INVESTING WITH PURPOSE:

placing stewardship at the heart of sustainable growth

November 2020

CONTENTS

FOREWORDS

FOREWORD BY JOHN GLEN MP, ECONOMIC SECRETARY TO THE TREASURY

For the past three years I have had the pleasure of chairing the Asset Management Taskforce, which brings together the Government, senior representatives from the asset management industry, regulators and other key stakeholders. Stewardship, sustainability and responsible investment have long been at the top of my agenda for this group, and investment by the asset management industry will be important in building back not only better, but greener. I therefore welcome this report from the Taskforce's Stewardship and Stakeholder Working Groups.

As well as being a global centre of asset management excellence, the UK is a world leader in stewardship standards. This is exemplified through the Financial Reporting Council's internationally respected UK Stewardship Code. I am delighted that this report seeks to build on that existing leadership, starting with an endorsement of the UK Stewardship Code, and thereby aims to accelerate its wider adoption across the asset management sector and the broader investment chain.

The UK was the first major economy to legislate to end our contribution to climate change by 2050. The asset management industry will have a key role to play in channeling investment into companies and technologies that will enable that transition. As public interest in sustainability and responsible investment continues to grow, there have been record inflows into funds that invest according to environmental, social and governance principles. It is clear that the asset management industry's responsibilities as stewards of capital and the need to fully consider the impact on society and the environment as part of investment decisions will only increase further. That is why the UK will become the first country in the world to make disclosures aligned with the Task Force on Climate-related Financial Disclosures (TCFD) mandatory across the economy.

I welcome the detailed analysis contained in this report, which outlines many of the tools already available to asset managers which enable them to act on behalf of savers and hold investee companies to account. This set of clear recommendations, which apply across the investment chain, will further enhance the UK's stewardship regime, and aims to ensure that asset managers are focused on delivering long-term, sustainable benefits for investors, the economy, the environment and society.

I would like to thank the many people involved in developing this report, in particular Keith Skeoch and Catherine Howarth for expertly guiding the Stewardship and Stakeholder Working Groups and to the Investment Association for providing the secretarial support.

FOREWORD BY KEITH SKEOCH, CHAIR AND CHAIR OF THE STEWARDSHIP WORKING GROUP AND CATHERINE HOWARTH, CHAIR OF THE STAKEHOLDER WORKING GROUP

Investment is a critical component of how we shape our economic future and will have a profound influence on the pace, durability and quality of the recovery from the Covid crisis. Turning savings into productive investments is one of the defining characteristics of a modern economy, creating the jobs and wealth that are needed for a prosperous society. The investment industry plays a pivotal role in this – aggregating the capital provided by savers and allocating it to investment opportunities that generate long-term value.

Institutional investors' ability to direct where capital is allocated and to monitor how it is used by corporate management teams gives them great influence in our economies. That influence can be used to protect and enhance not just the financial value of assets but the quality of life of millions of people who entrust their savings and pensions to professional investors. By acting as responsible stewards of capital, insisting that companies build wealth whilst protecting the public interest, whether by reducing carbon emissions, acting as decent employers, or operating with integrity towards consumers and suppliers, institutional investors can serve their own clients and beneficiaries more fully.

The focus on stewardship – the responsible allocation, management and oversight of capital on behalf of savers – has come to prominence over the last thirty years and is a critical component of an efficient investment environment. The UK has led the way in establishing good practice; from the creation of the Institutional Shareholder Committee, to the Walker and Kay Reviews that culminated in the creation of the world's first Stewardship Code in 2010. Stewardship needs to adapt and evolve to meet society's needs and improve the functioning of the investment system. This evolution cannot be aimed only at the here and now. It requires forward thinking to consider what society will need and demand in the future.

Our task was to draw together a set of recommendations to promote and facilitate the highest standards of stewardship in the United Kingdom whilst strengthening the UK's reputation as a global centre of excellence. We set out twenty detailed recommendations designed to directly tackle those issues that could strengthen stewardship in the UK. The recommendations are arranged in three pillars to support stewardship throughout the investment chain:

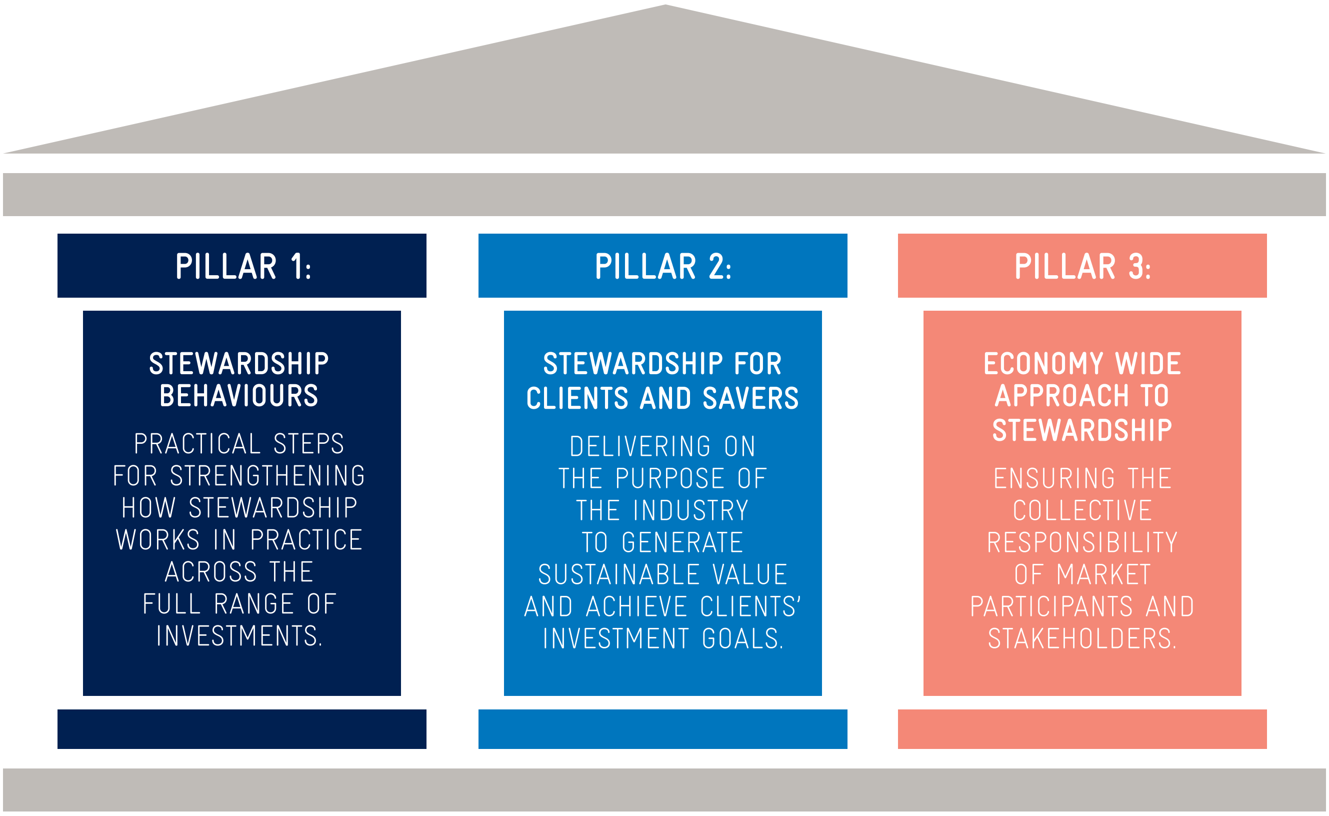
- Stewardship behaviors
- Stewardship for clients and savers
- Economy wide approach to stewardship

Taken together our recommendations will help put stewardship at the heart of the investment decision making process and play a role in helping the UK build back better.

