervisory structure. The existing framework comprises a mix of law, code, and supervisory powers, split between multiple regulators. Greater clarity of roles and responsibilities is essential to deliver the desired outcomes.

The Investor Forum's purpose is to put stewardship at the heart of investment decision making, and our focus is on delivering effective collective engagement outcomes. As such, we believe our practical experience is relevant to this debate. The views expressed in this letter are our own; many of our Members will respond directly to the DP, and other parties, notably The Investment Association, will represent the industry's views on the broad range of issues.

We would like to make four key points, in two areas:

Regarding the regulatory framework:

- A **clear regulatory framework,** embodying high standards and defined expectations, is essential to promote effective stewardship and to maintain and promote the UK's position as a global leader in this area;
- A **principles-based approach** is well suited to drive innovation and competition in stewardship activities and deliver effective outcomes.

Regarding effective stewardship:

- It is crucial to have a **robust definition of stewardship**, based on the responsibilities of each party in the investment chain to their clients. We suggest changes are required in the **DP's key attributes** of effective stewardship.
- **Collective engagement** is an efficient way of delivering effective change, and therefore plays an important stewardship role. Clear endorsement from regulators of its benefits could significantly reduce perceived barriers to this activity.

A clear regulatory framework

A number of regulators and Government departments have an interest in promoting effective stewardship, **leading to both notable overlaps and gaps in regulation, supervision and enforcement in the complex investment chain.**

As the FRC successor gains statutory status, careful thought will need to be given as to how its powers interact with those of the FCA and the work of the Department of Work and Pensions and The Pensions Regulator. We therefore applaud and encourage efforts by the FCA to work with the range of supervisors and regulators to achieve a consistent framework.

The FCA has a key role in this debate, given its powers in relation to asset managers, life insurers, markets and potentially investment consultants. Supervisory practices can be an important mechanism to drive change through the system. Although not mentioned in the DP, the extension of the Senior Manager & Certification Regime (SM&CR) could be viewed as an opportunity for the FCA to consider how effectively firms embed stewardship throughout their organisation. **We believe that investors would welcome clarity as to how the FCA envisages using its supervisory powers to advance stewardship practices**.

Investor stewardship is an area where the UK is a global leader; the establishment of The Investor Forum is one example of the UK's continued advancement of stewardship practices globally. Any review of regulation should therefore seek to maintain the competitiveness of UK-based asset managers, as well as to enhance global investor confidence in investing in and through the UK.

A principles-based approach: balancing regulation and codes (Q7)

The strength of a principles-driven approach to stewardship is that it sets a framework within which investment institutions can operate with professionalism and apply their own judgement to deliver engagement outcomes.

A well thought-out and implemented principles-based approach to driving improvement in stewardship activities and outcomes will encourage competition, diversity of approach and innovation. Lack of clarity or an overly complex rules-based approach could inhibit stewardship activity or lead to the furthering of a tick-box mentality, and on reporting rather than the delivery of outcomes.

The Stewardship Code has a key role to play in encouraging institutions to rise to the challenge of delivering stewardship excellence and then to demonstrate how they have delivered outcomes for the benefit of their clients. In our recent consultation response to the Stewardship Code,[1] we put forward our view that significant clarification and simplification is required if the proposed Code is to foster the delivery of effective outcomes.

In our opinion, the balance of the current draft shifts towards that of a detailed rulebook. Our view is that the detailed guidance should be dropped altogether, or at least cut back significantly so that the weight of the document is on the principles and provisions. The Stewardship Code is a Code – which means that to be effective it should be about principles, not detailed rules. This is particularly important given the pending change in statutory powers and personnel at the FRC, and the potential overlap with the powers of other regulators.

One aspect of the Code that is a welcome positive addition is the concept of an annual Activities and Outcomes Report. This reflects existing best practice as well as our own experience of publishing an annual review of collective engagement activity, which can be scrutinised and challenged by our Members and the public. Among other steps, a formal sign-off by the Chief Investment Officer (or equivalent) could help embed and reinforce the stewardship agenda throughout the signatory organisation. This could help to ensure that stewardship is at the heart of investment decision-making and would represent a powerful response to the Kingman Review.

[1] Link to Investor Forum response to FRC Stewardship Code consultation.

