



# Building a regulatory framework for effective stewardship

**Discussion Paper**

DP19/1

January 2019

## How to respond

We are asking for comments on this Discussion Paper (DP) by **30 April 2019**.

You can send them to us using the form on our website at: [www.fca.org.uk/dp19-01-response-form](http://www.fca.org.uk/dp19-01-response-form)

**Or in writing to:**

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# 1 Introduction

## Context

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- 1.1** This joint Discussion Paper (DP) calls for input on how best to encourage the institutional investment community to engage more actively in stewardship of the assets in which they invest.
- 1.2** Historically, the UK has been at the forefront of developing codes of best practice on stewardship, including through industry initiatives. The Financial Reporting Council (FRC) published the current Stewardship Code in 2010, building on a code issued in 2009 by the Institutional Shareholders Committee. This was the first Stewardship Code introduced in any major market.
- 1.3** Expectations around the role of stewardship have since risen, particularly in light of notable corporate failures and criticisms of how stewardship is exercised. Most recently, Sir John Kingman's Independent Review of the Financial Reporting Council (the FRC Review) recommended that a 'Revised Stewardship Code more clearly differentiates excellence in stewardship' and that it should focus more on 'outcomes and effectiveness'.
- 1.4** The FRC sets out proposed revisions to the Stewardship Code in an accompanying consultation paper (CP), and its associated reporting requirements, taking into account the recommendations on stewardship in the FRC Review. In preparing the proposed revisions, the FRC has sought initial feedback from 170 members of the investment community, company organisations and representative bodies. With these revisions, the FRC aims to consolidate and to maintain the UK's strong reputation on stewardship internationally.
- 1.5** Also as part of the package of papers released today, the Financial Conduct Authority (FCA) is consulting on the implementation of the sections of the amended Shareholder Rights Directive (SRD II) that are relevant to FCA-regulated asset managers and life insurers in the UK.<sup>1</sup> In implementing these provisions, the FCA is catering for the scenario where an implementation period is in place after the UK's departure.<sup>2</sup>
- 1.6** SRD II will change the legislative landscape for stewardship in the UK. The proposed implementation of the Directive in the UK will establish a minimum regulatory baseline, with the Stewardship Code promoting higher standards beyond this. We note that, given the global scope of UK capital markets, SRD II would have some relevance to regulated firms and corporate issuers even in a scenario in which the Directive was not implemented in the UK.

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1 Directive 2017/828 of the European Parliament and of the Council of 17 May 2017 amending Directive 2007/36/EC as regards the encouragement of long-term shareholder engagement.

2 In March 2018, the UK Government and the European Commission agreed the terms of an implementation period, which was included in the draft Withdrawal Agreement. During this period, set to start on 29 March 2019 and lasting until 31 December 2020, EU law will continue to apply in the UK. This would require the UK to implement SRD II by 10 June 2019.

- 1.7** Against this backdrop, this DP aims to advance the debate about: what effective stewardship entails; what the minimum expectations of financial services firms which invest for clients and beneficiaries should be; what higher standards the UK should aspire to; and how these might best be achieved. We also consider the potential public and private benefits of improved stewardship.
- 1.8** The discussion generated can also help institutional investors learn from existing best practice and methods for delivering effective stewardship, as they prepare to comply with SRD II and (if they choose to follow it) the revised Stewardship Code.
- 1.9** Stewardship by asset owners and asset managers involves active oversight of assets in which they invest and where they choose to invest. These activities support the functioning of the UK's financial markets by enhancing their quality and integrity, and they contribute to sustainable, long-term value creation for beneficiaries. In the long run, effective stewardship is expected to have wider economic and societal benefits. There is some evidence that institutional investors favour asset managers that offer higher standards of stewardship, for example on environmental issues.
- 1.10** We have an opportunity to ensure any new UK standards that are developed contribute to establishing global best practice. This is not only in the interests of investors and investee companies, but should also have a clear benefit for the broad institutional investment community on which individuals and households increasingly rely to look after their financial interests.
- 1.11** Work on this DP, and on the Stewardship Code consultation, had been underway for some time before the FRC Review was published in December last year. Nonetheless, in considering responses to this DP, the Government departments and regulators will take account of the recommendations in the Review. The Government will be responding formally to the Review in due course.

## Joint responsibility for stewardship

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- 1.12** Several Government departments and regulators have an interest in promoting effective stewardship. We consider it important that the role of each agency is understood by stakeholders, and that any actions are aligned to ensure the best outcomes for UK markets.
- 1.13** As the financial regulator, the FCA has a strong interest in effective stewardship. Raising stewardship standards will contribute to the FCA's strategic objective to ensure that relevant markets function well, and to its 3 operational objectives: market integrity, consumer protection, and effective competition.
- 1.14** The FCA aims to ensure that regulated financial services firms, such as asset managers and life insurers, are delivering good outcomes for their customers. For many firms, the exercise of stewardship will be integral to the effective delivery of their services to clients and beneficiaries, for example, when an asset manager invests on behalf of asset owners over the long term. In other cases, stewardship may not be integral to a firm's acting effectively as an agent for its clients.
- 1.15** The FCA also has an interest from a market integrity perspective, given the role of stewardship in enhancing the quality of markets and the effectiveness of capital

allocation. In setting Listing Rules (LRs), Prospectus Rules (PRs) and Disclosure Guidance and Transparency Rules (DTRs), the FCA has a role in setting standards for the interaction between issuer companies and their investors, both at the time of issuance and on a continuing basis.

- 1.16** Stewardship will be an area of focus for the FCA's supervisory engagement, which reflects its importance to the FCA's objectives. This work will consider the extent to which a firm that claims to engage in stewardship is doing it appropriately, and will also review how stewardship contributes to the fulfilment of a firm's stated purpose. The FCA will also include stewardship and related issues in its research strategy for 2019/20.
- 1.17** The FRC has sought to advance high standards in stewardship through its voluntary Stewardship Code, underpinned by a 'comply or explain' provision for certain financial services firms in the FCA's Conduct of Business Rules (COBS).<sup>3</sup> Revising the Stewardship Code, along with the recent revision of the UK Corporate Governance Code, aims to contribute to supporting the FRC's objective of 'promoting corporate governance and investor stewardship with a long-term focus.'
- 1.18** While not co-authors of this DP, Her Majesty's Treasury (The Treasury), the Department for Business, Energy & Industrial Strategy (BEIS), the Department for Work and Pensions (DWP) and the Pensions Regulator (tPR) also have an interest in stewardship.
- 1.19** The Treasury oversees financial services legislation and capital markets regulation. It has launched several initiatives to foster long-term investment and the effectiveness of capital markets, including the Patient Capital Review.
- 1.20** BEIS has a strong interest by virtue of its overall responsibility for the company law framework, its role in overseeing corporate governance, and through its sponsorship of the FRC. BEIS is also the sponsoring department for SRD II, with specific responsibility for certain new requirements under SRD II in respect of directors' remuneration and the transmission of information to shareholders.
- 1.21** DWP's interest derives from its oversight of the legislative framework for private occupational pensions, while tPR is responsible for protecting workplace pension schemes. These are among the largest asset owners in the UK. DWP and tPR consider that trustees of occupational pension schemes have an important role in the oversight of the assets in which they invest and to whom they lend. DWP introduced legislation in 2018 to help clarify and strengthen trustees' investment duties, including their policies in relation to the stewardship of investments.

## Working within existing capital markets structures

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- 1.22** The discussion we are seeking to advance in this DP is about how stewardship can be improved within the existing structure of UK capital markets, acknowledging UK conventions such as a unitary Board and voting rights for shareholders. We are not proposing to explore broader questions such as alternative ownership structures.

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<sup>3</sup> COBS 2.2.3, Disclosure of commitment to the Financial Reporting Council's Stewardship Code.

- 1.23** Since the financial crisis, considerable work has been undertaken, reflected in numerous papers on stewardship and related topics (see Appendix 1).
- 1.24** We want this DP to move the debate forward and build on the work to date. It focuses on what additional work is required to build a regulatory framework for effective stewardship for the benefit of UK investors and users of the UK's financial markets.
- 1.25** We are calling for input from stakeholders on:
- what constitutes effective stewardship
  - the challenges in delivering an effective regulatory framework for stewardship in the UK
  - how to strike the right balance between regulatory rules and voluntary codes of best practice.

## Other publications

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- 1.26** This DP is one of several papers published today. It is focused on exploring important questions of principle to foster development of high stewardship standards over the medium-term.
- 1.27** This DP is accompanied by 2 CPs which propose some specific measures designed to raise standards in the near term:
- The FRC is publishing proposed revisions to the Stewardship Code. These represent a significant enhancement of the Stewardship Code, including to: recognise the different stewardship responsibilities of different actors in the institutional investment community; to expand the scope of the Stewardship Code beyond listed equities; and to enhance reporting expectations to provide for public reporting on objectives, activities, outcomes and effectiveness.
  - The FCA is proposing changes to the FCA Handbook (the Handbook) to implement key provisions of SRD II in the UK. Among other things, these rules aim to enhance transparency around the investment and engagement strategies of FCA-regulated asset managers and life insurers, aligned with SRD II. In Chapter 6 we explore whether these rules are an appropriate minimum standard for stewardship, or whether further work is required.

## Who will be interested in this document?

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- 1.28** This DP is relevant to FCA-regulated asset management firms and life insurers. It will also affect issuers, public companies and signatories to the Stewardship Code and may be of interest to a wider range of stakeholders.
- 1.29** Interested stakeholders may include:
- FCA-regulated asset management firms and life insurers
  - pension schemes and their trustees
  - current and future signatories to the Stewardship Code
  - proxy advisers

- investment consultants
- industry groups or trade bodies
- public companies, issuers of debt and their advisers
- policy-makers and regulatory bodies
- consumer groups or individual consumers
- charities and civil society groups
- industry experts and commentators
- academics and think tanks.

## How to respond

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- 1.30** We invite stakeholders' views on the analysis presented and responses to the questions we raise by 30 April 2019.
- 1.31** Please use the online response form or write to us at the address on page 2.
- 1.32** We will consider your feedback and publish a feedback statement later in the financial year 2019/20.

## Equality and diversity considerations

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- 1.33** We have considered the equality and diversity issues that may arise from the proposals in this DP. We do not believe that the proposals in this DP adversely impact any of the groups with protected characteristics ie age, disability, sex, marriage or civil partnership, pregnancy and maternity, race, religion and belief, sexual orientation and gender reassignment.

