ICGN
International Corporate Governance Network

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30 April 2019

ICGN Response to the Discussion Paper: Building a Regulatory Framework for Effective Stewardship

Dear Mr Manning,

The International Corporate Governance Network (ICGN) is pleased to respond to the UK Financial Conduct Authority (FCA) and Financial Reporting Council (FRC) Discussion Paper on building a regulatory framework for effective stewardship.

Led by investors responsible for assets under management in excess of US$34 trillion, ICGN is a leading authority on global standards of corporate governance and investor stewardship. Our membership is based in more than 45 countries and includes companies, advisors and other stakeholders.

ICGN's mission is to promote high standards of professionalism in governance for investors and companies alike in their mutual pursuit of long-term value creation contributing to sustainable economies world-wide. Our policy positions are guided by the ICGN Global Governance Principles[1] and the ICGN Global Stewardship Principles (GSP)[2], both of which have been developed in consultation with ICGN Members and as part of a wider peer review. For more information on ICGN please see: www.icgn.org.

One of ICGN's core policy priorities is to make successful stewardship a reality.[3] ICGN's GSP were first published in 2003 and provide an international framework for investors to **implement their fiduciary obligations** on behalf of clients and beneficiaries. The GSP are currently endorsed by a wide range of influential institutional investors globally.[4] The Principles, along with ICGN's Model Mandate[5], published in 2012, have been emulated in markets around the world, most notably in Asia and Europe.

[1] See: ICGN Global Governance Principles: http://icgn.flpbks.com/icgn_global_governance_principles_jpn/

[2] See: ICGN Global Stewardship Principles: https://www.icgn.org/sites/default/files/ICGN_Global_Stewardship_Principles_JPN_1.pdf

[3] See ICGN Policy Priorities: https://www.icgn.org/sites/default/files/ICGN%20Policy%20Priorities%202018-9.pdf

[4] See list of investor endorsers of ICGN's Global Stewardship Principles: https://www.icgn.org/policy/icgn-global-stewardship-principles-endorsers

[5] See ICGN Model Mandate: https://d3n8a8pro7vhmx.cloudfront.net/intentionalendowments/pages/27/attachments/original/1420777456/ICGN_Model_Mandate_Initiative.pdf?1420777456

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A more recent addition to ICGN's policy output on stewardship was the publication of a member-approved Guidance on Investor Fiduciary Duty in 2018.[6] In late 2018 ICGN also launched the Global Stewardship Awards and published a series of model stewardship disclosure guidance documents relating to conflicts of interest, monitoring, engaging and voting.[7] Most recently, ICGN released in February 2019 its first Annual Investor Stewardship Survey, which was completed by over 40% of ICGN's investor members, representing over £10 trillion assets under management.

With regard to the UK and its Stewardship Code, ICGN has long engaged with the FRC about both corporate governance and stewardship. In our early 2018 response to the FRC regarding the UK Corporate Governance Code, we addressed a range of preliminary questions about the then-planned review of the UK Stewardship Code.[8] This past March 2019 we also submitted our response to the FRC with regards to the UK Stewardship Code consultation.[9]

In this context we are pleased to continue this dialogue with the FCA and FRC, and in doing so we recognise the leadership that the UK has shown in helping to define and shape the practice of stewardship in markets globally. Many of our comments in the March 2019 Stewardship Code consultation, cited below, serve as background for our response to the individual questions in this consultation. In particular, we would like to re-emphasise the importance of improving stewardship in practice, by focusing on both stewardship activities and outcomes, which are underpinned by institutional investors' sense of purpose, values and culture. This is emphasised in ICGN's first Stewardship Principle 1 which expresses the importance of having robust "internal governance" processes within investment firms themselves as the foundation of effective stewardship.

Question 1: Definition of stewardship

The definition offered is adequate but seems somewhat narrow in scope for certain aspects, while broad in others. The narrow dimension relates to the specific focus on institutional investors rather than other types of investors. While we can see merit in focusing on stewardship from an institutional investment perspective, the FCA/FRC should not dismiss the importance of good stewardship practices expected from other types of investors.

Where the definition is broad comes with the extension of stewardship's stated purpose is to create sustainable value for "beneficiaries, the economy and society". From a public policy perspective, we appreciate the role that stewardship can play in supporting broad social objectives of better economies, markets and societies. Even though many investors are increasing their awareness of the social impact of their investment activity, we believe it should be clear that for institutional investors the primary purpose of stewardship is to serve their fiduciary duty to their own clients and beneficiaries. At the same time long-term

[6] See ICGN Guidance on Investor Fiduciary Duties (2018): http://icgn.flpbks.com/icgn-fiduciary_duties/

[7] See Stewardship page on ICGN website: https://www.icgn.org/stewardship-0

[8] See ICGN 2018 submission to the FRC's consultation on the UK Corporate Governance Code: https://www.icgn.org/sites/default/files/4.%20ICGN%20Comment%20FRC%20UK%20Corporate%20Governance%20Code%20Consultation%20Feb%202018_0.pdf

[9] ICGN response to the FRC's UK Stewardship Code consultation, March 2019: https://www.icgn.org/sites/default/files/ICGN%20Reponse%20to%20the%20Proposed%20Revision%20to%20the%20UK%20Stewardship%20Code%20-%20March%202019.pdf

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investors have an interest in promoting sustainable societies and economies to preserve value for beneficiaries, and in this context, we are comfortable with the definition.