A robust definition of stewardship (Q1, Q2, Q3, Q4)

In order to provide a 'clear understanding of the role and purpose of stewardship,' it is crucial to first have a robust definition of stewardship. In our view, **stewardship is preserving and enhancing the value of assets with which one has been entrusted on behalf of others.** It reflects the fact that an investment intermediary looking after assets on behalf of a beneficiary or client has obligations of a fiduciary nature. We summarise our views on stewardship and effective engagement in the Appendix.

We consider that the FCA and FRC definition of stewardship in the DP does not adequately capture the true essence of stewardship in an investment context. Based on whether fiduciary as well as contractual responsibilities exist, each party in the investment chain must understand their responsibilities to their clients or beneficiaries and what that entails for stewardship responsibilities and accountability.

We welcome the valuable debate among market participants regarding the definition of stewardship catalysed by the FRC Stewardship Code consultation. The FCA's recent discussion paper on duty of care should also provide important input to the definition of stewardship.

Similarly, we welcome the DP's recognition that a description of Key Attributes of effective stewardship can be helpful to aligning expectations. These attributes warrant further thought and discussion once stewardship has been clearly defined, as does the role of any examples provided. In describing key attributes, the test should be whether they help to drive effective outcomes.

It is important to maintain a consistency of language across the various codes and regulations which inform stewardship activity. The term 'collective engagement' is a widely recognised and appropriate term in the UK, and we do not believe that the introduction of the term 'collaborative' in the Stewardship Code consultation or the FCA's use of the word 'cooperative' in the current DP advances the debate. Clarity of terminology would be helpful.

Collective engagement: overcoming barriers (Q9iii, Q10)

Collective engagement is crucial to overcome obstacles caused by fragmented ownership, which is a particularly acute issue for UK-listed companies. This issue was highlighted by the Kay Review and has been supported by BEIS, HM Treasury, a growing literature of academic evidence and the Investor Forum's own track record. Accordingly, we note that investor cooperation is one of the examples you provide as evidence of effective stewardship, but were disappointed that it was not retained as one of the Principles in the FRC's draft Stewardship Code.

There are many practical challenges involved in encouraging collective engagement:

- For collective engagement to work effectively, participants need to be clear about the objectives, the boundaries of engagement, and to feel assured that they are acting in a safe and secure environment.
- It requires a large number of, often global, investors employing a wide variety of investment strategies to work together, in a complex legal and regulatory context.

In order for regulation to be most effective, any new regulatory approach needs to build on practitioner experience about what delivers positive outcomes, and academic research that reinforces that experience. Key legal and regulatory issues that must be taken into account include:

- City Code and concert party considerations;
- the Market Abuse Regime; and
- competition law.

All three areas need to be considered in a global context, in particular taking into account US and European law and regulation.

A key element of success of the Investor Forum has been the development of our Collective Engagement Framework, which was architected with pro-bono support from a number of leading international law firms and benefited from consultation with the Takeover Panel and the FCA. In particular, guidance from the Takeover Panel has been helpful in reassuring investors that most stewardship activity should not give rise to concerns under the City Code on Takeovers and Mergers. Further similar guidance would be useful from the FCA as regards the value of collective engagement and the Market Abuse Regime.

We also note that competition concerns are rising up the agenda, in particular as regards "common ownership". We believe that it would be valuable for the FCA to address any competition concerns, perceived or otherwise, in order to encourage the exercise of effective stewardship activity, including collective engagement.

Given regulatory, legal and competition concerns amongst investment practitioners, there would be significant benefit from regulators addressing perceived and real obstacles to investors working collectively. **If collective engagement is viewed as an essential part of effective stewardship, this should be reflected as a priority in regulatory expectations.**

Conclusion

It is in the interest of savers, companies and the wider economy that the UK develops a regulatory regime that supports the delivery of world-leading stewardship. As the FCA states, this should also have a clear benefit for the broad institutional investment community, which individuals and households increasingly rely on to look after their financial interests.

We welcome the FCA's focus on the importance of stewardship, and believe it is important that the fragmented regulatory framework be clarified. Given the complex investment chain, a principles-led approach which places the role of culture and governance at its centre is key to incentivising all parties to do the right thing. Any potential change to regulation and supervision should therefore be considered in the context of whether it contributes to increased effectiveness of stewardship through the investment chain.