## 2 Executive summary

- 2.1** Stewardship is effective when asset owners, asset managers and other entities in the institutional investment community work together to promote sustainable, long-term value creation.
- 2.2** This DP considers how to improve stewardship within the existing structure of UK capital markets. Stewardship has a role to play across a variety of investment strategies and approaches. If it improves market quality, stewardship can make markets function better for all users. A focus of this paper, however, is the role of stewardship in investment strategies that aim to meet investors' financial interests over a long-term investment time horizon (eg investments managed on behalf of consumers in pension funds and life insurance policies).
- 2.3** Poor corporate governance and a lack of shareholder engagement have been cited as contributing to a culture of short-termism and to high-profile corporate failures. Recital 2 of SRD II, for instance, states 'there is clear evidence that the current level of "monitoring" of investee companies and engagement by institutional investors and asset managers is often inadequate and focuses too much on short-term returns, which may lead to suboptimal corporate governance and performance'.
- 2.4** Accordingly, steps have been taken – particularly since the financial crisis – towards more effective stewardship.
- 2.5** In 2010, the FRC issued the Stewardship Code, supported by FCA rules. The Stewardship Code was then updated in 2012 following the Kay Review, which concluded that changes to the functioning of the UK equity market were needed. Since then there have been a variety of initiatives to enhance stewardship, such as the Investor Forum that was established to support investors' collective engagement with companies. Appendix 1 of this paper summarises the key steps on the journey to effective stewardship since the financial crisis.
- 2.6** We are now beginning to strengthen the regulatory framework for stewardship. The implementation of SRD II is an important step in this regard.

### What effective stewardship looks like

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- 2.7** Individuals with pension assets or insurance policies rely on a community of financial services firms to look after their financial interests.
- 2.8** We consider that effective stewardship should reflect a clear understanding across the institutional investment community of clients' and beneficiaries' financial interests and their investment time horizon.
- 2.9** It should also promote transparency of stewardship activities undertaken by different firms, across asset classes, in pursuit of these interests. This may encourage the growth of a market for effective stewardship, enhancing the functioning, quality and integrity of the UK's financial markets.



**2.10** Effective stewardship by asset owners and asset managers may include the following key attributes:

- **A clear purpose** – A clear understanding of the scope, role and purpose of stewardship and good communication across the institutional investment community to align stewardship objectives
- **Constructive oversight, engagement and challenge** – Active monitoring of assets, constructive dialogue with issuers, exercise of ownership rights, and the integration of stewardship and investment decisions
- **Institutional culture and structures** – Institutional culture and structures (eg remuneration, performance measurement and asset manager selection) that support investment strategies and stewardship activities consistent with clients' and beneficiaries' financial interests over their investment time horizon
- **Disclosure and transparency** – Reporting and disclosures across the institutional investment community to demonstrate that stewardship activities reflect clients' and beneficiaries' financial interests over their investment time horizon.

## Key challenges

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**2.11** While progress has been made on the journey to effective stewardship in the UK, consistent with the key attributes described above, challenges remain.

**2.12** Exercising effective stewardship requires an investment in people and processes. The cost of these investments may reasonably be expected to be outweighed by the benefits and many firms rightly see their stewardship capabilities as a competitive advantage.

**2.13** However, some of these benefits – ie higher long-term investment returns – accrue not only to the firm that incurs the cost of exercising stewardship, but also to all other investors. As such, they may not invest as fully as they otherwise might and instead 'free-ride' on the stewardship of others.

**2.14** New rules that are due to come into effect under SRD II, intended to enhance transparency about how equity investors exercise stewardship, are a step towards addressing these challenges. SRD II aims to 'raise the bar' for stewardship across the market, with a view to encouraging a long-term perspective in investment strategy and corporate governance.

**2.15** However, we are considering whether the UK regulatory framework should aspire to go further than the provisions of SRD II.

## Balancing regulation and the Stewardship Code

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**2.16** The consultation papers accompanying this DP describe a range of proposed measures to enhance disclosure and transparency of stewardship activity and improve the quality and effectiveness of stewardship.

- 2.17** We consider the SRD II provisions to be an important baseline for stewardship. In respect of asset owners and asset managers, these measures include new rules for asset managers and life insurers regulated by the FCA.
- 2.18** Recognising the wider economic and societal benefits of effective stewardship, the FRC is also seeking to encourage higher standards through revisions to the Stewardship Code. This includes promoting effective stewardship beyond equity markets and to cover assets held either by UK investors internationally, or by international investors in the UK. We are keen to gather views from interested stakeholders on how far this balance between regulation and the Stewardship Code will deliver an effective regulatory framework for stewardship.
- 2.19** We are particularly interested in stakeholders' views on how to deal with some specific issues in the design of the regulatory framework, including the institutional, asset-class and geographical scope of the framework.

## 3 What is stewardship and why does it matter?

### What is stewardship?

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- 3.1** We define stewardship as the responsible allocation and management of capital across the institutional investment community, to create sustainable value for beneficiaries, the economy and society. Stewardship activities include monitoring assets and service providers, engaging issuers and holding them to account on material issues, and publicly reporting on the outcomes of these activities.<sup>4</sup>
- 3.2** These activities support the functioning of the UK's financial markets by enhancing their quality and integrity. Speaking at the FCA's Asset Management Conference in June 2018, the FCA's CEO, Andrew Bailey, commented that stewardship is 'A function of an asset manager's responsibilities towards its investors'. He went on to observe that 'The UK's listing regime is also predicated on the existence of responsible owners who engage with companies and make informed voting decisions in relation to the significant matters where their view is sought. So, it is part of the market integrity agenda too.'
- 3.3** By exercising stewardship and challenging issuers' strategies and decisions, asset owners and their asset managers can improve issuers' understanding of their interests and influence corporate strategy to further those interests. This can be expected to contribute to the long-term efficiency and effectiveness of capital allocation throughout the real economy, benefitting investors and society.
- 3.4** The Kay Review observed: 'The principal role of equity markets in the allocation of capital relates to the oversight of capital allocation within companies rather than the allocation of capital between companies. Promoting good governance and stewardship is therefore a central, rather than incidental, function of UK equity markets.'
- 3.5** In recent research, to which the FCA contributed, James, Kotak and Tsomocos find that financial market quality has a strong positive impact on economic performance. They find that it supports sustainable economic growth over the long term and reduces the risk of financial crises.
- 3.6** Market quality can be improved by greater transparency and by holding companies to account more effectively through active stewardship. In higher quality markets, companies will be less inclined to pursue strategies that produce immediate results, at the expense of delivering longer term value through investment in innovation.
- 3.7** Consistent with this perspective, other research finds that where asset managers engage more deeply with investee companies, these companies are more likely to

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<sup>4</sup> This is the definition in the FRC's revised Stewardship Code. We acknowledge different definitions have been applied by other groups, bodies and institutions.

pursue innovative strategies (Aghion, Van Reenen and Zingales, 2013). Elsewhere, there is also supportive evidence that such engagement can reduce 'downside risk' (Hoepner, Oikonomou, Sautner and Starks and Zhou, 2018).

- 3.8** Similarly, a study in 2017 concluded that, without the discipline of active investor engagement, a company's management is more likely to become entrenched and engage in value-destroying M&A activity (Schmidt and Fahlenbrach, 2017).
- 3.9** More generally, there is a growing body of literature on stewardship and sustainable investing. One recent study examines the impact on investment returns of active engagement with companies on environmental, social and governance (ESG) matters. The authors conclude that active shareholder engagement with investee companies on these matters improves governance and performance, encouraging a longer-term perspective (Dimson, Karakas and Li, 2018).
- 3.10** Stewardship has an important role to play in protecting consumers' interests by aligning firms' incentives with the long-term interests of consumers of financial services. Consumers could also benefit from better information about how investors are engaging with issuers to promote their interests. In this regard, encouraging effective stewardship is linked to broader regulatory efforts to ensure that financial services firms' governance, culture and incentives are directed towards promoting consumers' best interests.
- 3.11** Transparency of firms' stewardship activities should help to develop a competitive market for stewardship in the interests of consumers. When working well, financial services firms would compete with each other to deliver high-quality investment decision-making, oversight of assets and engagement with and challenge of issuers. Such a market could significantly improve corporate governance and responsiveness to asset owners, with wider benefits for the economy and society.

## What structures exist in the UK to enable investors to exercise stewardship with companies?

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- 3.12** Public companies in the UK are characterised by a separation of 'ownership', by shareholders who may be widely dispersed, and 'control', which sits largely in the executive and Board. As in other situations where one party (the 'principal') engages another to act on their behalf (the 'agent'), the principal puts in place a set of arrangements for agents to act in the principal's best interests. This is typically done through active dialogue, contractual provisions, disclosure requirements and setting financial incentives.
- 3.13** In the investment context, stewardship is a way of managing this principal-agent problem.
- 3.14** Features of legislation applicable to companies, including the Companies Act 2006, the FCA's LRs, PRs and DTRs, and the corporate governance framework, already aim to address issues that derive from the principal-agent problem. For example:
- Under the DTRs, public companies admitted to the market are required to disclose certain information, including in annual reports and through audited financial

statements. They are also required to make ad-hoc disclosures in line with the Market Abuse Regulation (MAR).

- The LRs set out qualitative standards for premium-listed companies, such as the need to have an independent business. That is, directors should be free to make decisions for the benefit of the shareholders.
- Shareholders are empowered to influence the company by voting on key strategic decisions. The practice of providing all shareholders with equal voting rights (one-share, one-vote) is a longstanding assumption underpinning the UK corporate governance framework. The LRs require that companies seeking premium listing offer proportionate voting rights on key matters, and that shareholders are informed via circular. For UK-incorporated companies, the Companies Act 2006 prescribes that key votes take place at the company's Annual General Meeting (AGM), where important decisions are approved, such as the company's report and accounts, directors' remuneration, the final dividend and the appointment of auditors. Shareholders may also table shareholder resolutions to make recommendations to the Board on any matter of policy, operations or strategy.
- Shareholders may vote on appointment of directors to the Board to represent their interests and to challenge management. This right is enshrined in the Companies Act and reinforced through the FRC's Corporate Governance Code. The FCA's LRs require that premium-listed companies apply the Principles of this Code and comply or explain against its detailed Provisions. The UK's unitary Board structure – which provides for both executive and non-executive directors, as well as an independent Audit Committee and Chair – aims to bring diverse views to company decisions.