This Report is the product of collaborative engagement throughout the value chain. Our two working groups included representatives from investment management firms, pension funds, company directors and investment advisors as well as the FCA, FRC, BEIS, DWP, TPR and HMT, who all provided valuable input and comment. We are deeply grateful to Andrew Ninian and Sarah Woodfield at the Investment Association for their energy and enthusiasm in providing critical secretarial support and ensuring the review was completed despite the Covid crisis. We were ably assisted by Rachel Lord as deputy chair of the Stewardship Working Group and Helen Dean as deputy chair of the Stakeholder Group. Finally, we are grateful to the Economic Secretary to the Treasury, John Glen MP, for commissioning us to deliver this report and for his personal conviction about the power and value of investor stewardship.

EXECUTIVE SUMMARY

LAST YEAR, JOHN GLEN MP, THE ECONOMIC SECRETARY TO THE TREASURY AND CHAIR OF THE ASSET MANAGEMENT TASKFORCE ASKED THE TASKFORCE TO ESTABLISH A STEWARDSHIP WORKING GROUP AND STAKEHOLDER WORKING GROUP TO MAKE PROPOSALS FOR HOW STEWARDSHIP AND RESPONSIBLE INVESTMENT COULD BE STRENGTHENED IN THE UK. THIS REPORT SETS OUT RECOMMENDATIONS TO IMPROVE STEWARDSHIP AND ENSURE THAT THE UK MAINTAINS AND ENHANCES ITS POSITION AS A CENTRE FOR EXCELLENCE IN STEWARDSHIP GLOBALLY. THE RECOMMENDATIONS ARE IN THREE PILLARS, WHICH TOGETHER STRENGTHEN STEWARDSHIP IN THE UK:



The investment management industry plays a major role in the economy, helping millions of individuals and families to achieve their life goals by helping them grow and receive an income from their investments, including through workplace pensions. The investment industry's purpose is to generate sustainable value and meet client's investment goals. These are usually financial, for instance having enough money to live on in retirement, but can also include non-financial elements, such as to invest in companies, governments or projects that have social or environmental benefits or that "do no harm". To achieve these objectives, investment managers help to allocate capital across the economy, putting it to work where it can be most productive across a range of different assets. But investment shouldn't stop there. To create long-term value for clients, investment managers should oversee and manage the assets they invest in to encourage, develop and support behaviour that will lead to sustainable returns. Collectively, this work of allocating, overseeing and managing capital falls under the umbrella of 'stewardship'.

The investment and stewardship landscape has changed significantly over the last decade and this change has only accelerated in recent years, for instance with the rise of 'ESG investing' and significant changes in capital allocation away from listed equities. At the same time, we have seen an increased focus on the roles and responsibilities of investors as stewards. As broader societal trends, such as digitisation, have connected savers with their investments; the role of the investor has become subject to more visible public scrutiny. We have seen deeper scrutiny of stewardship responsibilities in the wake of the 2008 financial crisis and in response to a number of high-profile corporate failures. Regulators and other stakeholders have recognised the important role that stewardship can play in promoting well-functioning markets and in turn increased their expectations of investors living up to their stewardship responsibilities.

Investors have continued to evolve their approach to stewardship in response to new challenges, such as the coronavirus pandemic and the risks posed by climate change; but there is increasing recognition that they could go further and that a wider range of market participants need to recognise their role in stewardship. Investors need to make the most of their rights and responsibilities to promote long-term value across the economy.

Following a wave of regulatory interventions focused on enhancing transparency and accountability of stewardship practices, the industry must now step forward to meet the challenge of deepening and strengthening the role of stewardship in the UK. This report, produced by two dedicated Working Groups for the UK's Asset Management Taskforce, sets out a blueprint for a truly economy wide approach to stewardship to ensure that investment supports sustainable value creation, not just for savers but also for the economy, environment and society. This blueprint is formed by 20 recommendations under three key pillars: Stewardship behaviours; Stewardship for clients and savers; and Economy wide approach to stewardship. The investment industry is committed to collaborating with a wide range of market participants and stakeholders to deliver on these recommendations.

The Working Groups found themselves developing and finalising these recommendations amidst a pandemic that put the purpose of the industry to the test. The industry has been challenged to show stewardship in action – the role that the industry plays in seeing through market volatility and protecting and preserving sustainable value for its clients, the wider economy, environment and society is even more important now than ever.

"Stewardship is 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"

(FRC, UK STEWARDSHIP CODE, 2020)

PILLAR 1:

STEWARDSHIP BEHAVIOURS

Expectations of investors

This report calls for a step change in the industry's approach to the culture, governance and incentivisation of stewardship. We ask the industry to redouble their efforts to become signatories to the UK Stewardship Code and for the Investment Association (IA) to support its members in this endeavour. We also urge asset owners to redouble their efforts as stewards; we want to see a significant increase in the number of asset owner signatories, across both the public and private sectors. Stewardship and ESG considerations should be fully integrated into the investment process, across and within different products and investment strategies; this systematic approach is essential to ensuring that stewardship is at the heart of the investment process.

Historically, stewardship and corporate governance have been focused on voting and engagement in listed equities. This narrow focus no longer meets the needs of clients who expect their managers to steward their assets responsibly across the full range of investment securities. Given the increasing prominence of debt both in asset owners' strategic asset allocation, and on company balance sheets, investors and corporates must facilitate a culture of engagement and collaboration to enhance sustainable value in fixed income. We recommend that bondholders make full use of the rights and responsibilities currently available to them. The nascent state of bondholder stewardship is related in part to the limited rights that come with ownership of debt securities to effectively hold management of investee companies to account. As stewardship in fixed income develops, it will be important to have a debate about the appropriateness of existing bondholder rights to hold company management to account. In a similar vein, we also ask for stewardship best practice to evolve in private markets.

Investors don't always make the most of the tools available to escalate concerns with company management. We propose that investors should use requisitioned resolutions more proactively as an escalation tool and develop robust model resolutions that can be applied across a range of different sectors to escalate critical shareholder concerns. The industry should test the use of model resolutions on climate change, given the urgency with which companies must change their approach to responding to this critical risk.

Expectations of companies

We also set out a range of parallel expectations of companies to support effective stewardship outcomes.

Companies should facilitate engagement at the executive team and board level for bond and equity holders and ensure this engagement is both strategic and long-term in nature. They should also inform investors about the key drivers of long-term risk and value creation, so that investors can effectively incorporate these drivers into their investment process and support companies to address them in their engagement. This is even more important as we consider the long-term sustainability of companies in light of the coronavirus pandemic. Companies that are seeking additional capital, either through new equity or bonds, need to demonstrate how they are transitioning their business model to a more sustainable footing.

Key to this is the development of a consistent and comparable global approach to reporting on a wider range of sustainability information. We endorse efforts towards the global harmonisation and coordination of sustainability reporting standards. We welcome the recent statement of intent to do so by the five reporting framework standard setting institutions and the statements of support from the UK Government and regulators for the development of internationally agreed standards[i]. Pending this harmonisation, it is critical that issuers coalesce around a core set of reporting standards to support better comparability of sustainability factors. The UK asset management industry supports the early adoption of TCFD by investee companies and the use of other reporting standards, such as SASB, as a stepping stone until an international reporting standard is developed.

We also recommend that Government should advance a legislative underpin, requiring both public and large private companies to make TCFD disclosures, recognising the significant contribution that large private companies will make to the net zero carbon transition. We are encouraged by the commitments to mandatory TCFD reporting across the investment chain by 2025, as set out by the UK's Joint-Government-Regulator TCFD Taskforce[ii].

We also call for better quality explanations against the provisions of the UK Corporate Governance Code and a review of the quality of the application of the Wates Principles and implementation of their Director Duties by large private companies.

