CMIT

30 August 2024

UK Stewardship Code Review – an open letter from the Capital Markets Industry Taskforce

High standards of corporate governance have long been a strength of the UK's capital markets. As the Capital Markets Industry Taskforce (**CMIT**) said in its open letter on corporate governance in November 2023, we strongly believe that the UK's governance and stewardship regimes must be designed and implemented in a way that takes proper account of their effects on the country's economic growth and its international competitiveness. As such, we in particular welcomed the remit letter sent to the FRC by the Secretary of State for Business and Trade in November 2023 emphasising the role of the Financial Reporting Council (**FRC**) in promoting the growth and competitiveness of the UK.

Since then, there have continued to be a number of positive developments, including most recently the FRC's announcement on 22 July of a significant update to the UK Stewardship Code (the **Code**). We welcome the FRC's five themes and its stated intent that the new Code should drive better dialogue and investor outcomes and, in so doing, support the effectiveness and growth of UK markets.

The importance of growth and competitiveness

The global capital markets have changed significantly in the last 10 to 20 years. Now is the time to consider how those changes have impacted the relationship between public company boards and their investors. And there is an opportunity for the UK, in a bold and progressive way, to take a global thought leadership role, starting from the premise that asset managers, asset owners and issuers have a shared interest in companies' success. We need to think creatively about how to balance growth, competitiveness and high standards and define what we mean by them. In our view competitiveness does not mean low standards, quite the opposite, but we do need to recognise where and why we set standards that are more restrictive than other global markets. Further to the recently announced intention of the new Government to implement the recommendations of the Kingman Review, we must also not allow the transformation of the FRC into ARGA to distract from the excellent work of reform underway at the FRC.

The Code is perceived to be the most prescriptive of any major jurisdiction. We therefore agree with the FRC, as it said on 22 July, that its principles require rethinking so that they drive the right stewardship outcomes for investors and asset owners without constraining issuers or creating undue reporting burdens for them. Markets work best when there is a clear alignment of interests between savers, asset owners, asset managers and issuers – and this chain has been fragmenting in recent years. This has been assisted by an overly conservative view of risk in the UK. We need to adjust this mindset and not be so afraid of failure that we stifle innovation and the opportunity for growth. This is why governance reforms need to be put into the context of the broader financial and pension reforms which have at their core the need to access higher returns for long term savers, and to support and drive UK economic growth. This requires a system that is willing to embrace appropriate levels of risk.

Based on the many discussions that we have had with market stakeholders in the last few months, we set out below some core principles that we believe are essential to help drive a more effective model for stewardship in the UK.

1. The Code should be clearer

The purpose of the Code has become unclear. This is down partly to the broad definition of what 'stewardship' is[1] and the duplicative nature of some of its principles. The Code would benefit from being more focused and precise, centred on an outcomes-focused approach that is consistent with the central purpose of promoting a company's long-term success and the creation of value for its shareholders. As many as seven of the current 12 principles could be removed – just leaving client and beneficiary needs (principle 6), engagement (principle 9), collaboration (principle 10), escalation (principle 11) and exercising rights and responsibilities (principle 12). This is not because the intent behind the other principles is wrong, but because the expectations set out in them are mostly captured by these five core principles.

The unclear purpose and wide current definition of stewardship, and a disconnect with the Corporate Governance Code, has meant that there is now an over-emphasis on investors evidencing how they have held issuers "accountable" and on codification and 'box-ticking' over outcomes. This has led to reporting crowding out essential dialogue between investors and companies. And the heavy burden of reporting has created the need for systems, processes and dedicated teams to deliver this that only larger companies can afford to put in place.

2. The Code should foster high quality engagement between issuers and investors and so drive better outcomes for both

Effective stewardship is founded on high quality engagement between an issuer and its investors, working towards the common goal of enhancing the long-term success of the business and the value it creates for its owners. The current Code has increased friction between investors and investee companies, notably through how the requirement on signatories to show measurable proof of engagement with investee companies has been implemented, for example through escalation tactics. Boards often view this as combative. Rather, escalation should only be made after attempts to reach a resolution through engagement have been exhausted, with escalation understood as reflecting a failure of previous engagement, rather than an objective in its own right.