- 3.15** The ability to influence company decisions through voting has long been regarded as a fundamental shareholder right and a means to exercise stewardship. This right also places responsibilities with investors. The UK system is designed around the assumption that investors will exercise these rights and responsibilities.
- 3.16** Effective stewardship extends beyond the exercise of voting rights. It also entails close monitoring of, and engagement with Boards and management (individually or collectively with other investors). This engagement may be on thematic issues across issuers (e.g. climate change), or on specific, targeted matters relevant to a particular issuer.
- 3.17** Engagement may focus on matters such as: capital structure, strategy and operations, financial performance, and risks & opportunities. Where permitted by its mandate, an asset manager may seek to exit an investment if engagement is unsuccessful.
- 3.18** How asset owners and their asset managers exercise stewardship, and best exert influence, will differ according to the size and ownership structure of investee companies. The exercise of stewardship may also differ by investment strategy (see Chapter 5).
- 3.19** It has also been argued that 'block' ownership of companies can enhance the effectiveness of stewardship by giving those asset owners a sufficiently large stake in long-term performance. That said, it is sometimes suggested that there is a tension between having shareholders that are large enough to exert sufficient influence over investee companies, while at the same time upholding the rights of minority investors.

- 3.20** A recent report by the Big Innovation Centre<sup>5</sup> observed that large block ownership of public companies is very low in the UK by international standards. The report encouraged the FCA to relax the 3% ownership threshold for notification by UK-incorporated listed companies in its DTRs.
- 3.21** This is not, however, a universally-held view. Since originally consulting on this threshold, the FCA has explored this question with market participants – eg when implementing amendments to the Transparency Directive in the UK in 2015, and in the context of Discussion Paper (DP 17/2) on the Effectiveness of Primary Markets. The FCA does not at this time think there is a case for consulting on any changes to this rule.
- 3.22** Collective engagement with investee companies is an important way of increasing influence when ownership is fragmented. Asset managers join forces to promote issues of common interest. The Kay Review recommended that steps be taken to facilitate collective actions by asset managers.
- 3.23** In response, the Investor Forum was established in 2014, with 2 core objectives: (i) to make the case for long-term investment approaches; and (ii) to create an effective model for collective engagement with UK companies. Forty-two firms have since joined the Investor Forum as full members. These firms between them hold or manage almost a third of the market capitalization of the FTSE All Share index.
- 3.24** Investors conducting non-voting engagement as part of their stewardship must be satisfied that they are acting in line with relevant legal and regulatory provisions. This includes how they handle information gained during this engagement.
- 3.25** Investors need to consider how to handle inside information in line with the MAR. Firms also need to be able to demonstrate to their internal compliance functions that they are not 'acting in concert' when engaging on a collective basis with a subset of the company's investors.
- 3.26** As part of its 2019/20 policy workplan, the FCA will be considering if firms are operating appropriate systems and controls for handling and processing inside information. This work will also consider how information flow supports the functioning of markets, including stewardship. We have been told on occasion that firms would welcome greater certainty on how to engage with issuers and other investors for stewardship purposes without risk of becoming subject to obligations in respect of inside information. So, this will be an opportunity for stakeholders to highlight areas where the market would benefit from further clarity.

## Environmental, social and governance considerations in stewardship

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- 3.27** Stewardship activities that focus on ESG factors can help investors and companies to preserve long-term value. Examples can be found in UN Principles for Responsible Investment (UNPRI), A practical guide to ESG integration for equity investing.

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5 Big Innovation Centre (2017). See Section 4, Chapter 4 pp.62-79

- 3.28** Consistent with the Law Commission finding on the fiduciary duty of investment intermediaries, effective stewardship should take into account ESG factors in investment-decisions, where these are financially material.
- 3.29** ESG factors that may not have a material financial impact in the next earnings quarter may still have a material financial impact over years. Asset owners and asset managers that invest in line with clients' and beneficiaries' interests and investment time horizon would be expected to take these long-term impacts into account.
- 3.30** Building on this, in an additional review in 2017 the Law Commission recommended that pension fund trustees disclose their stewardship policies, including engagement and voting practices, and it recommended that Independent Governance Committees (IGCs) report on how contract-based schemes take these matters into account. The FCA has committed to consulting on the implementation of these recommendations in respect of IGCs' oversight of contract-based schemes' policies.
- 3.31** DWP has since consulted on implementing the recommendations made for trust-based pension schemes. DWP introduced regulations in 2018 that will require trustees to set out in their Statement of Investment Principles how they take financially material factors into account, including ESG issues. They will also be required to set out their stewardship policies, including engagement and voting practices. These amendments will come into force from October 2019.
- 3.32** In addition, from October 2020, the regulations will require trustees of certain defined contribution occupational pension schemes to publish an implementation statement setting out how they have acted on these Principles.
- 3.33** In its recent DP on climate change and green finance (DP18/8), the FCA noted: 'When taking investment decisions, pension providers increasingly recognize that climate change may reduce investment values and pension outcomes. As the regulators of personal pension schemes, including workplace personal pension schemes, we want to ensure that those making investment decisions take account of all financially material risks, including climate change.'

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

**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)?

## 4 What effective stewardship looks like

- 4.1** Investors rely on different firms to look after their financial interests. To be effective, stewardship needs to have the right institutional 'scope'. This means, the right firms – those that contribute to the investment process – need to be engaged in stewardship activity in the right way.
- 4.2** To explore this further, this chapter describes the roles of different actors in the institutional investment community. We explain why effective stewardship is dependent on good communication and complementary actions among these actors.
- 4.3** Investors invest in a range of asset classes and across jurisdictional borders. Recognising this, this DP explores the extent to which consideration needs to be given to stewardship beyond listed equity and beyond the UK. Applying an appropriate asset-class and geographical 'scope' can help to realise the benefits of stewardship more fully.
- 4.4** Against this background, this chapter sets out some possible key attributes of effective stewardship.

### Institutional scope of stewardship

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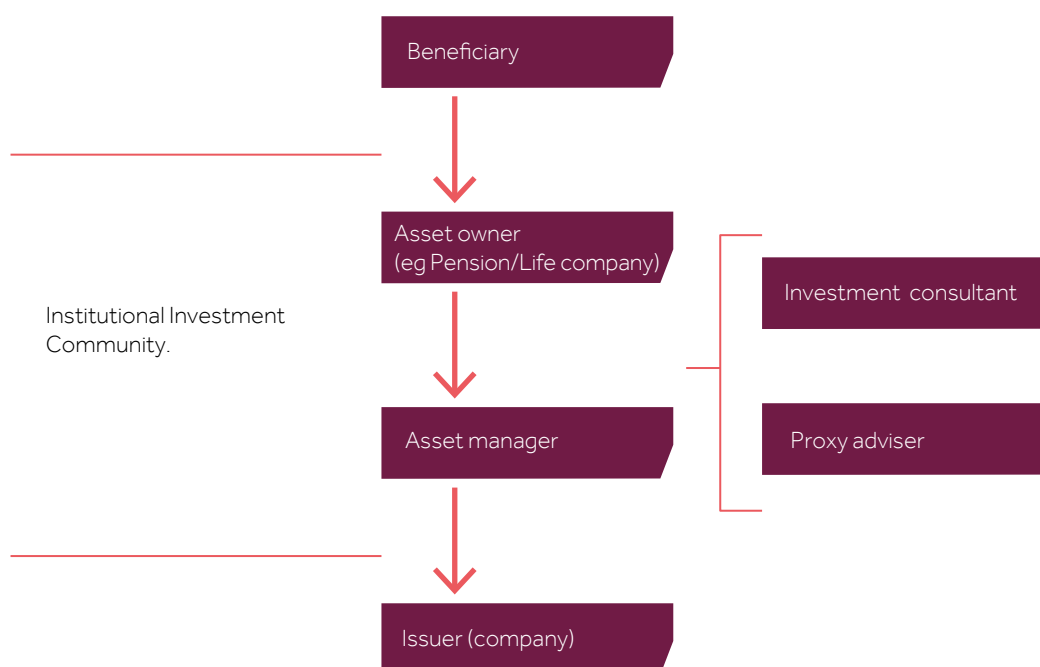
- 4.5** Increasingly, individuals rely on a range of firms to look after their financial interests. According to the Office of National Statistics (ONS) there has been a downward trend in the proportion of financial assets held directly by individuals and households. As Franks and Mayer (2017) observe, publicly listed companies in the UK are predominantly owned by investment funds. In the early 1960s, households' direct ownership of shareholdings in the UK stood at more than 50%. By 2016, this had fallen to around 12%.
- 4.6** This has implications for how stewardship may be exercised. This DP focuses on the investment activity of financial services firms, where this is undertaken for the economic benefit of individuals, ie beneficiaries. In some cases, these economic benefits may be derived through a direct interest in those investments (eg membership of a trust-based pension scheme). In others, they may be derived via a contractual relationship with a provider (eg life insurance policy), in which the value of investments held by the provider is used to deliver on contractual obligations.
- 4.7** Under these arrangements, pension or life insurance providers are effectively asset owners. They, in turn, often rely on multiple asset managers (which may or may not be part of the same group of companies) to manage investments on their behalf. They also often engage other specialist service providers, such as investment consultants and proxy advisers. In addition, IGCs and Governance Advisory Arrangements exist to provide independent challenge to firms on behalf of the members of contract-based workplace pension schemes.
- 4.8** In trust-based schemes, the relationship the trustees have with the managers of the underlying investments can vary depending on whether the trustees directly mandate



asset managers (more typical in defined benefit schemes), or use a unitised pooled fund arrangement. In the latter case, there will tend to be greater distance between the trust Board and the underlying assets.

- 4.9** The variety of roles played by these financial services firms adds complexity to stewardship. For stewardship to be effective, each of the actors in this community must be informed about, and incentivised to support, clients' and beneficiaries' financial interests.
- 4.10** A simplified view of the key firms in the institutional investment community is presented in Figure 1. Brief descriptions may be found in the Glossary (see Annex 2 – Glossary of terms).
- 4.11** We recognise that many other institutions perform important functions in the investment process. This includes brokers, custodians, nominee companies, registrars and financial market infrastructure providers, such as central counterparties and central securities depositories. We do not consider these further in this DP since our focus here is on those firms in the institutional investment community that either take investment decisions directly, or support investment decision-making.
- 4.12** While also outside the scope of this DP, it is worth noting that questions have periodically been raised about how retail shareholders' rights are exercised, where they have a direct investment and shares are held on the share register via a nominee company. Nominees hold securities on behalf of individual shareholders as a cost-effective method of electronic shareholding and to facilitate transactions. In doing so, the nominee becomes the legal owner, while the individual shareholder is the beneficial owner.
- 4.13** This system of 'intermediated securities' has been criticised by some as making it harder for retail investors to assert voting and information rights, where they do not hold their shares directly. A Law Commission scoping study on the legal framework covering 'intermediated securities' is due to be carried out as part of the Commission's current work programme.