Board directors, responsible for stewarding investors' capital, must be at the table in conversations about developing an economy wide approach to stewardship. We recommend that all board directors become better engaged in the stewardship process. We propose the Financial Reporting Council (FRC) develops tools and resources to support directors to better understand investors' evolving approach to stewardship in light of the UK Stewardship Code.

PILLAR 2:

STEWARDSHIP FOR CLIENTS AND SAVERS

Our recommendations also challenge the investment industry to put the interests of clients and savers at the heart of stewardship; supporting them to have a tangible sense of ownership and engagement with their investments. Investment managers must be proactive about their approach to understanding and responding to clients' stewardship priorities and demonstrate how they are meeting the needs of savers.

The relationship between asset owners and investment managers sets the tone for sustainable value creation and aligning incentives right across the investment chain. We endorse the commitment by the IA and Pensions and Lifetime Savings Association (PLSA) to establish a new working group exploring how to embed a focus on stewardship in this relationship. The project must give clarity to how a long-term focus can be achieved right through from selection to appointment and the contractual relationship that underpins this (including the investment mandate) and ongoing oversight and performance assessments.

As pension scheme members' interest in the sustainability of their investments increases, it is essential for funds to engage them on the role of stewardship in delivering sustainable value and in serving their best interests. We therefore call for UK pension schemes to be required to explain how their stewardship policies and activities are in members' best interests. While some funds have been very active, other pension funds have had historically low engagement with the stewardship agenda. To boost engagement, we recommend the establishment of a dedicated council of UK pension schemes (both public and private) to promote and facilitate high standards of stewardship of pension assets.

PILLAR 3:

ECONOMY WIDE APPROACH TO STEWARDSHIP

Finally, we consider the wider stewardship ecosystem and challenge different market participants in this ecosystem to recognise their collective responsibility to promote effective stewardship.

Investment consultants, proxy advisers, index providers, credit rating agencies and data providers are all critical service providers for investors who can have significant influence over the responsible allocation, management and oversight of capital. We recommend that all these market participants should seek to become signatories to the service provider principles of the UK Stewardship Code, if they are not already. They should proactively demonstrate how their services support effective stewardship outcomes. Their clients, primarily pension funds and investment managers, should set out this expectation in their selection and engagement with these service providers. The FRC should support the wider range of service providers to apply these principles.

We also ask for the UK Government to evidence their commitment to the stewardship agenda through setting an expectation that Local Authority Pension Schemes and investment pools, other relevant asset owners in Government, and also UK Government Investments who advise the Government on the management of certain assets, commit to becoming signatories to the Stewardship Code by 2022.

The Working Groups have highly valued the contributions of a wide range of government and regulatory departments who have responsibilities for stewardship with respect to different parts of the investment chain. We call for HM Treasury (HMT); the Department for Business, Energy & Industrial Strategy (BEIS); the Department for Work and Pensions (DWP); the Financial Conduct Authority (FCA); the Financial Reporting Council (FRC); the Prudential Regulation Authority (PRA) and The Pensions Regulator (TPR) to continue and formalise their coordination forum to promote a coherent approach to the regulation of stewardship and corporate governance.

As the FRC transitions to the Audit, Reporting and Governance Authority (ARGA) and is put on a statutory footing, and with responsibility for the UK's Corporate Governance and UK Stewardship Code, there is a significant leadership role they can play in coordinating this activity. A system wide approach to introducing new rules and requirements is essential in ensuring that expectations and requirements of all market participants are consistent and aligned. In addition to this regulatory group, there should be a body of senior market participants from across the asset owner and investment manager community who can be used as a sounding board for the strategic direction of stewardship. We recommend that the Asset Management Taskforce and other multi-stakeholder groups be used to fill this role.

SUMMARY OF RECOMMENDATIONS

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STEWARDSHIP BEHAVIOURS – PRACTICAL STEPS FOR STRENGTHENING HOW STEWARDSHIP WORKS IN PRACTICE ACROSS THE FULL RANGE OF INVESTMENTS

Expectations of Investors

Recommendation 1:
The Working Groups endorse the UK Stewardship Code as the best in class marker of stewardship. We expect that investment managers will become signatories to the Code. The IA should work with its members to identify and support non-signatories to sign up.

Recommendation 2:
There needs to be a step change in investment managers' approach to the culture, governance and incentivisation of stewardship. The IA should work with the industry to achieve this change through the development of guidance and sharing of best practice.

Stewardship in different asset classes

Recommendation 3:
Bondholders should make full use of the rights available to them, living up to their responsibilities as stewards. The IA should work with industry to develop guidance on how stewardship in fixed income can be improved – to support the industry to set expectations of bond issuers and hold them to account, and to overcome barriers to engagement with issuers.

Recommendation 4:
More emphasis is needed on stewardship in private markets. Asset owners and investment managers should identify common criteria for best practice stewardship in private asset classes. The IA should consider the quality of UK Stewardship Code disclosures in relation to private markets and identify how to progress best practice stewardship in this asset class.

Escalation

Recommendation 5:
Shareholders should use requisitioned resolutions more proactively as an escalation tool and develop model resolutions to escalate a range of critical concerns with investee companies, including on climate change. The industry should develop guidance to overcome existing barriers to requisitioning resolutions.

Recommendation 6:
Following the findings of the Law Commission review, Government should review the provisions on requisitioning shareholder resolutions in the Companies Act, examining whether the requirement for 100 shareholders who hold on average £100 of paid up capital, or the 5% threshold places an excessive barrier in practice on the use of this stewardship tool.

Expectations of Companies

Recommendation 7:
Investors should set out clear expectations of companies in post-Covid-19 recovery, particularly those that are seeking additional capital from investors. Investors should commit to using their stewardship responsibilities to ensure that companies are meeting these expectations.

Recommendation 8:
We endorse the FRC's recent review of AGMs and support continuing work by the FRC into the requirements on companies in respect of shareholder meetings, particularly AGMs. The work should prioritise ways to ensure greater access to and participation in AGMs (including through the use of available technology) by diverse shareholders whilst retaining the accountability of directors to shareholders.

Recommendation 9:
Regulators and investors should continue to support ongoing international efforts to enhance and harmonise corporate reporting standards for sustainability, including those at IOSCO, IFRS and an alliance of the leading standard setters. Pending an international standard, industry and regulators should consider steps to promote further voluntary adoption of existing widely accepted frameworks and standards such as TCFD, SASB and GRI. The UK asset management industry supports the early adoption of TCFD by investee companies and the use of other reporting standards, such as SASB, as a stepping stone until an international reporting standard is developed.

Recommendation 10:
Large private companies should ensure that they are meeting investor, government and stakeholder expectations to demonstrate their governance arrangements and impact on stakeholders through improving their disclosures against the Wates Principles and s172 Directors' Duties reporting requirements.

Recommendation 11:
The UK Government should amend company law to require all large UK incorporated companies (public and private) to report in line with TCFD. Companies should also have regard to industry endorsed disclosure frameworks and investors should reinforce this expectation through their stewardship activity.

Recommendation 12:
Companies, asset managers and their advisors need to take responsibility for reinforcing the Corporate Governance Code's Comply or Explain regime and ensuring that the quality of explanations improve. Investors should set out their support for the Comply or Explain regime and reinforce this with their engagement and voting approach. Investors should set out the attributes of a high-quality explanation.

Recommendation 13:
The FRC, in collaboration with key stakeholders, should develop free-to-use resources for company directors to deepen their understanding of stewardship and the 2020 Stewardship Code. This programme should focus on the shift in expectations arising from the more expansive definition of stewardship embedded in the new Code and the need for constructive engagement between investors and investee companies.

