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BIG INNOVATION CENTRE

The need for an integrated regulatory approach to stewardship

Steering Group of The Purposeful Company

Purposeful Company Steering Committee
The need for an integrated approach to stewardship reform

1. Context

The importance of stewardship to effective functioning of capital markets is widely accepted and topical. The purpose of this paper is not to recap the case for stewardship, nor to set out the elements of good stewardship. We refer readers instead to our paper 'Thoughts for change', which sets out the views of the Steering Committee on these topics.

The purpose of this paper is instead to identify how Government policy on stewardship needs to be joined up to be effective. As the Kay Review noted, one of the challenges in relation to stewardship and long-termism is the extent of fragmentation of the investment chain. Different investment chain entities are subject to different forms of regulation undertaken by different regulators. The Financial Conduct Authority (FCA), Department for Work and Pensions (DWP), The Department for Business, Energy, and Industrial Strategy (BEIS), and the Financial Reporting Council (FRC) all have roles in overseeing different aspects of the investment chain in ways that have an impact on stewardship. All of these bodies are in the process of implementing changes to their oversight of investment chain entities in a way that impacts on the stewardship environment in the UK. The implementation of the EU Shareholder Rights Directive (SRD), which is still intended by the Government notwithstanding the UK's departure from the EU, will be taken into account in a number of these workstreams.

Given the fragmentation of the investment chain, one of the challenges is to establish a framework that ensures consistent and integrated application of stewardship across that chain. The current period of review creates both a risk and an opportunity. The risk is that review is undertaken in a fragmented manner by different bodies, reflecting and cementing the current fragmentation of the investment chain. Regulation may then be enacted in a way that is not mutually reinforcing. The opportunity is for those bodies to work together to support a consistent framework that allows stewardship responsibilities to be viewed as a whole, and thereby to create a framework that is dynamic and can be subjected to continuous improvement over time, without the need for complex simultaneous amendment of multiple streams of legislation or regulation. To maximise the opportunity and minimise the risk we recommend that:

- BEIS institute an oversight project to ensure practical integration of the various regulatory touch-points for stewardship; and
- The Stewardship Code is developed in a way that creates an integrated framework for stewardship that is pointed to by relevant regulation or guidance applying to all key categories of entity within the investment chain.

The appendix summarises the current range of stewardship activity, illustrating the complexity of the current environment for regulatory change. This paper sets out what we consider to be the priorities for cross-cutting regulatory co-ordination to deliver an enduring positive outcome for stewardship in the UK.

2. Delivering integrated policy

Although stewardship is being considered across a range of investment chain entities, with regulatory and code-based developments in a number of areas, there is a risk of initiatives to some extent being disjointed, reflecting the fragmentation of the investment chain.

Key points providing an opportunity for integration would appear to be:

- **Implementation of the SRD**, and in particular ensuring that proxy agencies are subject to sufficiently robust regulatory oversight.

- **Statutory Guidance** for DWP regulations, which will set out how occupational pension funds should meet their obligations in relation to the Statement of Investment Principles (SIP).

- **The FCA's review** on a range of matters including implementation of matters arising from the DWP regulations / Law Commission review, including on the role of Independent Governance Committees (IGCs) for stakeholder pensions and group personal pensions, plus issues arising from the Asset Management Market Review, including the role of Authorised Fund Manager (AFM) boards under the Senior Manager and Certification Regime (SM&CR).

- **The Stewardship Code** provides the major opportunity for an integrated view of stewardship across the investment chain.

There is an opportunity, notwithstanding different regulatory bases, to create a common framework for integrated stewardship across the investment chain. The mechanism for this would be an enhanced Stewardship Code, which although not the basis of regulation, should be pointed to by all relevant regulation (in a manner analogous to Conduct of Business Rule 2.2.3 for asset managers[1]). Combined with implementation of the SRD, which could point different investment chain entities to this Stewardship Code, this provides an opportunity for an ongoing and dynamic mechanism for progressively improving stewardship over time. It is also the only realistic opportunity for bringing meaningful requirements to bear on proxy agencies and investment consultants.

Our key policy recommendations are therefore as follows:

- The Stewardship Code should become the standard integrated guidance for how all investment chain entities meet their stewardship responsibilities. As such it should, in line with our previous recommendations, be extended so as to apply in a tailored manner to key investment chain entities (including asset owners asset managers, proxy agencies, and investment consultants), be broad in its definition of stewardship, and focus on implementation of stewardship rather than just reporting.