**Figure 1: A simplified view of the institutional investment community**



## The geographical and asset class scope of stewardship

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### Geographical scope

- 4.14** In 2017, UK-managed assets amounted to £7.7 trillion, of which approximately 60% were managed on behalf of pension funds and insurance companies. UK equities are, however, a decreasing proportion of UK asset managers' portfolios.
- 4.15** According to data from the Investment Association (IA), the proportion of UK-issued equities managed by UK asset managers declined to 30% of total UK-managed equities in 2017, from just under 50% in 2008. The overall asset allocation to equities remained broadly stable at around 40% of total UK-managed assets over this period. UK equities comprised 12% of total UK-managed assets in 2017.<sup>6</sup>
- 4.16** Although investment portfolios are increasingly diversified across jurisdictions and international asset allocation decisions are typically made centrally, there is some evidence of a 'home bias' in stewardship. That is, investors are more likely to engage actively with investee companies in their home jurisdiction.
- 4.17** When considering the geographical scope of their investments, UK asset owners and asset managers acting for the benefit of UK investors could be encouraged to extend their stewardship activities beyond their UK investments.
- 4.18** Just as UK asset managers are increasingly invested overseas, UK company shares are increasingly in the hands of overseas investors. At the end of 2016, data from the ONS indicated that 56% of shares of FTSE 100 companies were held for beneficial owners outside of the UK.
- 4.19** The most effective stewardship of UK listed companies would therefore be achieved if overseas investors were also active participants.

### Asset class scope

- 4.20** When thinking about asset ownership, it is important to recognise that equities are only one type of investment asset. The largest part of the remaining 60% of UK asset managers' portfolios was allocated to fixed income investments in 2017. Of this, 20% comprised UK corporate bonds and approximately 40% were overseas bonds.
- 4.21** Owners of financial assets other than equities have traditionally been less active in stewardship. But bondholders and owners of other assets, such as private equity or infrastructure assets, also have a role to play in stewardship.
- 4.22** Taking the example of bonds, despite their often fixed-interest returns, bond investors have an interest in overseeing the actions of Boards and management to assess a company's capacity to service debt. Active engagement can help to reveal hidden risks or vulnerabilities in an issuer's corporate strategy or operations that could significantly affect its credit worthiness. Bondholders can also influence an issuer's disclosures. One example is to encourage more comprehensive, credit-relevant and forward-looking ESG-related disclosures.

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6 Investment Association Asset Management Survey 2017-18.

- 4.23** As bondholders do not have voting rights in the way equity holders do, the practice of stewardship will differ to that for equity shares. Bondholders have typically considered their influence to be limited to engaging with issuers before issuance – as the terms of the issue and any covenants are being finalised. But bondholders can actively monitor and pursue non-voting engagement with Boards and management on an ongoing basis – and industry liaison suggests that they increasingly do.
- 4.24** Many asset management firms manage investments in multiple asset classes. Even within the same firm, however, investment decisions in different asset classes are often taken by different teams. There may be challenges in coordinating the exercise of stewardship across asset classes – particularly if an issuer is in financial difficulty, or strategic decisions are being contemplated that might affect the holders of different asset types in different ways.
- 4.25** The issues and opportunities that arise in this context have had limited attention to date, but we would welcome stakeholders' views.

## **Key attributes of effective stewardship**

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- 4.26** We believe that a regulatory framework for effective stewardship would promote a clear understanding, across the institutional investment community, of clients' and beneficiaries' financial interests and their investment time horizon.
- 4.27** It would also promote transparency of stewardship activities undertaken by different firms across asset classes in pursuit of these interests.
- 4.28** More broadly, effective stewardship might exhibit the key attributes set out in Table 1 below (these are reflected in the Principles and Provisions of the proposed revised Stewardship Code). Alongside is a non-exhaustive list of actions and behaviours that we believe to be consistent with each key attribute.
- 4.29** There is no single way to exercise effective stewardship. Firms' organisational purpose, objectives, investment strategy and access to resources will influence their stewardship priorities and objectives.

**Table 1: Key attributes of stewardship and example activities and behaviours**

Key attribute	Example activities/behaviours
<p><b>1. A clear purpose</b></p> <p>A clear understanding of the scope, role and purpose of stewardship and good communication to align stewardship objectives</p>	<p>The institutional investment community has a clear understanding of the role and purpose of stewardship that reflects clients' and beneficiaries' financial interests over their investment time horizon and takes appropriate account of financially material ESG risks</p> <p>Asset owners have a clear investment strategy reflecting beneficiaries' financial interests over their investment time horizon, which they communicate to asset managers and service providers such as investment consultants and proxy advisers</p> <p>Asset managers, overseen by asset owners, exercise stewardship across asset classes and across international portfolio holdings</p>
<p><b>2. Constructive oversight, engagement and challenge</b></p> <p>Active monitoring of assets, constructive dialogue with issuers, exercise of ownership rights, and the integration of stewardship and investment decisions</p>	<p>Asset managers monitor closely issuer companies' strategies and engage actively with Boards/ management to exert influence</p> <p>Stewardship activity is proportional to the scale of investments, prioritised to reflect clients' and beneficiaries' financial interests over their investment time horizon</p> <p>Stewardship activities are not siloed, but rather are integrated with investment decision-making</p> <p>Where possible (and with appropriate regard to relevant conduct rules), both asset owners and asset managers cooperate with each other to enhance their influence</p> <p>Asset owners and asset managers exercise ownership rights in a manner consistent with clients' and beneficiaries' financial interests over their investment time horizon</p> <p>Asset owners and asset managers conduct appropriate due diligence on proxy advisers' voting recommendations where used</p>
<p><b>3. Culture and institutional structures that support effective stewardship</b></p> <p>Culture and institutional structures promote and support investment strategies and stewardship activities consistent with clients' and beneficiaries' financial interests over their investment time horizon</p>	<p>An industry-wide culture of effective stewardship promotes actions across the institutional investment community consistent with clients' and beneficiaries' financial interests over their investment time horizon</p> <p>Institutional structures and practices (eg remuneration, performance measurement, peer-group comparisons, and investment consultants' asset manager selection criteria) create conditions and incentives that promote effective stewardship and good outcomes for clients and beneficiaries</p>
<p><b>4. Disclosure and transparency of stewardship activities</b></p> <p>Reporting and disclosures across the institutional investment community to demonstrate that stewardship activities reflect clients' and beneficiaries' financial interests over their investment time horizon</p>	<p>Asset owners and asset managers report periodically on their stewardship activities, demonstrating that these are integrated with investment strategies and investment decisions and that they reflect clients' and beneficiaries' financial interests over their investment time horizon</p> <p>Asset owners and asset managers disclose their use of service providers (e.g., proxy advisers, investment consultants) and how this supports their stewardship objectives</p> <p>Service providers in turn report on how their decisions support clients' stewardship objectives</p>

- 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.
- 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?

## 5 Key challenges to effective stewardship

- 5.1 The Kay Review identified several challenges in achieving effective stewardship, including the complexity of the relationships in the institutional investment community.
- 5.2 Such challenges include barriers to stewardship that arise from costs, misaligned incentives and the flow of information. The nature and importance of these challenges may differ by investment strategy. We consider these in the remainder of this section.

### Incentives and costs

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- 5.3 Exercising effective stewardship requires an investment in people and processes. Engaging with an issuer on a particular issue or theme may last months or years. This requires an extended commitment of skilled experts to monitor assets, prioritise issues for engagement and engage credibly and constructively.
- 5.4 Changes to investment processes and technology may be required to integrate stewardship activity into investment decision-making, to coordinate effectively across functions, and to support engagement across asset classes and service delivery to clients.
- 5.5 We expect these costs to be outweighed by the benefits. Indeed, many firms rightly see their stewardship capabilities as a competitive advantage. But, some of these benefits – ie higher long-term investment returns – help not only the firm incurring the cost of exercising stewardship, but also all other investors.
- 5.6 So, some firms may not invest as fully as they otherwise might and instead 'free-ride' on the stewardship of others. This leads to under-investment in stewardship, poorer standards and uneven coverage of stewardship across the market.
- 5.7 Market quality may also be impaired. Issuer companies may be subject to insufficient market discipline and may have less regard for long-term value creation in their strategies and decisions. This may justify further regulatory intervention to raise standards and encourage investment in stewardship across the whole institutional investment community.
- 5.8 Our preliminary analysis of the stewardship reports of a sample of UK asset managers give some initial indication of current stewardship practices.<sup>7</sup> All firms in the sample disclose how they adhere to the current Stewardship Code and all firms report directly to their clients – either on request or periodically.
- 5.9 Most firms provide an annual report and an annual 'responsible investment' report to describe their stewardship in relation to ESG matters. Climate change is currently the most prevalent stewardship theme. Many firms also choose to report on how their

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7 This analysis draws on information on a sample of large UK asset managers' stewardship activities from the UNPRI and the IA, as well as disclosures under the FRC's current Stewardship Code.

stewardship activity supports the delivery of Sustainable Development Goals (SDGs). However, the method and intensity of oversight, engagement and challenge is not always clear from the reports.

- 5.10** Similarly, it is difficult to ascertain how much firms have invested in their stewardship capabilities and – importantly – the degree to which stewardship is integrated with investment decisions.
- 5.11** As a result, it is not easy to distinguish between firms based on the 'quality' of their stewardship and the extent to which it has a meaningful impact on the long-term success of investee companies.<sup>8</sup> The FRC Review made a similar observation. Proposed revisions to the Stewardship Code, including enhanced reporting requirements, aim to support better differentiation of stewardship quality across firms.