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STEWARDSHIP FOR CLIENTS AND SAVERS – DELIVERING ON THE PURPOSE OF THE INDUSTRY TO GENERATE SUSTAINABLE VALUE AND ACHIEVE CLIENTS' INVESTMENT GOALS

Recommendation 14:

The Working Groups support the IA's and PLSA's commitment to establish a new steering group to explore how to embed a focus on long-term factors including stewardship in the relationships between asset owners and investment managers.

Recommendation 15:

UK pension schemes should be required to explain how their stewardship policies and activities are in scheme members' best interests. TPR should issue related guidance on how trustees might evidence that their stewardship policies and activities are in members' best interests.

Recommendation 16:

A dedicated council of UK pension schemes should be established to promote and facilitate high standards of stewardship or pension assets. Members of the council should either be signatories of the UK Stewardship Code or have publicly committed to signing the Code within two years of joining the council.

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ECONOMY WIDE APPROACH TO STEWARDSHIP – ENSURING THE COLLECTIVE RESPONSIBILITY OF MARKET PARTICIPANTS AND STAKEHOLDERS

Recommendation 17:

Continuing the success of the working level collaboration that already exists, the cross regulatory forum on stewardship should be maintained and formalised as a standing forum on stewardship for the FRC, FCA, TPR and the PRA and their sponsoring departments (BEIS, Treasury and DWP).

This should be complemented with senior level industry, government and regulator engagement on stewardship. The Asset Management Taskforce and other multi-stakeholder groups should be used as a senior level sounding board for this strategic direction of stewardship and its regulation and as a means to develop a response to specific corporate or market-based issues.

Recommendation 18:

Funded public service schemes (including Local Authority Pension Schemes and investment pools), other relevant asset owners in government and UK Government Investments (who advise the government on the management of certain assets) should embed stewardship in their own investment processes and become signatories to the UK Stewardship Code.

Recommendation 19:

All service providers in the stewardship investment chain, including proxy advisors, index providers, data providers and credit rating agencies should demonstrate how they support effective stewardship. We encourage them to do so through becoming signatories to the service provider principles of the UK Stewardship Code. The FRC should explore how the service provider principles can be applied to a wider range of market participants – both those who act in an advisory capacity and those who provide wider market services.

Recommendation 20:

Investment consultants should demonstrate how they support effective stewardship through becoming signatories to the Code. We urge consulting firms to provide more active support to clients in raising the standard of their stewardship activities, including client oversight of asset managers, client engagement with managers on stewardship performance, and client engagement with beneficiaries regarding stewardship priorities. This should include consideration of alignment of stewardship approach of asset managers to the client’s stewardship needs as a factor in the selection and recommendation of asset managers.

INTRODUCTION

Stewardship has been a core feature of the UK's investment landscape for decades, with institutional investors seeking to ensure that companies are well run and well governed and taking account of their key stakeholders, with the ultimate goal to generate sustainable returns for their clients. Initially this role focussed on governance issues, but over the years has expanded to consider the full range of material risks to investments, including environmental and social factors.

2020 was always going to be an important year for stewardship in the UK, with the implementation of three key regulatory initiatives seeking to boost the transparency and accountability of institutional asset owners' and investment managers' stewardship.

The UK Stewardship Code 2020 (the Code)[iii] sets a world-leading and ambitious standard for stewardship, through principles that set out the key behaviours of an effective steward. The newly implemented Shareholder Rights Directive II[iv] sets a minimum level of transparency and accountability between asset owners and investment managers to ensure that all market participants are fulfilling their obligations as stewards and to ensure public transparency on how shareholders exercise their rights. Since late 2019, pension funds have been meeting new requirements[v] to demonstrate how their approach to stewardship and ESG integration has been implemented under revised investment regulations.

These regulatory interventions follow a decade of scrutiny for the investment industry and its role in promoting sustainable capital markets, following the financial crisis of 2008, which prompted the Kay review[vi]. In 2016, there was intense debate over the corporate governance system in the UK in response to the Government's focus on the impact that companies have on their stakeholders and how the stakeholder voice could be better incorporated into board decision making. This was coupled with a handful of high-profile corporate failures. This led to increased focus on how companies demonstrate they are upholding their Directors' Duties, the development of the Wates Principles for Corporate Governance in large private companies, as well as expectations of the role of investors in holding companies to account and significant regulatory focus on stewardship in the UK.

Stewardship has been a core feature of the UK's investment landscape for decades, with institutional investors seeking to ensure that companies are well run and well governed and taking account of their key stakeholders, with the ultimate goal to generate sustainable returns for their clients.

The development of the revised Stewardship Code was accompanied by a joint discussion paper[vii] from the FCA and FRC asking how best to encourage the institutional investment community to engage more actively in stewardship of the assets in which they invest. In their feedback statement of late 2019[viii], the FCA agreed that they should not impose further requirements on investors at this time. However, they identified several remaining barriers to effective stewardship. They encouraged the investment industry to accelerate market led initiatives to overcome these barriers.

Against this background, the Economic Secretary to the Treasury and Chair of the Asset Management Taskforce asked the Taskforce to establish a Stewardship Working Group and Stakeholder Working Group to develop proposals for how stewardship and responsible investment could be strengthened. He challenged the Taskforce to find ways in which the investment industry can deepen its expertise in stewardship and responsible investment to enhance the UK's position as a world leader in investment management.

The Stewardship Working Group and a Stakeholder Working Group were established to convene key stakeholders from the investment community as well as core service providers, government departments, regulators and other stakeholders. They were tasked with considering how the Asset Management Taskforce can promote and enhance the UK as a centre of excellence for stewardship and provide concrete proposals for change. The Working Groups were asked to use their convening power and diverse perspectives to promote a common purpose and understanding of stewardship, to drive coherence and synergies across the range of existing initiatives in this area – to develop a truly economy wide approach to stewardship that serves the public interest and delivers better outcomes for asset owners and ordinary savers.

Established in October 2017, the Asset Management Taskforce was designed to encourage greater dialogue between the government, the industry and the FCA to ensure the UK investment industry continues to deliver for consumers and the wider economy. The Government committed to use the Taskforce to identify opportunities to enhance the UK's competitiveness as a leading global centre for investment management and oversee the delivery of HM Treasury's Investment Management Strategy. The Taskforce is chaired by the Economic Secretary to the Treasury and is comprised of CEOs from a diverse cross-section of the investment management industry, senior representatives of investor groups and the FCA.

1. WHAT IS STEWARDSHIP AND WHY IS IT IMPORTANT?

The investment management industry plays a major role in the economy, helping millions of individuals and families to achieve their life goals by helping them grow and receive an income from their investments, including through workplace pensions. 75% of UK households use an investment manager's services[xi]. The industry invests billions of pounds in companies and finances the development of transport networks, hospitals, schools and housing projects.

The investment industry's purpose is to generate sustainable value and to meet their client's investment objectives. These clients are individual retail savers and institutions like pension funds, insurers, charities and governments. Investment objectives are usually financial, for instance having enough money to live on in retirement, but can also include non-financial elements, such as to invest in companies, governments or projects that deliver social or environmental benefits or that "do no harm".

To achieve these objectives, investment managers help to allocate capital across the economy, putting it to work where it can be most productive and produce most value across a range of different assets - listed equities, corporate debt, private markets, real estate and infrastructure. This allocation of capital plays an essential role in supporting a flourishing economy: providing the long-term finance to drive innovation, finance businesses, housing, infrastructure, jobs and communities in the UK and across the world. This role is even more important as we consider the need for long-term investment to rebuild our economy in light of the Covid-19 pandemic. Investment shouldn't stop there. To create long-term value for clients, investment managers oversee and manage the assets they invest in to encourage, develop and support behaviour that will lead to sustainable returns. Collectively, this work of allocating, overseeing and managing capital falls under the umbrella of 'stewardship'.