With a focus on delivering positive outcomes from stewardship activities, regulators and supervisors could help further embed collective engagement activities. We believe there is value in the FCA taking steps to:

1. Endorse collective engagement as an efficient way of delivering effective change and positive stewardship outcomes; and
2. Ensure that any unnecessary barriers to collective engagement are kept to a minimum, given the complexity of the system and the potential for unintended consequences.

We would welcome an opportunity to discuss any of the issues raised further; please do contact Andy Griffiths (andy.griffiths@investorforum.org.uk) or me.

Yours sincerely,

Simon Fraser
Chairman

Appendix: Defining stewardship and effective engagement

This section sets out our thoughts on the important areas of stewardship and engagement, based on our observations and experience since the Investor Forum was established in 2014.

Definitions of stewardship and engagement

We believe that **stewardship** is preserving and enhancing the value of assets with which one has been entrusted on behalf of others. It reflects the fact that any investment intermediary looking after assets on behalf of a beneficiary or client has obligations of a fiduciary nature.

Engagement is active dialogue with a specific and targeted objective. It is intended to put the stewardship role into effect. The underlying aim of the engagement dialogue should always be to preserve and enhance the long-term value of assets on behalf of beneficiaries and clients.

We have summarised the perspectives of the Investor Forum on the key characteristics and desired outcomes of stewardship in Table 1.

Characteristics of effective engagement

Effective engagement requires a process that:

- is set in an appropriate context of long-term ownership and has a focus on long-term value preservation and creation, so that the engagement is aligned with the investment thesis
- is framed by a close understanding of the nature of the company and the drivers of its business model and long-term opportunity to prosper
- is based on clear objectives, focused on effecting change
- recognises that change is a process and that, while haste may at times be necessary, change should not be inappropriately rushed
- employs consistent, direct and honest messages and dialogue
- is appropriately resourced so that it can be delivered professionally in the context of a full understanding of the individual company
- uses resources efficiently so that engagement coverage is as broad as possible whilst using all the tools available, including collective engagement
- involves reflection so that lessons are learned in order to improve future engagement activity

These elements are necessary in order for engagement to receive the most favourable response from the engaged company and to give the best chance of delivering value-enhancing change through engagement.

To be impactful, engagement requires clear objectives, professional resource and persistency. There are no short-cuts to the delivery of effective engagement, and most complex situations require bespoke strategies rather than a more generic “one size fits all” approach.

Collective engagement

The Investor Forum has built a track record over the last four years in conjunction with its members. We believe this practical approach, supported by academic evidence, and the recommendations of the Kay Review, illustrates the value of collective engagement as part of an investor’s stewardship activity.

If done effectively, collective engagement helps company boards understand the underlying reasons for investors’ concerns, while respecting that it is their duty to run the company. It therefore puts them in a much stronger position to take action, rebuild trust and develop their long-term strategy on behalf of all stakeholders.

Collective engagement has a number of powerful attributes. It:

- addresses concerns raised in Kay Report over fragmented and disparate ownership;
- increases the impact of individual investor messages by presenting it within a framework which has a critical mass of support;

- offers investors an additional tool to escalate their stewardship activity, allowing existing institutional investors to catalyse change and restore value, as an alternative to the transfer of value which often accompanies action by the more opportunistic of activist shareholders;
- helps companies by clarifying investor concerns, addressing corporate confusion over conflicting or varied messages;
- improves dialogue by reducing a company's ability to use "divide and rule" tactics.

Barriers to engagement

There are many practical challenges involved in encouraging collective engagement. It requires a large number of, often global, investors employing a wide variety of investment strategies to work together, in a complex legal and regulatory environment.

For collective engagement to work effectively, participants need to be clear about the objectives, the boundaries of engagement, and to feel comfortable that they are operating in a safe and secure environment. This is why it was critically important that we create a comprehensive framework. We believe that the establishment of the Forum's Collective Engagement Framework has made an important contribution to the development of engagement practice.