## Misaligned incentives

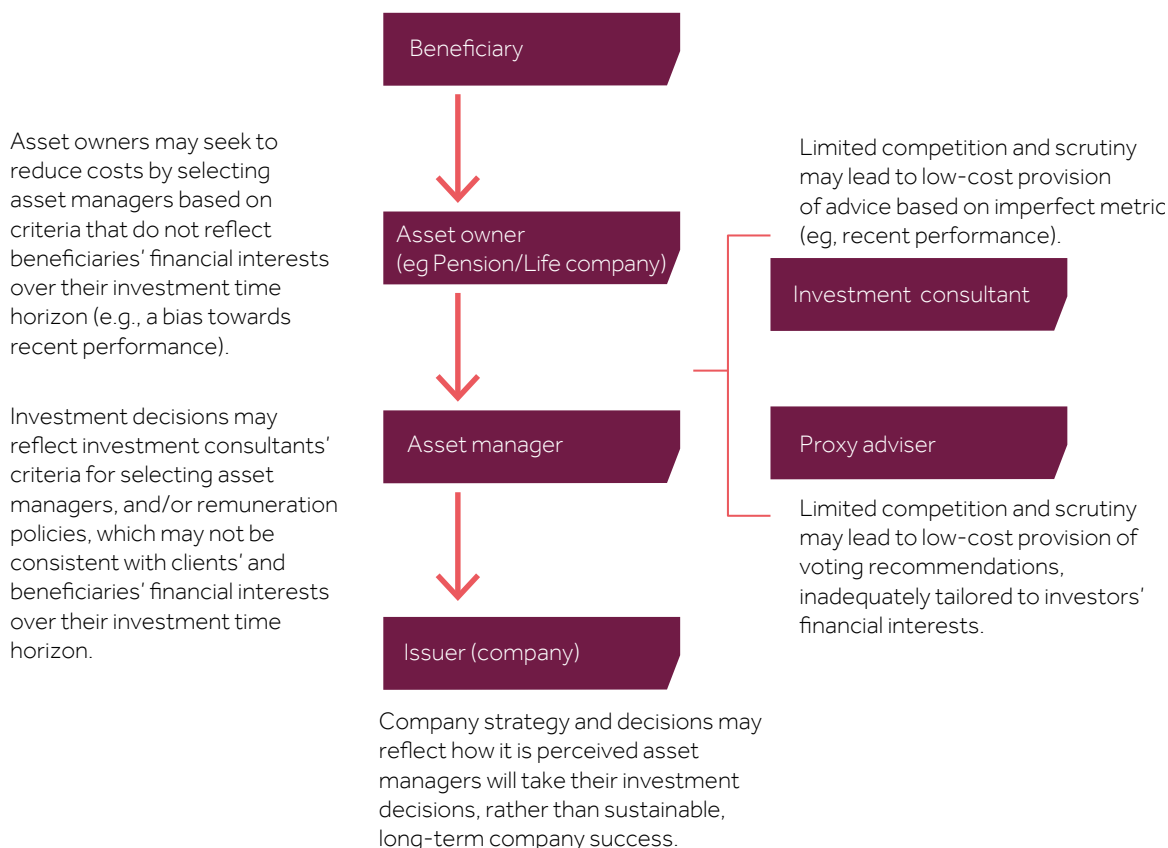
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- 5.12** Each firm in the institutional investment community is governed by its own set of contracts, disclosure requirements and financial incentives. These may not always be aligned with clients' and beneficiaries' financial interests and investment time horizons. Some of the incentive problems that could arise are shown in Figure 2.
- 5.13** For instance, the Kay Review observed that asset manager selection is typically based largely on recent performance, rather than more detailed, and more costly, due diligence of asset managers' investment strategies.
- 5.14** This exacerbates a culture of short-termism. As set out in Chapter 11 of the Kay Review, if asset manager selection is based on near-term performance, individual fund managers are likely to be rewarded on a similar basis, and investment decisions will deviate from investors' long-term objectives. This will ultimately cascade down to the companies in which they are invested.

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8 The FRC Review made a similar observation in Recommendation 42.

**Figure 2: Possible incentive issues across the institutional investment community**



## Stewardship under different investment strategies

- 5.15** There are likely to be differences in incentives to engage in stewardship activities across investment strategies. Where investors hold fewer liquid assets, have less diverse portfolios and/or are unable to exit investments, there may be a greater incentive to use stewardship as a tool to protect asset value.
- 5.16** For example, the contractual arrangements underpinning venture capital and private equity funds typically envisage the investor proactively engaging to protect and enhance value.
- 5.17** By contrast, actively managed funds investing in liquid securities enable managers to adjust weightings and to sell shares. Where a firm perceives the cost of engagement to outweigh its potential benefits, and the costs of failing to engage can be avoided through sale, the firm may consider it preferable to sell down rather than exercise stewardship.
- 5.18** Index-tracker funds do not allow for 'bottom-up' share selection and do not give the asset manager a choice around whether or when to exit. The inability to exit investments increases the incentive to undertake stewardship activities and the largest 'universal' holders do invest in stewardship activities. On the other hand, passive investors can compete largely on the basis of lower fees, possibly increasing



incentives to free-ride on stewardship benefits provided by others rather than incur stewardship costs themselves.

- 5.19** The nature of stewardship activities is likely to differ between index-tracker and actively managed funds. Forthcoming research draws a distinction between 'routine' engagement and 'deep' engagement (James, Mittendorf, Pirrone and Robles-Garcia 2019).
- 5.20** Since they conduct less detailed research on individual companies, index-tracker funds may be more likely to pursue 'routine' thematic engagement strategies. They may set minimum expectations across all portfolio firms for particular aspects of strategy or governance, such as executive remuneration or Board composition.
- 5.21** An actively-managed fund, by contrast, may be more likely to identify idiosyncratic issuer-specific matters. Where they choose to do so, therefore, they may engage with issuers on a deeper and more targeted basis. There is value in both types of engagement, but the balance of engagement strategies observed may influence overall market quality.

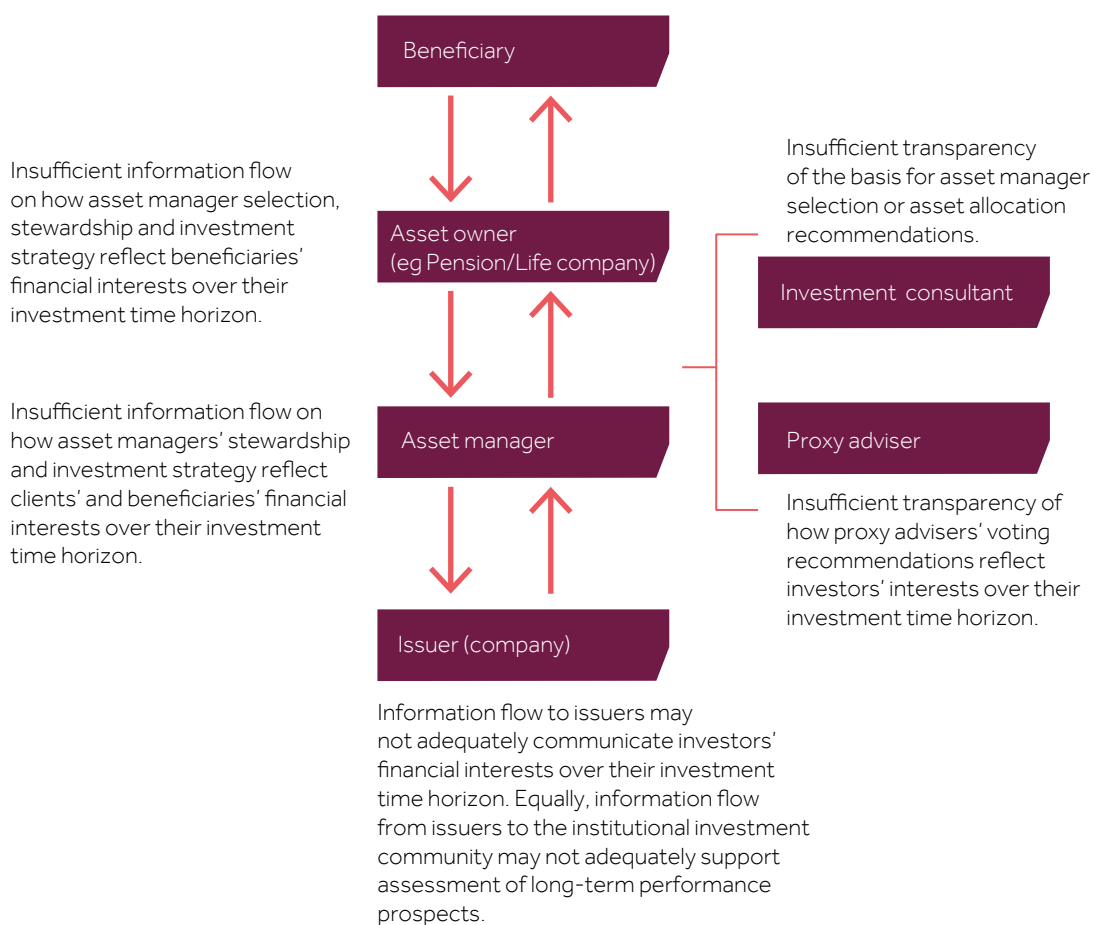
## Information flow between asset owners, asset managers, service providers and issuers

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- 5.22** Asset managers are required under existing regulations to disclose information about what they invest in and what their objectives are. This helps investors to decide whether an investment is right for them.
- 5.23** However, SRD II recognises that existing information requirements may not be adequate to enable asset owner to monitor the extent to which asset managers act in their best long-term interests. Additionally, they may not have access to enough information to assess whether the asset manager pursues a strategy that provides for effective shareholder engagement.
- 5.24** This is corroborated by a finding from a 2016 survey of asset owners and asset managers by the IA and the Pensions and Lifetime Savings Association (PLSA). This survey reported that, while 68% of asset owners have a stated policy on stewardship, only 37% set out their stewardship expectations in the mandates they give asset managers.
- 5.25** The measures to implement relevant provisions in SRD II proposed alongside this DP aim to enhance communication, disclosure and transparency across the institutional investor community. This could improve outcomes for beneficiaries and clients by encouraging better alignment of investment strategies and stewardship activities with their financial interests over their investment time horizon.
- 5.26** There may also be a need for greater transparency about the activities of key service providers. Proxy advisers play an important role in voting decisions. As part of the initiative to improve information flow, SRD II provides for additional disclosures by proxy advisers (see Chapter 6).

- 5.27** Investment consultants similarly play an important role in the institutional investment community. They provide advice to asset owners and others on investment strategy, asset allocation and asset manager product selection.
- 5.28** At the request of the FCA, the Competition and Markets Authority (CMA) conducted a market investigation into the investment consultancy sector. The CMA reported in December 2018, concluding that there are competition problems in the market for investment consultancy and fiduciary management services. Limited competition in the investment consultancy segment may leave these firms under insufficient scrutiny and subject to insufficient market discipline to demonstrate the quality of their service provision.
- 5.29** The CMA is proposing remedies to promote greater trustee engagement and provide them with more information on fees and performance of their providers. It is also recommending that the Government extend the regulatory perimeter to capture all the activities of investment consultants.
- 5.30** There may also be more to do to enhance the quality and usability of information on stewardship activity where it does exist. As more information on firms' stewardship activities becomes available under the SRD II disclosures and the Stewardship Code, there may be a need to develop assessment criteria to help users differentiate firms based on these disclosures.
- 5.31** The information flow in the other direction – that is, from the issuer to the institutional investment community – may also sometimes fall short of adequately supporting stewardship in the interests of long-term value creation. For instance, in its recent DP on climate change and green finance (DP18/8, Chapter 5), the FCA notes: 'The specific circumstances of a particular company will determine the scope and nature of the disclosures it needs to make to adequately inform investors. However, there is a significant risk that a company will not satisfy disclosure requirements if it provides no information on climate-related issues or if the company's Board has not considered whether the company needs to provide such disclosure.'
- 5.32** As asset managers' interest in ESG matters has grown over recent years, several market data and index providers have developed indices, scoring methodologies and standardised metrics to help firms track public companies' ESG performance. We would be interested to hear from stakeholders how such metrics are used and the extent to which issuers' disclosures are adequate to inform the development of these metrics.
- 5.33** The scope for loss or distortion of information across the institutional investment community is illustrated in Figure 3.