This stewardship role has been part of the landscape for decades. The expectations of shareholders were first set out by institutions and investor groups. This was formalised in 2010, when the UK Stewardship Code was published. The first in the world, it set the standard for stewardship globally and many other jurisdictions have since followed the UK's lead in developing their own Stewardship Codes. The UK's high governance and listing standards as well as stewardship expectations on institutional investors continue to attract a range of companies to list in the UK and overseas capital to invest in UK companies.

The Working Groups believe that it is essential to build on this global leadership - the UK must continue to develop best in class standards for stewardship and corporate governance to encourage companies and capital to list, operate and invest in the UK.

As other markets incorporated their own versions of the Stewardship Code, it became clear the UK's Code needed a refresh to continue to be world leading. In response the FRC updated the UK Stewardship Code which led to substantial revisions and a more expansive definition of stewardship. The new 2020 Stewardship Code was published in October 2019.

The investment management industry supports the definition of stewardship set out in the UK's 2020 Stewardship Code, which has been adopted and endorsed by the FRC and FCA.

"Stewardship is 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"

FRC, UK Stewardship Code, 2020.

This definition characterises a new best in class for stewardship, setting clear expectations for the role of stewardship throughout the investment chain, from the ultimate providers of capital (savers and institutions), through to the users of that capital (the companies).

THE CAPITAL CYCLE

KEY TERMS

- Savers are individuals that are putting their money at risk to seek an investment return. They may be retail investors or members of a pension scheme.
- Investment managers' clients are asset owners. These are individuals (for example retail investors who buy funds through platforms or direct from an investment manager) or institutional investors that collectivise investments on behalf of a group of beneficiaries (for example pension funds, insurers, charities or governments, investing on behalf of scheme members, policy holders, charitable beneficiaries or citizens).
- Investment objectives are the goals that individual savers or institutional investors have for their investments. Goals can be multifaceted – for instance, to generate income for a specific purchase or expense, to save enough for retirement, or to achieve positive environmental or social impacts through one's investments.
- These aggregated savings or investments form 'capital' which is provided by asset owners and allocated by investment managers across the economy to provide financing for companies through debt or equity. Companies need capital to invest in their business and grow. They finance growth through the provision of debt and equity for investors.
- When investors invest in companies, they do not own the company or its underlying assets; they purchase securities (either debt or equity) that give them certain ownership rights, such as the right to receive dividend payments, or vote at the company's AGM (equities) or the right to interest on their capital (bonds).
- Stewardship is 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.

DELIVERING LONG-TERM VALUE TO CLIENTS AND BENEFICIARIES AND IN AGGREGATE TO THE ECONOMY, THE ENVIRONMENT, AND SOCIETY

The central purpose of stewardship is to generate sustainable long-term value for the beneficiaries of the investment process, who are the end owners of capital.

To achieve this, investment managers consider material risks and opportunities for the long-term value of the companies they invest in. These risks and opportunities could relate to the company's strategy, quality and diversity of the management and board, the impact of climate change on the business strategy, or how the company promotes employee voice. They assess the impact of companies' activities on society, the environment and the economy and how in turn events in society, the environment and the economy impact the value of the company.

The current crisis triggered by the coronavirus pandemic only reinforces the understanding that natural events have a huge impact on the financial success of individuals, companies and whole economies.

The integration of stewardship and consideration of a wide range of risks and opportunities, including environmental, social and governance (ESG) factors in the investment process leads to better investment outcomes for clients. The assessment of these factors informs investment decision making and stewardship activities - investors' support and challenge companies to better manage material risks or impacts and to promote well-functioning markets.

In aggregate and over the long-term, the explicit integration of all material risks into the investment process should also result in positive impacts for society, the environment and the economy. This wider impact can be accelerated where clients explicitly state their preferences and mandate their managers to achieve positive impact for the environment and society through their investment objectives.

WHAT IS THE ROLE OF DIFFERENT MARKET PARTICIPANTS TO DELIVER STEWARDSHIP?

The relationship between asset owners and investment managers is fundamental to driving effective stewardship and a long-term approach to investment. This relationship sets the tone for the way investment managers make investment decisions, act as stewards and ultimately how they create sustainable value.

There are also a range of market participants that contribute to stewardship. Asset owners, investment managers, investee companies, government, regulators, investment consultants, index providers, proxy advisers and data providers all play different roles in the responsible allocation, oversight and management of capital.

Together, these participants have a responsibility to promote and strengthen stewardship across the investment chain.

Asset owners should express demand for stewardship by communicating their investment beliefs and objectives through the signals, incentives and expectations transmitted in selection, contractual relationship and ongoing performance assessment. This demand is critical to ensuring that investment is focused on long-term sustainable value and is aligned with the best interests and investment objectives of the end beneficiary. How investment managers respond to this client demand, engage clients on their expectations on stewardship, and are transparent and accountable about how they are achieving their investment objectives is crucial to achieving successful stewardship outcomes.

RESPONSIBLE ALLOCATION OF CAPITAL

Responsible capital allocation is a core component of stewardship. Savers and institutions will have different investment goals and time horizons. They may be investing for growth or for income, have different risk appetites and may also have preferences or a responsibility to ensure that their investment achieves positive environmental or social impacts.

Asset owners make capital allocation decisions by choosing investment strategies that will meet the investment goals and time horizon of their end beneficiaries. They assess how best to meet these needs and make decisions about the relative weighting of different asset classes, the characteristics of different investment opportunities and how they manage the balance of risk versus return. A key component of this should also be choosing an approach to stewardship that supports their investment goals.

Where clients have goals to achieve environmental and social impact, or to minimise adverse impacts through their investments, asset owners may also allocate capital away from assets with negative environmental and social characteristics and towards those with positive characteristics. While this is common for charities and some governments, in practice, for investors such as pension funds and retail investors, this approach is still relatively rare. A few UK pension funds are starting to express their investment beliefs with regards to the world that their beneficiaries retire into and there is increased interest from retail investors and pension scheme members about the environmental and social impact of their investments. We have seen a 119% growth in responsible investment funds under management (FUM) between January 2019 and September 2020[x].

Asset owners make further allocation decisions when they delegate to investment managers through investment mandates. They channel capital through investment managers and investment strategies that will best help them meet their objectives. Investment managers support these allocation decisions by developing a choice of investment products and services to meet client demand.

We have seen a

119%

growth in responsible investment funds under management (FUM) between January 2019 and September 2020.

RESPONSIBLE MANAGEMENT AND OVERSIGHT OF CAPITAL

Investors seek a return through managing risk and opportunity. The responsible management and oversight of capital involves identifying and managing both financial and strategic risks to the long-term value of investments.

Investors consider a range of issues which could impact on the long-term performance and value of the investment including:

- the effective application of the UK Corporate Governance Code and other governance codes;
- Directors' Duties, particularly those matters to which they should have regard under section 172 of the Companies Act 2006;
- capital structure, risk, strategy and performance;
- diversity, remuneration and workforce interests;
- audit quality;
- environmental and social issues, including climate change; and
- compliance with covenants and contracts

An important way that investors manage these risks is to incorporate the wider set of financial and material ESG risks and opportunities into the investment process. For active managers, this involves making investment decisions which impacts on the cost of capital. Both active and index investors engage with their investments to support them to better identify, communicate and manage these risks and opportunities.

This is not a definitive list - stewardship works best when it is focusing on the right issue for the right company at the right time. Different investors may take a different view on which issues are most material for different companies or sectors. Investment managers purchase securities in different asset classes including equities, fixed income and undertake direct investment and ownership in the underlying asset in real assets. Each security has different rights and responsibilities associated with ownership. We explore the rights and responsibilities that investors have in different asset classes and as a result the way that they conduct their stewardship activities in Section 2. Investors use these rights to support and challenge companies to promote sustainable value.