Given the focus on institutional investors and the fact that a substantial amount of institutional investment is linked to pension funds or other forms of long-term savings/financial planning, it also may be helpful for the definition of stewardship to be more explicit about its focus on long-term capital and investment perspectives.

Question 2: Specific areas of focus

We support the inclusion of material environmental, social and governance (ESG) factors as key considerations across the investment process and such considerations should also be central in dialogue and engagement with companies. In addition, ICGN advocates that there is scope for greater inclusion of systemic risks as a key consideration within the purview of stewardship. While climate change is cited in the discussion paper, we believe it is also important that investors recognise and address other systemic risks such as cyber security, globalization, weak rule of law, human rights, income inequality and other factors that pose threats to the long term health of companies, financial markets and societies.
The United Nations Sustainable Development Goals (SDGs) provide a comprehensive framework for assessing societal risks. While many of the SDGs are best addressed through governments and public policy, the private sector can also play an important role. In this context, the scope of stewardship, when aligned with fiduciary duty to investor beneficiaries, can extend to include wider systemic and societal risks.

Question 3: Key attributes

The four key attributes as presented in the Discussion Paper reflect good common sense in terms of investor governing principles for stewardship. Ultimately, stewardship depends on company culture and values, supported with strong governance structures. The four attributes are interrelated, so it may not be helpful to suggest which of the four is most or least important as requested. However, there important governance questions relating to stewardship that are not specifically articulated in these attributes. These are cited in ICGN's Global Stewardship Principles relating to Principle 1 regarding 'investor governance', and the statement of key attributes might benefit from including them. These include:

- Ethics, values and conflicts of interest;
- Ensuring sufficient resources to meet stewardship responsibilities; and
- Establishing an appropriate remuneration structure that is aligned with stewardship outcomes and timeframes.

Question 4: Geographical and asset class scope

We think it is inevitable that much stewardship activity will occur in the institutional investor's home market. This "home bias" reflects a range of factors, including language, familiarity, logistics and cost. However, we agree that it is desirable to have overseas investors active in stewardship as well, and we are aware of academic research suggesting that teams of local and overseas investors collaborating together can produce positive stewardship outcomes. We would note that organisations such as ICGN facilitate cross-border investor networking and collaboration among investors to promote good stewardship.

We agree that stewardship should extend beyond equities into other asset classes, and moreover, we believe there is scope for exploring the similarities and differences in stewardship activity between fixed income and equity investors. While shareholders are often seen to bear the residual risk of the company, creditors ultimately bear that risk, as we

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have recently seen in the UK in the case of Debenham's. ICGN believes the scope of stewardship should embrace fixed income, as well as other asset classes within the institutional investment umbrella. As we noted in our response to the UK Stewardship Code consultation, there should be greater clarity or guidance given as to whether stewardship in fixed income should extend to government debt, as well as to corporate debt.

Question 5: Differing investment objectives and strategies

An investment strategy is a key determinant of how stewardship will be implemented. In particular the stewardship dynamics between actively managed portfolios and stewardship tracker funds can differ significantly, and as stewardship continues to mature, we will see the emergence of best practices in different stewardship approaches.

Given the scale of investment portfolios, in terms of number of investee companies and also geographic scope, many investors must optimize their use of human resources to prioritise their stewardship and engagement efforts effectively. Many investors use screening tools, linked to ESG scoring methodologies which culminates in risk assessments and priority engagement themes. Other considerations include:

- Alignment with their investment strategy, client objectives and overall investment beliefs, for example violations of the UN Global Compact Principles, labour standards controversies or environmental harm. According to the ICGN Investor Survey, over 80% of institutions now have some form of exclusions policy, with controversial weapons excluded by most; followed by tobacco and thermal coal.

- Scale of investment in terms of size of holding and level of value at risk. The size of the holding as a fraction of the value of the fund will guide how much resource to employ into the engagement effort and the degree of influence and impact that can be achieved. With a larger share of equity, direct influence can often be exerted towards the board - where the shareholding is smaller, collaborative initiatives help to leverage the power of influence.

- Materiality of risks and opportunities relative to asset exposure and financial performance – ultimately impacting share value. This is often assessed in relation to the industry sector (high impact sectors such as oil, gas, mining or infrastructure), geography (politically sensitive regions) or by theme. In particular, poor ESG performance is closely monitored, particularly recurring issues, and whether it could materialize into a significant business detriment; or impact the share price in the short, medium or long term.

- Responding to unforeseen events, for example Chairman / CEO resignation, an acquisition not aligned to strategic direction, changes to remuneration policy and accounting concerns. Collaboration is particularly helpful in reacting to controversial events, particularly via a collective investor body, which can facilitate dialogue with companies or through strategic partnerships with stakeholders and NGOs.