**Figure 3: Possible information issues across the institutional investment community**



**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.

**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.

## 6 The scope of the regulatory framework for stewardship

- 6.1** Regulation has an important role to play in dealing with the principal-agent problems described in Chapter 3, and addressing the specific challenges to effective stewardship described in Chapter 5.
- 6.2** This DP is an opportunity to advance the debate on whether current and proposed regulation supports the role of stewardship in promoting well-functioning markets.
- 6.3** We also seek feedback on how to deal with some specific issues in the design of the regulatory framework, including the institutional, asset-class and geographical scope of the framework.

### Context

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- 6.4** The current regulatory framework for stewardship, as described in Chapter 1, is primarily based on the FRC's Stewardship Code, underpinned by limited FCA rules. These rules require firms that manage investments for professional clients which are not natural persons to disclose the nature of their commitment to the Code. If they do not commit to the Code, they must explain their alternative investment strategy. DWP has also introduced legislation which places certain stewardship obligations on trustees of occupational pension schemes.
- 6.5** As noted in Chapter 1, this DP is accompanied by two CPs that: (i) set out the actions the FCA proposes to take to implement effectively key provisions of SRD II the UK, in the scenario where an implementation period is in place after the UK's departure from the EU; and (ii) propose revisions to the FRC's Stewardship Code. As noted, SRD II would have some relevance to regulated firms and corporate issuers even in a scenario in which the Directive was not implemented in the UK. We welcome stakeholders' views on what measures would be appropriate in such a scenario.
- 6.6** With the implementation of SRD II and other existing related regulations by DWP, asset owners regulated by both the FCA and tPR, and FCA-regulated asset managers, will be subject to a range of requirements (many of which will apply on a 'comply or explain' basis) that aim among other things to enhance transparency of their investment and engagement strategies:
  - In the case of the FCA, it is proposed that these requirements will sit alongside other conduct rules applicable to financial services providers in the Handbook.
  - In the case of trustees of occupational pension schemes, regulated by tPR, the SRD II provisions will be implemented largely by way of enhancements to pension trustees' Statement of Investment Principles. This would be achieved through existing legislation, which is due to take effect from October 2019.
- 6.7** SRD II requirements seek to enhance stewardship by asset owners and asset managers, but are limited. In many areas, the Directive is also less detailed and less prescriptive than

requirements anticipated by the revised Stewardship Code. The FRC's proposals for revisions to the Stewardship Code establish key Principles and Provisions that reflect the key attributes of effective stewardship explained in Chapter 4.

- 6.8** In the main, signatories will be expected to adopt the Stewardship Code on an 'apply and explain' basis. They will also be expected to report annually on the effectiveness of the outcomes achieved by their stewardship activities.
- 6.9** Other than where the provisions of SRD II are implemented via existing rules or legislation that is already in progress, it is proposed that SRD II provisions will be implemented largely by way of a copy-out of the Directive text. The new rules will establish a minimum baseline for asset owners and asset managers regulated by the FCA or tPR. Being focused largely on disclosure, these provisions rely primarily on market discipline to drive change. Proposed revisions to the Stewardship Code will promote higher standards of stewardship beyond the regulatory rules and the 2012 Code, and for assets other than listed equity.
- 6.10** Firms covered by the FCA's COBS rule 2.2.3 will be expected to become signatories to the revised Stewardship Code and adhere to its Principles and Provisions. If they have not, they must explain why and what their alternative investment strategy is. Pending feedback on both the FCA's proposed new rules to implement SRD II, and the revisions to the Stewardship Code, the FCA does not propose to change the rule that references the Code at this time.
- 6.11** The approach we are proposing to take in transposing SRD II would leave firms with significant discretion on how they undertake stewardship. We consider that this approach will allow a market for stewardship to develop, while avoiding prescriptive requirements that could stifle different approaches to stewardship where these appropriately reflect firms' different organisational purposes, circumstances and available resources.
- 6.12** We would welcome respondents' views, however, on whether the proposed balance between regulatory requirements and the Stewardship Code is right, or whether there are specific areas where we should go further to strengthen the regulatory framework.

## How the proposed measures link to attributes of effective stewardship

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- 6.13** The balance between the minimum requirements set in legislation and rules-based measures to be implemented by the FCA or DWP, and the higher standards set by the Stewardship Code, is summarised in Table 2. The measures are mapped to the key attributes of effective stewardship explained in Chapter 4.

### 1. A clear purpose

- 6.14** Public disclosure rules for asset owners and asset managers, and rules to govern communications between asset owners and managers, will help to identify any difference in the objectives and the practice of shareholder engagement and the exercise of shareholder rights across the institutional investment community. Investors will be better able to assess consistency with their financial interests and investment time horizon and encourage the emergence of a market for stewardship.

- 6.15** Proposed revisions to the Stewardship Code will encourage signatories to describe their organisational purpose and establish similar expectations for service providers (including proxy advisers and investment consultants).

## **2. Constructive engagement**

- 6.16** The FCA's proposed new rules for life insurers and asset managers, and existing legislative requirements introduced by DWP for trustees of occupational pension schemes, provide for public disclosure of firms' engagement policies. These disclosures will be expected to include, at a minimum, information in several specified areas (eg how the firm monitors key strategic, operational and ESG matters and how it exercises voting rights), and how these have been implemented. Asset owners and asset managers that do not have an engagement strategy will have to explain why not.
- 6.17** The FCA's proposed new rules also provide for public disclosure of the details of arrangements between asset owners and asset managers. This includes how these arrangements incentivise the asset manager to make investment decisions and engage with investee companies to improve performance over the medium to long term.
- 6.18** These rules will be complemented by the revised Stewardship Code. It will apply to a wider range of firms and asset classes, and directly encourage constructive engagement, integration of stewardship with investment decisions – including pre-investment decisions – and active exercise of rights and responsibilities.

## **3. Institutional culture and structures**

- 6.19** Public disclosure of how the arrangements between asset owners and asset managers are consistent with the nature of asset owners' financial commitments to beneficiaries should help to show whether institutional structures support a long-term perspective in investment decisions.<sup>9</sup>
- 6.20** Under the FCA's proposed rules, these disclosures will be complemented by provisions for public disclosure of asset owners' investment strategies and disclosures by asset managers to asset owners. This includes disclosures on how implementation of their investment strategies contribute to medium- and long-term performance. We expect transparency in these areas to contribute to a culture of effective stewardship.
- 6.21** The Stewardship Code will build on the legislative/rules-based regime. It will aim more directly to encourage signatories to establish objectives that create sustainable value for investors. Signatories will also be expected to disclose how their established organisational culture enables them to fulfil their stewardship objectives, and align governance, resourcing and remuneration policies to the delivery of these objectives.

## **4. Disclosure and transparency**

- 6.22** The FCA's proposed rules for insurers and asset managers, and similar requirements under existing legislation introduced by DWP, are also intended help to break down information barriers arising from the complexity of relationships in the institutional investment community. Enhanced disclosures will give asset owners key information which will empower them to select asset managers based on alignment with their own and their beneficiaries' interests, and to hold them to account on their stewardship.

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<sup>9</sup> The SRD II text refers to these financial commitments in terms of "the profile and duration of asset owners' liabilities".

**6.23** Enhanced reporting requirements under the revised Stewardship Code will further increase transparency of how stewardship is being exercised across the institutional investment community.

**Table 2: Balance between proposed regulatory rules and the revised Stewardship Code**

Regulatory rules	Revised Code
<p><b>1. A clear purpose</b></p> <p>Requirements to govern disclosure by asset owners and asset managers on engagement policies and investment strategies, and how these have been implemented for equity holdings.</p>	<p>Signatories to integrate stewardship with their decision-making and demonstrate how they take ESG issues into account; and actively consider whether prospective investments are aligned with their stewardship approach.</p> <p>Signatories to communicate clearly with stakeholders.</p> <p>The proposed revised Code will further: extend institutional scope (eg to service providers such as investment consultants and proxy advisers); extend asset class scope.</p>
<p><b>2. Constructive oversight, engagement and challenge</b></p> <p>Asset owners and asset managers to publicly disclose details of engagement policies and the arrangements between them, including the exercise of voting rights, and demonstrate that these have been implemented in a way consistent with the nature of asset owners' financial commitments to beneficiaries.</p>	<p>Signatories to:</p> <ul style="list-style-type: none"> <li>• integrate stewardship with their decision-making</li> <li>• actively consider whether prospective investments are aligned with their stewardship approach</li> <li>• undertake constructive engagement to protect and enhance the value of assets</li> <li>• actively exercise their rights and responsibilities.</li> </ul> <p>Proposed revised Code will further: extend institutional scope (eg to service providers); and extend asset class scope.</p>
<p><b>3. Culture and institutional structures that support effective stewardship</b></p> <p>Asset owners to disclose:</p> <ul style="list-style-type: none"> <li>• how investment strategies align with the nature of asset owners' financial commitments to beneficiaries</li> <li>• how arrangements between asset managers and asset owners (including matters such as remuneration) incentivise actions/ decisions aligned with the the nature of asset owners' financial commitments to beneficiaries.</li> </ul> <p>Asset managers to make certain disclosures to asset owners, including how implementation of their investment strategies contributes to medium to long-term performance.</p>	<p>Signatories to establish and disclose:</p> <ul style="list-style-type: none"> <li>• stewardship objectives, how they serve the interests of clients and beneficiaries, and create sustainable value for investors</li> <li>• organisational purpose, strategy, values and culture, directed towards fulfilling their stewardship objectives</li> <li>• governance, processes, resources and remuneration that support the delivery of their stewardship objectives</li> <li>• policies to manage conflicts of interest which put the interests of beneficiaries and/or clients first.</li> </ul> <p>The proposed revised Code will extend expectations across asset classes and to service providers, encouraging a long-term perspective across the institutional investment community.</p>
<p><b>4. Disclosure and transparency of stewardship activities</b></p> <p>Asset owners and asset managers to disclose publicly their engagement policies and how they have been implemented (including how votes have been cast).</p> <p>Asset owners to disclose publicly how their investment strategies are consistent with the nature of asset owners' financial commitments to beneficiaries, and how their arrangements with asset managers are consistent with this strategy.</p> <p>Asset managers to disclose to asset owners how the implementation of their investment strategies is consistent with asset owners' best long-term interests.</p>	<p>Signatories to communicate clearly with stakeholders.</p> <p>Signatories to publicly report against Principles and Provisions in the revised Code.</p> <p>Proposed revised Code will further: extend expectations to service providers; extend asset class scope of expectations.</p>