There is no single prescribed hallmark of 'good stewardship'; it does not consist of a set list of activities that achieve good outcomes in every situation. The UK Stewardship Code emphasises the need for investors to demonstrate how their approach leads to better investment outcomes. In some cases, simply setting expectations of companies can result in the long-term behaviours that investors want to see. In other cases, more pressure is needed - collaborative engagement or voting against a board member may be needed to reinforce these expectations. For asset owners, the responsible management and oversight of capital involves overseeing and holding their managers to account on how they are managing their investments. This will involve regular reviews of their manager's approach to stewardship as a part of their overall performance to ensure they are meeting their investment goals.

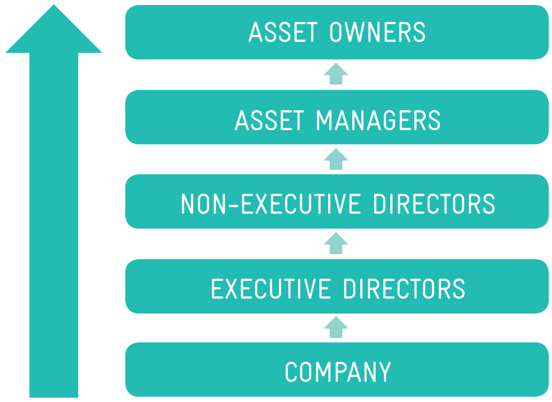
LIMITATIONS OF STEWARDSHIP

Investing does not come without risk. In fact, a key feature of investment is making judgements about the relative level of risk and return that is needed to achieve different investment goals. Stewardship can help to minimise or make risk acceptable. For example, investment managers conduct due diligence prior to investment so that risks are fully understood and engage with the company to ensure these are effectively managed.

Investors are not responsible for the management of the companies they invest in. The board are responsible for governance and setting the strategy while the Executive Directors run the company. All directors of the company are ultimately responsible for fulfilling their Directors' Duties to shareholders and taking account of their impact on other stakeholders such as employees, communities, the environment and suppliers. Non-executive directors provide independent oversight of whether the company is being run in the interest of stakeholders and all shareholders. In the UK, this is done through a unitary board structure. The coronavirus pandemic has clearly demonstrated the importance of companies looking after their employees, the communities they operate in and the customers they serve, to ensure that they will be viable businesses in the future.

Boards are accountable to their shareholders and it is the responsibility of investors to hold the board to account for its actions and the way the company is managed. Investors have certain rights and responsibilities to manage their investments responsibly and will use these to address potential concerns with company behaviour.

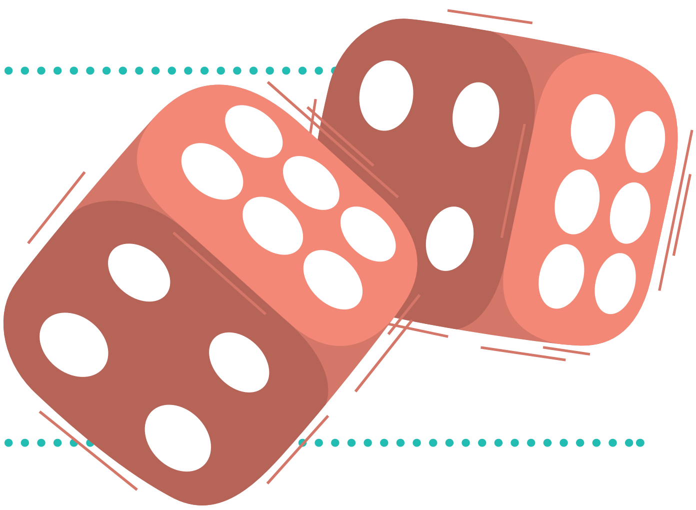
ASYMMETRY OF INFORMATION



Even the best stewardship practices will not lead to a perfect market with no corporate failures. It is important that stewardship is not seen as a silver bullet in preventing these; investing involves risk and without it, returns are unlikely to be delivered. What investment managers can do is manage risk in order to generate sustainable value on behalf of clients.

Investment managers seek to encourage companies to change their behaviours where they believe there is a risk to long-term value, but ultimately it is the responsibility of company management to listen and respond to their concerns, where appropriate. Stewardship can help a company to improve its prospects if the underlying business is viable and if the company is receptive to constructive engagement with investors. Where sustained stewardship efforts are not effective, it may be the right course for some investment approaches to reduce exposure to the risks posed by the company in order to protect clients and end investors by exiting the investment.

Effective stewardship can help to reduce, minimise or make risk justifiable but cannot (and should not) eliminate risk altogether.



INVESTORS' ROLE IN PROMOTING WELL-FUNCTIONING MARKETS AND ADDRESSING SYSTEMIC RISKS SUCH AS CLIMATE CHANGE

The UK Stewardship Code recognises that best practice in stewardship involves not just promoting the integrity and sustainable value of the companies in which institutional investors invest, but also promoting the integrity of the market, as the long-term value of investments is tied to the resilience and strength of the wider economy. Effective stewardship therefore involves setting clear expectations on minimum market standards and engaging with regulators, policy makers and other market participants to promote sustainable growth across the economy. This includes responding to systemic risks that undermine sustainable value creation.

Climate change is one example of a systemic risk that is having a significant and growing impact across the economy. Savers and institutions are significantly exposed to the detrimental impacts of climate change on the value of their assets. The global nature of investments mean that they will be exposed not just to the impact of extreme weather patterns on the value of the assets they are invested in in the UK but all over the world. Investors have an important role to play in using their stewardship obligations to respond to this systemic risk.

In terms of capital allocation, investment managers can assess which investments are best placed to create sustainable value in a decarbonised economy as well as which assets will support adaptation to and mitigation of the worst impacts of climate change. They can support governments and consumers around the world by providing capital for adaptation and mitigation infrastructure programs. They can support asset owners to allocate capital in response to climate change through the development of products that offer superior climate change risk management.

While some asset owners and investment managers are divesting from greenhouse gas intensive assets, the modern economy is not yet set up to abandon these products and industries altogether without significant disruption to everyday life and financial stability. Accordingly, investment managers also fulfil their management and oversight responsibilities by actively engaging with the companies they are invested in to support them to manage the physical and transition risks from climate change and make progress to more sustainable business models.

Investors are also engaging with policy makers and regulators to support them to introduce the policy interventions needed across different parts of the economy to achieve net zero carbon emissions by 2050 which is necessary to meet the goals of the Paris Agreement.

INVESTORS ROLE IN THE COVID-19 CRISIS AND POST-COVID RECOVERY

Learnings from the coronavirus pandemic will continue to evolve as the pandemic and its impacts persist. The economic instability that has ensued has highlighted the important role of stewardship in responsibly allocating, managing and overseeing capital. Investors' role as stewards can also play a key role in economic recovery.

Throughout the crisis investment managers have continued to engage with companies, supporting them to navigate immediate challenges to business continuity. As stewards, investment managers favour companies that can demonstrate that they are well run and take a long-term view of how they treat their employees, communities, suppliers, pension savers and customers. The investment industry's role is to cut through economic uncertainty and market volatility, to work with and support good businesses that produce sustainable long-term value for clients. Early in the pandemic, investors set out their commitment to support British businesses across a range of challenges from managing AGMs, the sustainability of dividend payments and fair pay[xi].

In the context of the pandemic, there is emerging evidence that investment managers are engaging more with investee companies on how they are treating their employees, from promoting the physical and mental health of their workforce to how they are investing in their training and support. They are also looking closely at how companies are engaging with other key stakeholders, including communities, suppliers and customers to inform their business decision making.