[1] COB 2.2.3R states that: 'A firm…must disclose clearly… (1) the nature of its commitment to the Financial Reporting Council's Stewardship Code; or (2) where it does not commit to the Code, its alternative investment strategy'

- All relevant regulatory stewardship requirements should point to the Stewardship Code as defining how stewardship responsibilities should be met. So for example, as well as directly transposing relevant regulatory requirements from the SRD:

    - The DWP in the Statutory Guidance for the new pensions regulations should refer explicitly to becoming a signatory of the Stewardship Code being an important part of demonstrating compliance with stewardship requirements;

    - The FCA should, in addition to transposing CRD requirements for Institutional Investors, Asset Managers, and Proxy Agencies[2], introduce for each of these entities a rule along the lines of COB 2.2.3R requiring them to state whether they are a signatory to the Stewardship Code and if not why not. FCA Guidance should emphasise the relevance of the Stewardship Code in meeting the regulatory requirements arising as a result of the CRD.

    - In its updated regulations and associated guidance relating to IGCs, the FCA should likewise include a rule requiring IGCs to disclose whether they are signatories to the Stewardship Code and if not why not. Guidance relating to fulfilment of IGC responsibilities relating to stewardship should reference the Stewardship Code.

- As part of its ongoing review of AFM board responsibilities and SM&CR, the FCA should consider explicitly including having and implementing a policy on Stewardship within the definition of 'value for money' and 'acting in the best interests of investors' (not excluding the possibility of a 'policy of no policy').

- The FCA should consider how its oversight of investment consultants could be used to emphasise to them their stewardship responsibilities, and to include a requirement for them corresponding to the current COB 2.2.3R for asset managers (requirement to disclose whether a signatory of the Stewardship Code).

- As an alternative channel to influencing investment consultants, BEIS review of stewardship implications of the Insolvency Code review could be used as a way of introducing requirements for stewardship to be considered in mandates and hence the investment consultants' role in that.

Integration across BEIS, DWP, FCA and FRC will be vital to create this integrated stewardship vision. Once achieved, however, the Stewardship Code and associated market-driven review process will provide a mechanism for continuous improvement in stewardship.

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[2] Ensuring that proxy agencies need to comply or explain against the Stewardship Code as part of implementation of the SRD is particularly important. There is currently a self-regulated set of Best Practice Principles produced by the industry, but they do not make adequate reference to the role proxy agencies play in stewardship and their associated responsibilities.

Appendix: Review of stewardship activity

The table below sets out the current stewardship activity underway in the market.

Activity and timing	Key elements relating to stewardship	Investment chain entities covered
Shareholder Rights Directive Due to be implemented in summer 2019 Some dependency on nature of deal on leaving the EU (may not be implemented in 'no-deal' scenario) Implementation for different investment chain entities will be via different routes: Occupational pensions via DWP (see below) Institutional investors via FCA	Rights relating to transparency and exercise of voting: • Certain rights for: companies to obtain information on their shareholders; for shareholders to obtain information on how to exercise their rights; for ultimate beneficiaries to be able to exercise rights via intermediaries at proportionate cost Comply or explain for asset owners and asset managers: • Policy on engagement, voting and monitoring • Publish an implementation report • Publish how they have voted at AGMs Disclosure requirements for asset owners: • How main aspects of equity investment strategy align with nature and duration of liabilities and contribute to medium to long-term performance of assets • How any arrangement with asset managers incentivises them to invest in a way that aligns with nature and duration of liabilities and incentivises them to make investment decisions based on medium to long-term financial and non-financial performance and to engage with companies to improve their performance in the medium to long-term • How evaluation and remuneration of asset manager are in line with duration and profile of liabilities and take absolute long-term performance into account • How turnover costs of the asset manager are monitored and any target range set for turnover • If one of the above is not in place then explain why not Asset managers to report to asset owners on the above including:	Asset owners: life insurers, occupational pension funds Asset managers Proxy agencies

