SLAUGHTER AND MAY/

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UK STEWARDSHIP CODE CONSULTATION

FLEXIBLE PRINCIPLES NOT PRESCRIPTION

Introduction

Since its last major overhaul in October 2019, the UK Stewardship Code 2020 (the "**Code**") can claim some considerable success - signatories include most of UK's significant asset managers and many global asset managers. To an extent, its successful take-up has created its own issues. Signatories have to report annually on their stewardship credentials against all "reporting expectations" in the Code and there is a perception that the current reporting expectations are applied too prescriptively, leading to a tick-box mentality that drives asset managers and asset owners towards certain short-term activities simply to demonstrate compliance with each detailed expectation. Investee company feedback indicated concerns on the resulting costs and resourcing burdens put on them in having to provide extensive information to signatories preparing stewardship reports, often at inconvenient times of their own reporting cycle. On the other side, the investor community has itself raised concerns that the Code places significant reporting burdens which detract from actual constructive engagement with investee companies. In addition, many have noted that the influence proxy advisors can have on voting decisions of asset managers should support a more robust framework.

Following the launch of its review of the UK Stewardship Code, and the announcement of interim changes to reporting requirements for existing signatories, the FRC had set out a number of key themes that would form the basis of the review - distilled into four "Ps": *Purpose, Principles, Process and Positioning*. After extensive outreach involving over 1500 stakeholders, the FRC has now published its formal consultation on proposed changes to the Code. Unsurprisingly, the consultation reflects, and is organised around, those themes.

The consultation will run until **19 February 2025**. The FRC expects to publish the updated Code in the first half of 2025, which will apply from **1 January 2026**. The FRC is also hosting a series of roundtable discussions over the coming months as part of the consultation, which interested stakeholders should consider participating in if they wish to share their views on the proposals.

> // *Our aim is to ensure [the Code] continues to drive effective stewardship by supporting high quality disclosures…in a way that does not place onerous reporting burdens on signatories* //
>
> FRC UK Stewardship Code consultation (pg 4)

Purpose - what is stewardship and the Code for?

Stewardship 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*." The current definition was the subject of much debate during the consultation on the 2020 revision, and there remains a view that it does not properly reflect the primacy of value creation for clients and beneficiaries in stewardship. As noted in the consultation, some interpret the definition as meaning that purpose of stewardship in this context can be the pursuit of wider environmental and societal objectives *in and of themselves*, while the "leading to" language can contribute to the interpretation that creating value for clients must always deliver wider additional benefits to the economy, environment and society.

The FRC has proposed a revised definition:

"*Stewardship is the responsible allocation, management and oversight of capital to create long-term sustainable value for clients and beneficiaries.*"

There is no longer a reference to wider benefits to the economy, environment and society within the definition itself, although the supporting commentary does provide that "*stewardship that supports sustainable long-term returns may lead to wider benefits for the economy, the environment and society*". The reference to "sustainable" is intended as a marker to the investor community that while it remains for them to make the investment decisions to deliver returns that meet the objectives of their clients today, that "*should not compromise their ability to do so in the future*".

The FRC had always maintained that the Code does not prescribe a single approach to effective stewardship. Nonetheless, the current version (while never explicitly setting out the Code's purpose) does say that the Code "*sets high stewardship standards*" for relevant organisations - which, together with the language of reporting "expectations" - may have contributed to it being seen as more prescriptive in nature. The revised version expressly sets out the Code's purpose and adopts a more modest tone in describing it simply as "*[helping] to support a market for stewardship by increasing transparency on how investors put policy into practice to deliver good stewardship outcomes*."

Process - a streamlined review

The Code currently requires disclosure of relevant policies and the context of any stewardship activity as part of the reporting expectations associated with certain Principles – notably in respect of information relating to an organisation's organisational structures, purpose, governance and resources that support stewardship. These disclosures are unlikely to change significantly from year to year. Whilst the FRC had always emphasized that the focus of any stewardship report should be on activities and outcomes, the embedding of policy and context disclosures along with activity and outcome disclosures within the reporting expectations for certain Principles under the current Code does mean that certain information often gets repeated year-on-year.

The FRC is proposing reporting in two parts - following the revised structure of the Code which would clearly distinguish between the more "one-off" disclosures relating to policy and context (what it calls the **Policy and Context Disclosure**) and the **Activities and Outcomes Report**. Although signatories still need to submit the Policy and Context Disclosure annually, the FRC is proposing to formally review this Disclosure only *once every three years* – if there are no or minimal changes. Signatories only need to update the Policy and Context Disclosure if there are material changes (as the signatory thinks necessary).

The focus will be on the **Activities and Outcomes Report** which will provide the relevant information on how it has exercised stewardship in the preceding year. This Report will be reviewed annually and will form the basis for FRC's assessment as to whether organisations have met the requirements to become, or remain, a signatory. The Report would include information on how they have applied the Principles through their stewardship activities and any outcomes of these activities.