## Proxy advisers

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- 6.24** Proxy advisers provide voting advice and other related services to asset owners and asset managers. Many asset owners and asset managers use proxy advisers' services to support them in the exercise of voting rights associated with their shareholdings. Through this activity, proxy advisers can exercise significant influence over the stewardship of companies in which their clients invest.
- 6.25** Recognising this influence, SRD II sets certain requirements for proxy advisers to increase the transparency of their activities and to deal with potential conflicts of interest. The Directive requires that proxy advisers:
- Disclose whether and how they apply a code of conduct, or explain why they have not done so
  - Disclose information on their research capabilities and how they produce their advice and voting recommendations (eg, models, methodologies, information sources and resources)
  - Identify and disclose any actual or potential conflicts of interests or business relationships that may influence the preparation of their research.
- 6.26** We expect that the Government will take steps in due course to implement these requirements in the UK.
- 6.27** SRD II responds to concerns raised by issuer companies and investor firms about the financial incentives for proxy advisers to invest in the resources they need to provide high-quality research and advice. Particularly where a company is putting more unusual or controversial strategic matters to shareholder vote, poor-quality advice could lead to a resolution being either accepted or voted down at an AGM, when the opposite outcome would have been in the best interests of the company and its shareholders.
- 6.28** Other concerns that have been raised include issues around the potential lack of transparency in the proxy advisor market, how proxy advisers manage conflicts of interest, and general standards of business conduct. For instance, some issuers have observed that they are not always given timely sight of proxy advisers' voting advice, which makes it difficult to respond to or challenge such advice and correct potential misunderstandings.
- 6.29** While the provisions of the Directive require disclosures in most of the areas in which concerns have been raised, they do not set any qualitative standards about how proxies should conduct themselves in these areas. Instead, the Directive relies on improved transparency to drive market discipline. However, such market discipline may potentially be weakened by the fact that the market for proxy advisory services is highly concentrated, with the sector dominated by two providers.
- 6.30** The service providers section of the Stewardship Code sets expectations for proxy advisers. The proposed Principles for proxy advisers emphasise the role that proxy advisers should play in promoting and enabling effective stewardship. They also set expectations for how this role should be supported by values, culture, governance processes, resources, remuneration and policies to manage conflicts of interest. The Provisions go on to set more granular expectations around matters such as service quality.



- 6.31** In addition, as part of their stewardship activities, and building on their responsibilities under the Directive, we anticipate UK asset owners and asset managers might take disclosures made by proxy advisors under SRD II and the Stewardship Code into account when deciding whether and how to use their services.
- 6.32** We seek views from stakeholders on whether there are issues with proxy advisors that are not adequately addressed by SRD II and proposed revisions to the Stewardship Code.

## Other areas for specific consideration

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- 6.33** The proposed approach to implementation of SRD II aims to set baseline regulatory standards for stewardship, consistent with the provisions of the Directive. In other areas, the framework for stewardship relies on adherence to the Stewardship Code.
- 6.34** For some of those areas, it may be that better outcomes could be achieved by extending the scope of regulatory requirements.
- 6.35** We set out below particularly pertinent areas. There may be other areas where stakeholders consider that additional requirements would be beneficial to support effective stewardship – or where greater precision in the rules would be useful to clarify how requirements should be met.
- 6.36** In addition, there may be a case to further review the interaction between the proposed measures and other existing requirements that affect how investors and issuers interact, such as the LRs, PRs and DTRs.

## Institutional scope of rules: Self-invested Personal Pension (SIPP) scheme operators

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- 6.37** SRD II applies to institutional investors, defined as occupational pension schemes and life insurers. In the UK context, SIPP operators are also important providers of pensions to individuals. To the extent that they can exercise stewardship over the investments contained in an individual SIPP, we could consider extending the requirements to such firms. We would welcome views on this aspect.

## Asset-class and geographical scope of rules

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- 6.38** We discussed in Chapter 4 the potential benefits of a broad asset-class and geographical scope for stewardship, to reflect how the composition of UK-managed investment assets has evolved over time.
- 6.39** In respect of geographical scope, the FCA's proposed rules framework to implement the provisions of SRD II extends to all shareholdings held by in-scope regulated firms, irrespective of whether the share issuers are admitted to trading on a regulated market in the UK, or a similar market overseas. The DWP's proposed rules framework has similar territorial reach.

- 6.40** However, we are not seeking to apply the UK regulatory framework to overseas investors in UK-issued assets. This is consistent with the general territorial scope of UK financial services regulation.
- 6.41** Since the asset scope of SRD II does not extend beyond equities, the proposed rules framework is similarly limited to regulated firms' shareholdings. The effectiveness of stewardship in respect of other asset-classes and overseas investors relies on the potentially broader reach of the Stewardship Code.
- 6.42** We are interested in feedback on whether there is more that should be done to incentivise international investors and to ensure they recognise the benefits of exercising stewardship, including in respect of their assets in the UK. And we would like views on whether there is a case for regulatory rules to expand the reach of stewardship beyond equities – noting the coordination issues discussed in Chapter 4.

## Quality of stewardship

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- 6.43** Consistent with SRD II, the proposed regulatory rules aim to enhance the quality of stewardship by improving disclosures and encouraging the development of a market for effective stewardship.
- 6.44** The FCA is not proposing to introduce rules that more directly regulate the quality of stewardship. The FCA does not propose to specify in rules how firms must exercise stewardship, for instance in areas such as the prioritisation and conduct of engagement with issuers, or the integration of stewardship activities with investment decision-making. Nor do the proposed new rules call out and seek to prohibit any specific poor practices.
- 6.45** Proposed revisions to the Stewardship Code do address such matters. We are interested in feedback about whether there are any areas in which we should consider additional regulatory rules either to improve stewardship quality or prevent poor practice, rather than relying solely on promoting effective practices through the revised Stewardship Code.
- 6.46** Additionally, in Chapter 5, we identified some areas where the engagement activities and approaches of active and index-tracker funds are likely to differ. We would be interested to hear whether stakeholders consider that regulatory actions are necessary to address any perceived harms.

## Flexibility in application

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- 6.47** Consistent with the Directive text, the FCA's proposed rules framework to implement key disclosure provisions in SRD II applies on a 'comply or explain' basis.<sup>10</sup>
- 6.48** This flexibility may be appropriate, particularly when considering the breadth of the new requirements and the different organisational purposes, strategies,

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10 Certain provisions in Article 3 of SRD II apply on a 'comply or explain basis': eg the requirement that asset owners and asset managers develop and disclose an engagement policy; and the requirement that asset owners disclose their investment strategy, how they incentivise their asset managers, and other metrics.

circumstances and resources of impacted firms. For instance, a small firm with a diversified portfolio may find it more difficult or costly to engage in stewardship in the same way or to the same extent as a large firm with a concentrated portfolio. Such a firm may opt for and explain a different approach to stewardship.

**6.49** However, given the potential benefits of effective stewardship and the desire to significantly raise the bar across the industry, we are interested in stakeholders' views on whether adherence to certain of these rules should be mandatory, rather than 'comply or explain'.

**6.50** We note that disclosure requirements under existing legislation introduced by DWP for trustees of occupational pension schemes apply on a mandatory basis. In addition, the 'apply and explain' compliance basis for the Principles of the Stewardship Code is stronger than that under the Directive.

**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?

**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?

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

- i:** Whether and to what extent the FCA's proposed rules for asset owners should be extended to SIPP operators?
- ii:** The case for regulatory rules to expand the reach of stewardship beyond listed equity
- iii:** Whether there is a role for UK regulators in encouraging overseas investors to engage in stewardship for their asset holdings 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
- 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.

**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.

**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)?

## Annex 1

### Questions in this paper

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

- 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?
- 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?
- Q9:** We welcome feedback on other specific aspects of the regulatory framework described above. In particular, we are interested in views on:
- i:** Whether and to what extent the FCA's proposed rules for asset owners should be extended to SIPP operators?
  - ii:** The case for regulatory rules to expand the reach of stewardship beyond listed equity
  - iii:** Whether there is a role for UK regulators in encouraging overseas investors to engage in stewardship for their asset holdings 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
  - 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.
  - 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.
- 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)?

## Annex 2

# Glossary of terms

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<b>Asset manager</b>	An individual or organisation to whom the responsibility for the day-to-day management of assets is delegated by an individual or institutional asset owner. The asset manager will act based on instructions given to them in an investment mandate, with discretion to buy and sell assets on behalf of another entity or person.
<b>Asset owner</b>	An institutional investor responsible for protecting assets on behalf of beneficiaries.
<b>Beneficiary</b>	An individual, natural person who derives an economic benefit from investments held with an investment intermediary or under a contract with a financial services provider.
<b>Bond</b>	A debt security issued by a company or national government and sold to investors.
<b>Client</b>	A person or organisation that receives a service from another person or organisation in return for payment.
<b>Engagement</b>	Communication between different stakeholders ie between asset owners and beneficiaries or investors and investee companies.
<b>Equity</b>	A share or stock in the share capital of an incorporated company
<b>Fiduciary duty</b>	The obligation to manage other people's money in their best interests ie an asset manager executing their role in clients' best interests.
<b>Financial Services and Markets Act 2000 (FSMA)</b>	Financial Services and Markets Act 2000. The main piece of legislation governing UK financial markets regulation.
<b>Index tracker fund</b>	An approach to investment which typically involves tracking the investment performance of a specific market index. A passively managed fund is also known as an "index fund".
<b>Institutional investment community</b>	In the context of this DP, institutional investment community refers to the community of firms that carry out or support investment activity for the economic benefit of individuals, ie beneficiaries. These include institutional investors – such as pension schemes and life insurers – and service providers, such as investment consultants and proxy advisers.
<b>Institutional investor</b>	Legal entities invested in funds or mandates, including pension schemes, charities, insurance companies, and endowment funds.
<b>Investment consultant</b>	An individual or organisation undertaking consultancy and/or fiduciary management services. Investment consultancy is the provision of advice to institutional investors on investment strategy, asset allocation and asset manager product selection.