One context for understanding the delivery of effective stewardship outcomes is to consider the key barriers to engagement and how they can be overcome. Through our work we have identified four key barriers to engagement, which are:

1. **Resourcing** – even the largest stewardship functions will always be resource-constrained and must overcome this to deliver across the breadth of companies in which the institution invests.
2. **Consensus** – it can be a challenge to reach consensus within an organisation, including between individual portfolio managers and between portfolio managers and the stewardship team; consensus between different investment institutions is still harder.
3. **Visibility** – companies and other investors may not know about the investment exposure that an investor has, and may not understand the drivers for an investment position, making dialogue and trust harder to achieve.
4. **Conflicts** – conflicts of interest may limit the scope of action of investors; it is important they have mechanisms for ensuring that client interests are always put first.
5. **Competition** – as stewardship becomes more of a differentiating factor for fund managers, more may sense they have a competitive interest in acting alone.

Overcoming barriers to engagement

A discussion among Investor Forum members in late 2018 revealed that investors perceive two main solutions to these barriers and to ensuring that engagement is effective:

- reinforcing the close integration of stewardship with the fund management activity; and
- making full use of all available resources, including collective engagement.

The decision to engage should be closely linked to investment decision-making. For many, engagement success is about enhancing value and being able to stay invested, yet exit must always be an option for an active house. Thus ideally, engagement should be part of the role of every fund manager and every analyst. Where this is done, issues around resourcing significantly reduce as there is no longer the same dependence on specialist stewardship staff.

In order to reach consensus internally as much as externally – and certainly for collective engagement with other institutions – it is often necessary to focus on areas of agreement not of disagreement, which may mean directing attention to the problems at companies rather than over-emphasising specific solutions to those problems.

What matters most to clients is delivering change at the companies of highest significance – both in terms of large investment positions and in terms of sizeable exposures to risks that are of the greatest concern to those clients. Investors should therefore use the most appropriate tool available to achieve their desired outcome.

Table 1: The components of Stewardship

<table>
<tr><td></td><td colspan="2">Stewardship
Preserving and enhancing the value of assets with which one has been entrusted</td></tr>
<tr><td rowspan="3">…delivered through…</td><td colspan="2">Investment approach and decision
Allocation of capital in accordance with investment purpose, mandate and client interests, at portfolio and individual asset levels</td></tr>
<tr><td colspan="2">Dialogue
Active discussions between companies and investors, of which there are two principal forms:</td></tr>
<tr><td>Monitoring
Dialogue for investment purposes: to understand the company, its stakeholders and performance.
Informs incremental buy/sell/hold decisions</td><td>Engagement
Purposeful dialogue with a specific and targeted objective to achieve change
Individual or collective basis as appropriate</td></tr>
<tr><td>…typified by…</td><td>Detailed and specific questioning; investors seeking insights</td><td>Two-way dialogue; investors expressing opinions</td></tr>
<tr><td rowspan="2">…characteristics of high quality delivery…</td><td colspan="2">• Framed by close understanding of nature of company and drivers of its business model and long-term opportunity to prosper
• Appropriately resourced so dialogue can be delivered professionally in the context of full understanding of individual company
• Dialogue must be consistent, direct and honest
• Dialogue is respectful and seeks to build mutual trust</td></tr>
<tr><td>• Set in a context of mutual understanding of fund manager’s investment style and approach
• Recognises that change within companies is a process and sometimes takes time to be reflected in external indicators of performance
• Resources are used efficiently so that neither party’s time is wasted
• Fuller insight leads to better informed decisions
• Includes feedback so that mutual understanding can be reinforced over time</td><td>• Set in a context of long-term ownership and focus on long-term value preservation and creation, so that engagement is aligned with investment thesis
• Recognises that change is a process; while haste may at times be needed, change cannot be inappropriately rushed
• Overall resources used efficiently so engagement coverage is as broad as possible whilst also proving effective
• Clear and specific objective leads to effective change
• Involves reflection so lessons are learned and taken fully into account in future</td></tr>
<tr><td>…resulting in…</td><td>• Changed investor decision-making
• Efficient capital allocation by investors
• Appropriate risk-adjusted returns for clients
• Preserved/enhanced value
• Delivery of client objectives and investment purpose</td><td>• Changed company behaviours
• Efficient capital allocation by companies
• Appropriate risk management by companies
• Preserved/enhanced value
• Delivery of corporate purpose and culture, through effective oversight</td></tr>
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