YEAR 1	**POLICY AND CONTEXT DISCLOSURE + ACTIVITIES AND OUTCOME REPORT** (Formal approval by Board and formal assessment by FRC of both documents)
YEARS 2 and 3	**POLICY AND CONTEXT DISCLOSURE + ACTIVITIES AND OUTCOME REPORT** (both submitted; no formal assessment of Policy and Context Disclosure if no or minimal changes)
YEAR 4	**POLICY AND CONTEXT DISCLOSURE + ACTIVITIES AND OUTCOME REPORT** (Formal approval by Board and formal assessment by FRC of both documents)

Principles - less is more

The Principles continue to operate on an "apply and explain" basis but have been restructured and reduced from 12 Principles that apply to asset managers and asset owners to just six Principles. The six separate Principles that apply to service providers have been reduced to four, including a specific Principle that applies to proxy advisors.

Instead of having Principles accompanied by reporting expectations, the Code now sets out each **Principle** with some supporting commentary, a **How to report** section which sets out high level concise prompts for signatories to explain how they have applied the Principle, and **Guidance** to accompany the reporting prompts, which provides further narrative and some examples to help signatories tailor their disclosures and adopt best practice in reporting. Guidance will not be subject to formal consultation so that it can more easily be updated or adapted for changes in the future. The consultation paper only includes example Guidance for one Principle (in Appendix D), but if this general approach is received positively, the intention is for the FRC to issue guidance for the entire Code.

In terms of content, the Principles have been substantially streamlined in order to reduce boilerplate and to focus only on information that the FRC considers is most relevant, insightful and valuable:

- **Removal of Context, Activity and Outcomes subheadings:** This is in recognition of the fact that outcomes of stewardship activities may span multiple years. Instead, the FRC intends for Guidance to provide support for reporting on outcomes and activities against the Principles.

- **Clearer expectations between asset managers and asset owners**. In view of the different rights and responsibilities of different organisations within the investment chain, the revised Principles offer greater clarity over how signatories should report. Principles 1, 2 and 6 are applicable to both while Principle 5 (relating to selection and oversight of external managers) applies primarily to those that manage their assets through third parties. Principles 3 (engagement) and 4 (exercise of rights and responsibilities) apply to those that manage assets directly. While those who manage assets directly (mainly asset managers) should focus on their stewardship activities, those that do not (mainly asset owners) should focus more on their oversight of their external managers. The FRC is proposing 10% of AuM as the threshold to determine which Principles apply, so for example, a signatory that manages 30% of their AuM through external managers and 70% directly should apply all Principles.

- **Engagement**: Principles 9 (Engagement) and 10 (Collaboration) have been amalgamated to reflect the fact that, while collaborative engagement can be an important and effective stewardship tool and may be used as part of a signatory's overall approach, not every signatory will have the opportunity (or think it appropriate) to engage collaboratively each year.

- **Escalation**: Escalation as a standalone Principle has been removed as it may be undertaken whenever necessary to achieve stewardship practices and spans a variety of means across different stewardship practices. Any escalation activities and their outcomes should simply be reported under each Principle where necessary.

Interestingly, explicit reference to ESG matters have been removed. This may be a reflection that, for many organisations, these now simply form part of the "normal" systemic integration of such issues into their investment decisions and stewardship practices.

Positioning – we already report this!

In order to reduce reporting burdens and recognising that some signatories may follow other reporting frameworks and/or report against other regulatory requirements relating to stewardship[1], it is proposed that the Code will allow signatories to refer to information disclosed outside their stewardship report as part of their assessment. This contrasts with the current position which requires the stewardship report to be a single, standalone report. However, mindful of the fact that such cross-referencing may undermine the utility of stewardship reports as providing a comprehensive overall view of a signatory's stewardship, the FRC is proposing to provide a clear policy on the appropriate use of cross-referencing.

A final P - Proxy advisors

It became clear during FRC's outreach that concerns relating to the influence of proxy advisors were top of the agenda of many stakeholders, particularly investee companies. Concerns were raised about the lack of transparency on the influence of proxy advisors on asset managers' voting decisions and the inability to engage constructively with the proxy advisors themselves. New Principles have therefore been introduced that apply specifically to proxy advisors and investment consultants respectively, reflecting their importance in the stewardship ecosystem. In particular, Principle 2 (for service providers) provides that "[p]roxy advisers [should] ensure the quality and accuracy of their research, recommendations and voting implementation." Reporting under this Principle would require proxy advisors to report on how they implement clients' policies, develop their own voting policies and make resulting recommendations. Proxy advisors should also explain how they have ensured the quality and accuracy of their research and recommendations and responded to any requests for engagement.

Parting thoughts

The FRC has clearly taken on feedback received during its outreach. The revised Code is framed as a more focused set of Principles with higher level "How to report" prompts, emphasizing the flexibility afforded to organisations to take different stewardship approaches as appropriate to their business model, investment strategy and different asset classes. Using Guidance that can be updated more easily to illustrate and support good practice in reporting is a welcome approach, as is a review process that focuses more clearly on relevant disclosures on activities and outcomes rather than static information on existing policies. It will, however, be interesting to see whether the new Principles relating to proxy advisors (and investment consultants) increase transparency and go some way to facilitate more constructive engagement between proxy advisors, investors and investees.

[11] For example, the Pensions Regulator General Code of Practice (which merges 10 existing Codes for Practice for the governance of different pension schemes) includes a module on Stewardship. Some schemes are also required to produce a Statement of Investment Principles and Implementation Statement, for which there is additional supporting guidance for reporting on stewardship. SRD II also imposes requirements for regulated asset managers and life insurers to report on their engagement policies and investment strategy.

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