Activity and timing	Key elements relating to stewardship	Investment chain entities covered
Transparency via FCA Proxy agencies TBD via FCA or BEIS Executive Pay via BEIS	• How the investment strategy aligns with the duration and profile of the liabilities • How financial and non-financial factors are used to evaluate long-term performance • Portfolio turnover and costs • Use of proxy voting agencies • Policy on stock-lending and how this interacts with their policy on engagement particularly around the time of AGMs Proxy advisers to: • Publicly reference a code of conduct they apply and report on its application on a comply-or-explain basis • If they do not apply a code, explain why not • Publicly disclose: key features of methodologies and models; approach to engagement; approach to conflicts of interest; sources of data; voting policies; extent local market variation is taken into account; approach to quality and quality assurance, including qualifications of staff The Directive also contains a number of reporting and voting regulations relating to executive remuneration, which broadly bring the rest of the EU into line with the UK's approach	
Occupational Pension Schemes (Investment and Disclosure) (Amendment) Regulations 2018 Coming into force 1 October 2019 or six months later	Occupational pension funds required by 1 October 2019 to produce a SIP to set out in SIP: • How they take account of financially material factors including ESG and climate change • Their approach to stewardship (monitoring, voting, and engagement) • Money purchase schemes must publish this SIP And from 1 October 2019: • Publish a Statement of Members' views setting out how they will take into account what members views are in their opinion on matters within the SIP From 1 October 2020:	Occupational pension schemes

Activity and timing	Key elements relating to stewardship	Investment chain entities covered
Statutory Guidance to be updated by DWP on how to comply with new SIP requirements	• Publish an implementation report on how they have acted on the principles in the SIP and how they took into account members' views The regulations also clarify that trustees may take into account members views and social or ethical considerations provided they have reasonable grounds to suppose members hold those views and provided it does not result in significant financial detriment Note that the DWP consider these requirements to reflect the requirements that would be imposed through implementation of the Shareholder Rights Directive	
Insolvency Code review	• Introduction of 'safe channel' for investors formally to log stewardship concerns • Incorporating stewardship in investment mandates • Further developments in early stages	
FCA Review of COBS 19.5 relating to Independent Governance Committees (IGCs), which oversee workplace group personal pensions Consultation due Q1 2019	Mirror requirements to those set out for occupational pensions above to be adopted by the FCA for IGCs including reporting on: • How they evaluate long-term risks including ESG • How they take member views into account • The policy (if any) on stewardship FCA to introduce guidance for such plans on taking into account financial and non-financial factors FCA to consider whether the remit of IGCs should also extend to non-workplace personal pension products	Workplace personal pensions
FCA Requirements on AFM boards	Following the Asset Management Market Review, the FCA proposed new rules for AFM boards (which oversee unit trusts in the UK market). This included a new value-for-money rule, adaptation of the SM&CR to make chair of the AFM board a Senior Manager with responsibility for ensuring	UK collective investment schemes (unit trusts)

Activity and timing	Key elements relating to stewardship	Investment chain entities covered
	they act in best interests of investors. Also proposed guidance on assessing quality of services. Role of AFM boards to be kept under review.	
Best Practice Principles (BPP) review 2019	The BPP is a set of best practice principles produced by proxy agencies (ISS, Glass Lewis, Minerva (Manifest), PIRC, IVOX, ProxInvest). They are reviewing this in the hope that it will become the ‘code’ that they sign up to in order to comply with the Shareholder Rights Directive. However, the current code has no independence governance oversight and says nothing about how proxy agencies contribute to stewardship (its principles relate to service quality, conflicts of interest, and communication) and amounts to little more than basic standards that would be expected of any professional services provider. The current review has been delayed following the departure of the Chairman, Chris Hodge, for personal reasons. He was determined also that there should be independent governance oversight of the code and rumours suggest that this may have been resisted by some of the proxy agencies.	Proxy voting agencies
FRC Stewardship Code Draft expected Q4 2018, with final code in H1 2019 to align with SRD implementation	The revised code is likely more explicitly to address the requirements of different investment chain entities, as opposed to being focussed mainly on asset managers Current code requires signatories to have on a comply or explain basis policies covering a range of areas such as: approach to monitoring, engagement, and voting; collective engagement; conflicts of interest; escalation; with reporting on application of the principles required The FRC tiering approach focusses on quality of reporting The new Code is also likely to emphasise application of stewardship rather than just reporting of stewardship	Currently asset owners, asset managers, and service providers may sign up on a comply-or-explain basis, although it is very much geared towards asset managers

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