In terms of capital allocation, investors have supported UK listed companies to raise the additional capital that they need to remain solvent and continue to operate throughout the pandemic. Between 1 March and 31 October, 64 FTSE All-Share companies raised over £18bn of additional capital through issuing new equity.[xii] The majority of these have taken place through 'accelerated bookbuilds' which have enabled companies to make use of flexibilities from the Pre-emption Group to raise capital with urgency on a non-pre-emptive basis. Investors are also working alongside government and banks to provide additional capital to support companies to repair their balance sheets as we enter economic recovery.

There are many lessons about stewardship to learn from the pandemic. Investors will consider companies' preparedness and resilience to severe economic shocks; the impact of our natural environment on economic opportunity, and how these risks can be effectively incorporated into the investment and stewardship process. Going forward, investors will evolve their approach to engaging with companies on tail risks as well as longer-term economic trends such as digitisation or greening of the economy, which may have been accelerated by several years.

A key area for consideration when investors choose to support companies going forward will be whether that company will continue to create long-term value. Investors may wish to see substantial commitments from corporate management to make their business practices more sustainable before they are willing to put additional capital at risk.

Between 1 March and 31 October, 64 FTSE All-Share companies raised over

£18bn

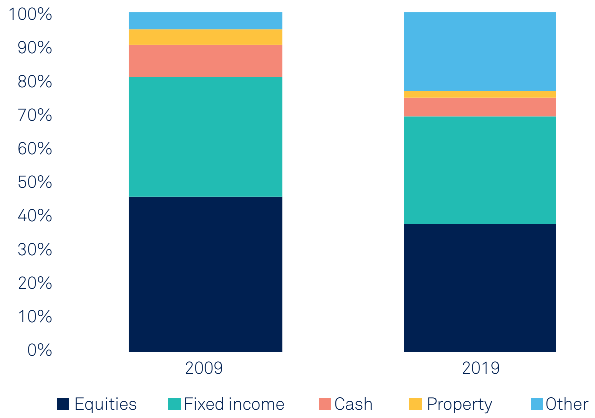
of additional capital through issuing new equity.[xi]

2. HOW DOES STEWARDSHIP WORK IN PRACTICE?

Over the last two decades, changes in regulations, tax incentives and the de-risking of pension assets in response to maturing populations have led to a significant shift in asset owners' asset allocation from equities to fixed income, private markets, real estate and infrastructure. We have also seen a significant shift in the way in which companies finance themselves, with a growing preference for debt over equity. This trend has only accelerated since the start of the 2008 financial crisis and in response to the coronavirus pandemic.

Until recently, the focus of the UK Stewardship Code has been on stewardship activities relating to equities. This stems from the significant rights associated with share ownership leading to substantial opportunities to influence company behaviour. But structural changes in the economy calls for a shift in emphasis in stewardship. The Code has purposefully recognised that stewardship promotes sustainable value across all assets and securities. How stewardship is applied in different asset classes will be driven by the rights and responsibilities associated with investing in them, as well their investment characteristics and time horizons.

CHANGING ASSET ALLOCATION UK MANAGED ASSETS (2009-2019)



Source: Investment Management in the UK 2019-2020 - The Investment Association Annual Survey

STEWARDSHIP IN LISTED EQUITIES

Stewardship has historically been understood as the domain and responsibility of listed equity investors. Many stakeholders assess the success of stewardship by how investors vote at a company's AGM. Shareholders have the right to vote at a company's AGM and cast an opinion on the way in which the company is being managed through the re-election of individual directors or through other resolutions such as approval of the annual report. Because of this right to vote and publicly demonstrate their support or opposition to the board, shareholders have significant leverage over investee companies, allowing investors to actively pursue their stewardship goals and achieve tangible changes in company behaviour towards long-term value.

In recent years, as a result of collective and concerted investor action focused on engagement and voting at the AGM, we have seen a significant improvement in the gender diversity of UK boards, companies aligning executive director pensions with the rest of the workforce and companies starting to take the risks of climate change more seriously.

But, voting at AGMs is just the tip of the iceberg. Stewardship covers a much broader range of activities all year round. The following framework can be used to understand how investors approach stewardship in listed equities:

- **Research** - Investors research and assess which companies will help meet clients' investment goals. They conduct this research in due diligence exercises prior to investment and on an ongoing basis to inform their investment and engagement approach.

- **Monitoring** – Ongoing monitoring of investee companies to assess the risks and opportunities to long-term value.

- **Setting expectations** – Investors set out their expectations of companies in their stewardship, responsible investment and voting policies and communicate these expectations regularly in direct engagement with management and board members.

- **Engage** - Investors engage with the companies they invest in year-round to ensure that their expectations are being met. In dialogue with company management and board members, investment managers raise issues which they think pose a material risk to the company and want to understand how companies are managing those risks and responding to their concerns or views.
- **Collaboration and escalation** - If investment managers don't think that companies are listening to their views, they may escalate their engagement. This might involve working with other shareholders either formally (through organisations such as the Investor Forum) or informally, requisitioning resolutions at an AGM or GM, or making public statements. Another mechanism is to formally write to the whole board where they have serious and unresolved concerns which have not been addressed by the CEO or chair.
- **Exercising rights and responsibilities** – Investors make use of voting and other rights as shareholders to influence company behaviour.
- **Investment choices** – Active managers will buy and hold companies and assets that help them to achieve their client's investment goals and sell those that won't. Exiting an investment due to stewardship concerns can be seen as the last resort, when all other approaches and engagement has resulted in no change. However, it can also be used as a first port of call – refusing to invest in companies where there are concerns about ESG criteria.

Shareholder engagement is a key stewardship tool. It is commonly thought that engagements are concentrated in anticipation of the company's AGM but they occur throughout the year and are often triggered by specific events. Many of these engagements will take place over an extended period; revisiting the issue (often over many years) to work towards key milestones to facilitate change.

Equity investors, especially those with significant holdings, are often able to engage directly with company management, including the CEO, CFO and other board members, including key positions such as the chair, and chairs of the remuneration, audit and nomination committees. Companies will often reach out to their largest shareholders to consult on certain issues including remuneration, governance issues or other material ESG concerns.

Shareholders prioritise their engagement in several ways: the risk profile of the company, the size or relative proportion of the holding, sector-based prioritisation or engagement on thematic issues. Investment managers take their client views into account on how to prioritise the issues that align with their investment beliefs and goals.

Where engagement or the setting of expectations has not led to positive outcomes, investment managers can express concern with the company's approach by voting against resolutions at a general meeting. Voting against or abstaining from voting is an indication that engagement up to the point of the AGM has not brought about the desired outcome or that the company has ignored the investor's expectations without adequate explanation.

Investors will adjust their approach to engagement and voting based on their stewardship priorities. For example, investors may choose to vote against boards that fail to meet minimum expectations on board diversity. If the investment manager conducts an engagement with a company which results in a change in the company's approach, more information or a clear explanation (for example a plan on improving board diversity) may allow the investor to vote in line with the board recommendation. Engagements often happen over many years, which means that the investors' expectations and company responses evolve. Through this evolution the investor will assess whether sufficient progress has been made to support the company or whether using their voting would be a helpful incentive to change the company's behaviour.

Investment managers pursuing an active strategy can reflect their stewardship priorities and those of their clients in the selection and retention of investments. An active manager's first stewardship tool may be refusing to invest in a company for stewardship reasons and its final tool for escalation may be the withdrawal of all or some capital from the company. Stewardship concerns will also be reflected in the risk premium of the company and therefore will impact on the company's cost of capital. The focus for index strategies is on oversight and developing index products which support clients' stewardship and sustainability preferences.

CASE STUDY: **COLLABORATION AND ESCALATION**

In 2019, Aviva Investors, EOS at Federated Hermes (on behalf of its stewardship clients), Legal & General Investment Management, M&G Investments and Newton Investment Management worked as part of Climate Action 100+'s core engagement group, alongside other investors, to encourage BP to disclose a strategy consistent with the goals of the 2016 Paris Agreement.