As we said in our open letter on governance in November 2023, good stewardship should revolve around committed long-term shareholdings and consistent and balanced conversations in relation to a company's strategy, governance and culture. It should recognise that shareholders can, and will, legitimately have strongly divergent views and can and should hold boards accountable for their actions on behalf of the ultimate asset owners.

We welcome the FRC clarifying that reporting against principles 10 (collaborative engagement) and 11 (escalation) can be done 'where necessary'. We believe this is a good first step in moving away from unwarranted escalation. It will also go some way towards supporting a revised and updated 'issuer and investor covenant', which should emphasise collaboration and the presumption of trust between investors and their issuer boards. This of course comes with accountability. Boards should demonstrably hold themselves accountable – for setting and communicating a clear strategy and for holding themselves and management accountable for its delivery. Investors should be similarly accountable as well, demonstrating how their actions contribute to positive outcomes for their clients. We would recommend that this is clearly articulated in the new iteration of the Code.

---

[1] It is currently defined in the Code as 'the responsible allocation, management and oversight of capital to create long term value for clients and beneficiaries leading to sustainable benefits for the economy, the environment and society'.

As a result of these better interactions, the Code should – and should be seen to – drive better outcomes for issuers and therefore in turn for their investors.

3. Good stewardship should be flexible and demonstrations of systemic stewardship should not be required

No two companies and no two investors are the same. They vary in size, structure, industry, geography, strategy, governance and financial health, while investors have diverse objectives, approaches, risk tolerances, time horizons and investment preferences. Recognising and understanding this is critical – there is no such thing as a one size fits all approach to stewardship. Reflecting this reality, the Code should move away from the 'apply and explain' to a genuinely 'comply or explain' approach to its principles.

Decisions in relation to voting should be driven by knowledge of a particular issuer and its specific circumstances, including its peers and its market context. The views of fund managers cannot and should not be divorced from the exercise of voting, indeed they should be a central factor in this process.

It is important to note that good stewardship should not always require a vote to be made. There will be circumstances where investors may not have strong opinions on a particular matter or the necessary resource to consider it properly. As such, not voting should not be seen as an indication of poor stewardship, nor should voting in line with the recommendation of the board of the issuer. Similarly, as is often now the case, simply voting against resolutions should not be seen, as a default, as effective stewardship.

This is linked of course to the issue of what resources investors have available to them, and the depth of understanding of the market this facilitates. Investors of all types should ensure stewardship teams have sufficient resources for deep engagement with management teams across their portfolios and be able to explain and justify a decision to outsource to a proxy adviser.

4. Excessive reporting should not be required as a result of the Code

As the FRC has already recognised in the five changes to reporting that it announced on 22 July, which we welcome, reporting against the Code had become too long, and as a result, was failing to provide useful, digestible information for the market or the FRC. If necessary, explicit guidance and word limits should be provided to assist in demonstrating compliance in a proportionate way. There should also be a culture of continuous improvement and refinement. Part of this could be a feedback process that allows for rectification and collaboration with the FRC before final assessment. This would enable asset managers to work closely with the FRC to enhance reporting practices and align with them with the needs of issuers and the wider market.

Conclusion

The Code sets the terms for the market of the relationship between asset managers and asset owners and is as critical to the system as the Corporate Governance Code which governs the relationship with boards. We believe that the core principles set out above would enable the revised Code to drive a 'reset' and drive a highly effective approach to stewardship in the UK for the mutual benefit of both issuers and investors.

As with our open letter on governance last year, we are confident that the principles will enable us to build towards a recast stewardship regime in the UK that contributes meaningfully to the international competitiveness of companies listed on UK markets as well as the markets themselves. And in doing

so the recast Code will contribute to driving the UK's economic growth for the benefit of all our citizens and enhancing the prospect of dignified and financially secure retirements for all.

Yours sincerely

Dame Julia Hoggett
Chair of the Capital Markets Industry Taskforce

Sir Jonathan Symonds
Member of the Capital Markets Industry Taskforce

Mark Austin
Member of the Capital Markets Industry Taskforce

Peter Harrison
Member of the Capital Markets Industry Taskforce

On behalf of the Capital Markets Industry Taskforce