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Question 6: Barriers to achieving effective stewardship

A significant barrier to achieving effective stewardship occurs when there is a lack of buy-in from the leadership of the investment institution and/or generally a poor culture within the institution that does not support stewardship objectives. Without such leadership there is unlikely to be sufficient resources committed to stewardship namely, human capital, data and effective client communications tools and processes. It is imperative that there is a basic understanding of what investor stewardship entails and a genuine desire for it to be implemented throughout the investment decision-making process and embedded in the business case. More generally, as the stewardship profession develops it will be important for investors to have a clearer understanding of its challenges, benefits and how to evaluate effective stewardship.

The problems of free riding and inconsistent stewardship quality are real and not likely to go away. But we believe that disclosure can go a long way towards making stewardship transparent and helping to create a market for good stewardship. We share the aspiration that for market leaders' stewardship quality will be a point of competitive differentiation. This is a virtuous circle that ICGN would like to support.

Question 7: Balance between regulatory rules and the Stewardship Code

While we fully recognise and support the positive potential that stewardship can bring to beneficiaries, economies and societies, we also recognise that evidence supporting the effectiveness of stewardship is still building and, in many ways, incomplete. We believe it is appropriate for regulatory authorities to "raise the bar" on stewardship, but prescriptive rules should be avoided, or at least used with caution.

We support the toughening of the Stewardship Code to "apply and explain" the overarching principles, given their broad scope. We agree it is sensible to use the Shareholder Rights Directive II framework as a base. However, until we have clearer evidence about the effectiveness of specific stewardship strategies, we believe that adopting prescriptive rules about how to conduct stewardship should be avoided, as each investor must align its stewardship activities with its own interpretation of fiduciary duty.

The more flexible "comply or explain" approach may be more appropriate for more detailed stewardship provisions, and we believe this is best supported through investor stewardship disclosures. We share, with FCA/FRC, the goal of establishing a competitive market for stewardship as the most effective way to achieve positive stewardship outputs. In aspiration, and in practice, we hope stewardship can inspire a race to the top.

Question 8. Proxy advisors

Proxy advisors are an important part of the stewardship "ecosystem". They provide important services to investors in the exercise of stewardship responsibilities, particularly with regard to voting rights and execution. As part of the chain of fiduciary duty, proxy advisors have the responsibility to provide their services in a way that allows their customers (investors) to achieve their stewardship obligations—ultimately to the benefit of end beneficiaries.

We would observe that proxy advisors are not alone in terms of the applicability of stewardship to their profession. They are only one of a number of third-party actors in the stewardship chain. Others include investment consultants, data providers, rating agencies, credit rating agencies and plaintiff law firms. All have a role to play, and there is potential for these and other types of service providers to add value to the stewardship process; but if poorly executed they can impede and detract from the practice of good stewardship.

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Question 9. Other specific questions

We believe that there may be benefits for regulatory rules to expand the reach of stewardship beyond listed equities to dispel potential narrow interpretations that this is "ultra vires" – or outside the scope of stewardship.

Linking questions 6 and 7 is how regulations can serve as either serve impediments or facilitators of investor stewardship. Without going into detail, we cite the need for regulation to better clarify boundaries in acting in concert rules so that investors can collaborate knowing that they are doing so within the bounds of the law.

A missing part of this discussion is the importance of stock exchanges in the stewardship ecosystem. They too have a role to play in promoting good stewardship and investor protections. In this context we would like to call particular attention to the governance of stock exchanges as a potential weak link to the system, particularly with regard to for-profit exchanges that themselves are listed and compete aggressively for new listings. We are concerned that competitive pressures can lead to a weakening of standards in many markets of the world, in ways that are anathema to the goals of stewardship. We cite, for example, the growth of dual class shares in the US, Hong Kong and Singapore as a negative example of regulatory competition to attract listings through watered down regulations that have the effect of entrenching management and marginalising accountability to minority shareholders who may be seeking to engage with the company.[10]

In a similar context in 2017 ICGN also cautioned the FCA against its proposal to create a new listing standard for sovereign controlled companies, citing the corporate governance risks and diminished accountability to minority shareholders. So, we conclude by stating that the FCA, as an important member of the stewardship ecosystem, also has a role to play in ensuring that minority shareholders in UK companies are not compromised in having their voice and rights protected appropriately.

We hope these comments are useful in your deliberations. If you would like to follow up with us with questions or comments, please contact me or our Policy Director George Dallas: george.dallas@icgn.org.

Yours sincerely,

Kerrie Waring
Chief Executive Officer, ICGN

Copies:

Niels Lemmers, Co-Chair, ICGN Shareholder Responsibilities Committee
Alison Schneider, Co-Chair, ICGN Shareholder Responsibilities Committee

[10] See ICGN Viewpoint on stock exchange governance, December 2018: https://www.icgn.org/stock-exchanges-and-shareholder-rights-race-top-not-bottom-0

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