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<b>Investment strategy</b>	Decisions and actions to implement investment beliefs, eg investors' decisions and subsequent actions to be taken on asset allocation, approach to risk, and use of risk hedging instruments.
<b>Investment time horizon</b>	The time horizon over which an investor is expected to hold their investments. For pension and insurance investments, the time horizon will generally reflect the time profile of expected payouts to beneficiaries.
<b>Pension fund: Defined Benefit</b>	A type of pension where the amount an employee receives on retirement is pre-determined, and is often calculated based on the employee's final salary and length of service. The amount received on retirement does not depend on the performance of the pension scheme's investments.
<b>Pension fund: Defined Contribution</b>	A type of pension where the amount received by a member on retirement will be calculated by reference to the contributions the employee makes to the scheme and the investment return on those contributions.
<b>Proxy adviser</b>	A person or an organisation that analyses, on a professional and commercial basis, company disclosure and, where relevant, other information of listed companies with a view to informing investors' voting decisions by providing research, advice or voting recommendations that relate to the exercise of voting rights.
<b>Service provider</b>	Service providers do not manage investments directly or have fiduciary responsibility. However, they play a key role in the investment community. Service provider activity considered to be in scope of the 2019 UK Stewardship Code includes but is not limited to: engagement; voting recommendations and execution; research and data provision; advice; and provision of reporting frameworks and standards.
<b>Stewardship</b>	We define stewardship as the responsible allocation and management of capital across the institutional investment community, to create sustainable value for beneficiaries, the economy and society. Stewardship activities include monitoring assets and service providers, engaging issuers and holding them to account on material issues, and publicly reporting on the outcomes of these activities.
<b>Responsible investment</b>	An approach to investing that aims to incorporate environmental, social and governance factors into investment decision-making to better manage investment risk and opportunities and contribute to a more sustainable economy.



## Annex 3

### Abbreviations used in this paper

<b>AGM</b>	Annual General Meeting
<b>BEIS</b>	Department for Business, Energy and Industrial Strategy
<b>CMA</b>	Competition and Markets Authority
<b>COBS</b>	Conduct of Business Sourcebook. The section of the FCA's Handbook that deals with business standards.
<b>CP</b>	Consultation Paper
<b>DB</b>	Defined Benefit pension scheme
<b>DC</b>	Defined Contribution pension scheme
<b>DP</b>	Discussion Paper
<b>DTRs</b>	Disclosure Guidance and Transparency Rules
<b>DWP</b>	Department for Work and Pensions
<b>ESG</b>	Environmental, Social and Governance
<b>FCA</b>	Financial Conduct Authority
<b>FRC</b>	Financial Reporting Council
<b>FSMA</b>	Financial Services and Markets Act 2000
<b>IA</b>	Investment Association
<b>IGCs</b>	Independent Governance Committees
<b>LRs</b>	Listing Rules
<b>MAR</b>	Market Abuse Regulation
<b>ONS</b>	Office for National Statistics
<b>PLSA</b>	Pensions and Lifetime Savings Association
<b>SDGs</b>	Sustainable Development Goals
<b>SI</b>	Statutory Instrument

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<b>SIPP</b>	Self-Invested Personal Pension scheme
<b>PRs</b>	Prospectus Rules
<b>R&amp;D</b>	Research and Development
<b>tPR</b>	The Pensions Regulator
<b>UNPRI</b>	United Nations Principles for Responsible Investment

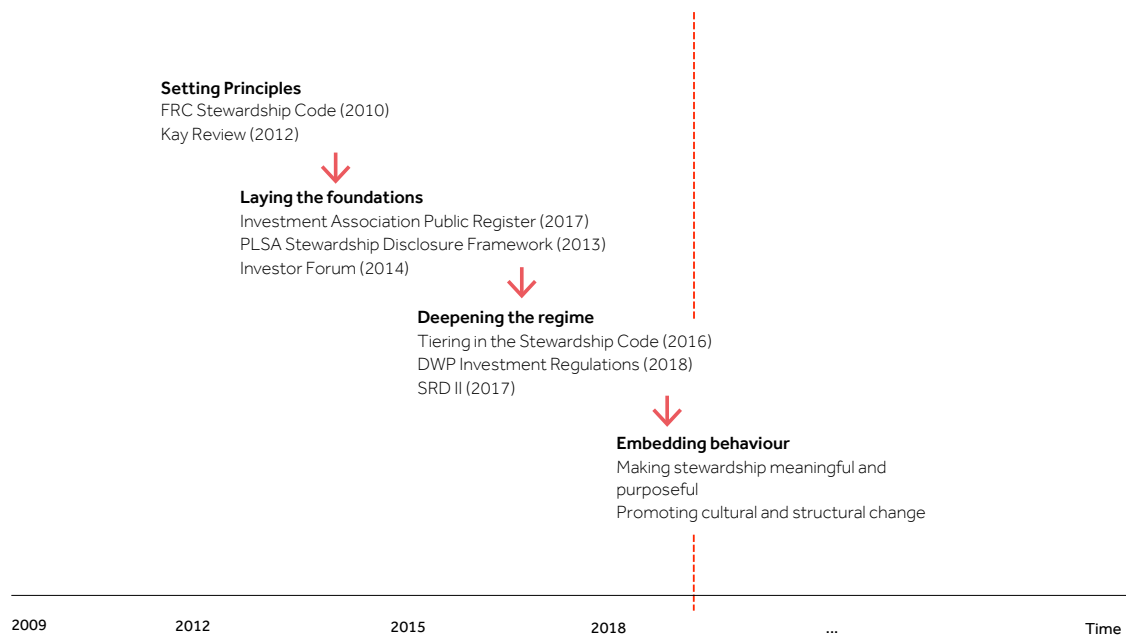
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# Appendix 1

## The journey to more effective stewardship

1. Since the financial crisis, the UK has embarked on a multi-stage journey towards more effective stewardship, with a view to dealing with many of the challenges described in the previous chapter. See Figure 4, below. Selected steps are summarised in this Appendix.

**Figure 4: The journey towards better stewardship**



### Setting principles

2. The Government-commissioned Kay Review, which reported in 2012, found that there was a short-termism problem in UK equity markets, in part reflecting a misalignment of incentives along the investment chain: 'we conclude that public equity markets currently encourage exit (the sale of shares) over voice (the exchange of views with the company) as a means of engagement, replacing the concerned investor with the anonymous trader.'
3. The Review concluded that a cultural change was needed to reorient equity markets towards their 'core purpose'. Recommendations from the Kay Review led to actions by Government and the industry to improve stewardship, including the Law Commission Review of Fiduciary Duty of Investment Intermediaries.
4. Stewardship activity in the UK has been guided by the Stewardship Code, for which the FRC was given responsibility following the 2009 Walker Review of corporate governance in the financial sector. The Stewardship Code was first published in 2010 and later updated in 2012 following the Kay Review to clarify the aim and definition of stewardship.
5. The Stewardship Code is a voluntary initiative, supported by FCA rules. It has to date been directed primarily at institutional investors investing in UK listed equity. It encourages signatories to adhere – on a 'comply or explain' basis – to seven principles with the stated

aim 'to enhance the quality of engagement between investors and companies to help improve long-term risk-adjusted returns to shareholders'.

6. From 2016, the Local Government Pension Scheme Investment Regulations required local authorities to formulate a policy that increases awareness and promotes engagement to reflect their stewardship responsibilities. The Guidance requests that administering authorities should become signatories to the Stewardship Code.

## Laying the foundations

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7. The IA has established a Public Register which aggregates information on voting behaviour in respect of FTSE All-Share companies. Its aim is to reveal how responsive investee companies are to shareholders' concerns. The IA has also introduced a Stewardship Reporting Framework to serve as a basis for public reporting of asset managers' stewardship activities. The PLSA similarly launched its Stewardship Disclosure Framework in October 2013.
8. Consistent with a recommendation from the Kay Review, the Investor Forum was established in 2014 to facilitate collective engagement by asset owners and asset managers. An important goal of the Investor Forum is to represent overseas investors in UK firms. Non-UK firms represent a third of the Forum's membership.

## Strengthening the framework

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9. This stage of the journey aims to strengthen the stewardship framework, by enhancing oversight of stewardship activity and giving it greater legislative and regulatory underpinning.
10. Following the Kay Review and the Law Commission's review of fiduciary duty, the DWP consulted on amendments to the regulation of Occupational Pension Schemes to encourage and enhance transparency of the stewardship activities of trust-based pension funds. Further to consultation, the Government confirmed that pension trustees will be required, among other things, to set out in their Statement of Investment Principles: how they take account of financially material factors, including ESG issues, in their investment decision-making; and their stewardship policies, including engagement and voting practices. The measures are due to come into force from 1 October 2019.
11. SRD II is the latest in a series of actions launched by the European Commission to promote better shareholder engagement and improve transparency in ownership of companies. SRD II follows the Commission's analysis of shortcomings in corporate governance during the financial crisis. This again identified short termism and insufficient engagement by shareholders as key issues.
12. SRD II requires asset owners and asset managers to make disclosures about their long-term investment strategies and their engagement with each other. These measures give regulatory underpinning to existing code-based measures to improve transparency by enhancing the flow of information across the institutional investment community, and to promote common stewardship objectives between institutional investors and asset managers.

- 13.** In Chapter 6 and in the accompanying consultation paper, we discuss measures that the FCA proposes to take to implement relevant parts of SRD II in the UK.

## Embedding behaviour

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- 14.** The impact of these measures will be greatest if they are accompanied by complementary actions to embed good stewardship throughout the institutional investment community. We recognize that, in this phase, there may be significant cultural and institutional barriers to overcome. For instance, there may be challenges in changing established practices and institutional features such as remuneration, performance measurement and asset manager selection criteria to better promote long-term, sustainable value creation.
- 15.** Proposed revisions to the Stewardship Code – summarised in Chapter 6 and detailed in the accompanying consultation paper – are taking a step towards embedding a culture of effective stewardship across investment decisions and across the institutional investment community.
- 16.** And relevant trade associations are actively promoting a longer term perspective in decision-making from the perspective of both the investor and the investee company via initiatives such as the IA's Long-term Reporting Guidance. This guidance was produced under the auspices of the IA's Long Term Productivity Plan, which The Treasury and BEIS asked them to undertake in 2016. It asks investee companies to tabulate and explain their annual capital allocation decisions.

We have developed this Discussion Paper in the context of the existing UK and EU regulatory framework. The Government has made clear that it will continue to implement and apply EU law until the UK has left the EU. We will keep the proposals under review to assess whether any amendments may be required in the event of changes in the UK regulatory framework in the future.

We make all responses to formal consultation available for public inspection unless the respondent requests otherwise. We will not regard a standard confidentiality statement in an email message as a request for non-disclosure.

Despite this, we may be asked to disclose a confidential response under the Freedom of Information Act 2000. We may consult you if we receive such a request. Any decision we make not to disclose the response is reviewable by the Information Commissioner and the Information Rights Tribunal.

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