The engagement was headlined by individual shareholders in the group deciding to co-file a shareholder resolution at the company's 2019 AGM. The core group of investors, working collaboratively as part of Climate Action 100+, successfully engaged with the company in a collaborative series of discussions with it, culminating in a landmark resolution which met Climate Action 100+'s goals and which the company's Board could recommend to its shareholders.

Collaborative engagement of this kind presents internal and external challenges. Internally, investors had to overcome administrative hurdles and engage relevant stakeholders (including in compliance, legal and communications) for their support. Externally, a consensus had to be reached between all co-filers as to the approach and content of the proposal. This was especially important as investors sought to engage in a consistent manner to increase the wider impact of the collaborative engagement initiative with BP.

The resolution put forward by Climate Action 100+ supporters was co-filed by nearly 10% of BP's shareholders and, with Board and management support, received over 99% approval from the voting shareholders.

Since the resolution was passed, BP has announced a new business purpose and its ambition to become a net zero company by 2050 or sooner, and to help the world get to net zero. BP has since announced a new corporate strategy aimed at becoming a net zero energy company and a new investor proposition, together with short and medium term targets and aims, designed to deliver long term value both for investors and for the company's wider stakeholders. The company has acknowledged that these changes were informed by its collaborative engagement with Climate Action 100+, as well as its view of the opportunities presented by the energy transition.

STEWARDSHIP IN FIXED INCOME

Corporate Debt

Fixed income represents a fundamentally different asset class to equities. Bondholders have different rights and responsibilities, leading to different stewardship expectations and opportunities. As we discussed at the beginning of this chapter, companies' balance sheets increasingly consist of large amounts of debt as one of their primary sources of financing. In some respects, there is an imbalance between the level of influence of bondholders versus shareholders given the critical role debt issuance plays in the financing of companies today. On the other hand, Directors' Duties to shareholders are clearly set out in company law and are a product of the risk profile of the investment.

In corporate debt, the issuer's sole responsibility is to uphold the rights granted to bondholders in the bond prospectus and the bond covenants, which typically cover the company's approach to capital structures and debt management. Post-investment, bondholder rights are limited as they do not have the right to vote at the company's AGM, unlike most equity investors. However, bond issuers do need to refinance or seek additional debt regularly and existing investors are often the first port of call, providing some opportunity to influence.

Bondholder meetings are infrequent and focus on procedural issues which only enable voting on a small range of issues such as approving amendments to debt covenants and/or terms of issuance, approving repurchase of the debt security or certain debt restructuring plans. Bondholders have no regular vote on the governance of the company, for example the re-election of board directors.

Fixed income investors have clear responsibilities to exercise good stewardship, as set out in the UK Stewardship Code. The broadening of the Department for Work and Pensions (DWP) implementation of the Shareholder Rights Directive II, also extends requirements for pension funds to incentivise stewardship in relation to debt as well as equity in their arrangements with investment managers. This is creating greater demand from clients on the exercise of stewardship in this asset class, expressed through Request for Proposals (RFPs) and investment mandates.

Fixed income stewardship is often characterised by pre-investment activities. Without the ability to hold fixed income issuers to account once the investment has been made through exercising voting rights, the onus is on investors to conduct rigorous research and analysis prior to any agreement and ensure that the bond prospectus and covenants provide sufficient protection to bondholders. Bondholders want to ensure that the company will generate the cashflow to meet their dividend payments and will be able to repay their invested capital when the bond matures.

Increasingly, managers are integrating ESG factors into their credit assessments of companies, with a focus on minimising downside risk. In terms of engagement, they are typically focused on business strategy, cash flow and leverage. This engagement can sometimes be focused on issues which arise during the term of the bond, which can be short-term rather than long-term.

Engagement prior to the issuance provides investors with an opportunity to engage on covenants or on the structure of the issuance. This sets the approach for the bond and allows investors to outline their priorities and concerns. Building ESG criteria into covenants can embed stewardship priorities into the foundations of the bond. In general, this is not well developed. In part, this is a structural matter: the fixed income market is relatively liquid and mobile. Issuers can be confident of raising the required capital, in the UK or a separate market, so bondholders seeking to set out conditions on their investment have less leverage. As a result, raising capital in the fixed income market does not often involve extensive engagement programs or tailoring the issuance to fit investors' stewardship priorities. Similarly, the highly liquid market has led to the development of a 'cov-lite' regime whereby covenants are being relaxed rather than becoming more robust. The issuer will often undertake a roadshow in the weeks before reissuance. The window for engagement prior to issuance may be very limited as the time between the announcement of a bond issuance and the closing of orders to purchase the bond can be as little as a few hours.

Following the investment, the opportunities to engage with the issuer are relatively limited. The opportunities that do arise may present themselves at investor roadshows or as part of the debt reissuance process. The refusal by investors to refinance or rollover bonds, or to divest may be an effective escalation tool if they are a significant holder. However, the leverage provided by debt reissuance must be viewed in the context of a highly liquid, mobile and global market, where investors also need to consider currency risk – refusing to refinance a bond where the issuer can find capital elsewhere may be an ineffective threat, unless you are a significant investor.

The Working Groups' members have noted that fixed income issuers, with fewer responsibilities towards bondholders and aware of the limited ability of investors to hold them to account, are less willing to accommodate engagement meetings; except where there are impending issuances or re-issuances and depending on the size of the investor. Access to the CEO or Chair is rare where the manager only holds a debt security in the company. Engagement is usually focused on the CFO or Head of Treasury. This inhibits investors' ability to engage on a broader range of strategic and ESG issues, which typically fall outside the treasury department's remit. Large multi-asset investors often rely on equity investors to hold companies to account and leverage their equity holding to gain greater access to management and escalate engagement. While equities and fixed income represent fundamentally different asset classes, their stewardship concerns, particularly in respect of ESG issues, may often align; there may be divergence on specific issues, but the desired outcomes are substantially similar. The extensive rights and responsibilities and stewardship activities of equity holders can help to bring equity and fixed income investors together, especially in large multi-asset houses. Poor financial performance ultimately causes a strain on cash flows and the issuer's ability to meet its credit obligations through the payment of dividends or repayment of the capital. Formal integration of the equities and fixed income research and engagement teams in many firms has provided greater access to issuers and allowed fixed income investors to have the stewardship conversations they need.

CASE STUDY: **CORPORATE DEBT**

The international business of Federated Hermes has engaged with Suzano, a Sao Paolo-based pulp and paper producer, on issues including governance, greenhouse-gas emissions, energy efficiency, water consumption, sustainability disclosures and genetically-modified trees since 2014. Improvements in the management of these important environmental dimensions help to improve the long-term sustainability of the company for the benefit of all types of investors. This includes advanced sustainability reporting, with a new sustainability report in 2019, and a post-merger sustainability strategy focused on sustainable innovation.

In early 2018, Suzano confirmed its long-rumoured acquisition of Brazilian pulp producer Fibria, in a cash and shares transaction requiring it to take on additional debt and rise in estimated net leverage. Such metrics alone suggest that this could have favoured equity investors and could have been received negatively by bond markets, as such a large acquisition would likely increase financial risk. However, looking at the transaction in a broader sense revealed clear benefits to Suzano's business profile that highlighted the aligned interests of equity and fixed income engagements. Suzano's management team had also confirmed a bondholder-friendly financial policy, reiterating that the company's net leverage target of 2x to 3x would takes priority over dividends and investments. Moreover, the real potential for Suzano's business profile to improve, combined with strong cash flows, well-signposted financial policy and potential benefits through synergies enabled a positive view of the company's credit profile.

Although the acquisition initially seemed like a growth story involving greater financial risk and nonalignment between equity and debt investors, it served as a reminder of the aligned interests of investors across the asset classes, whether on improving sustainability or on company performance and capital allocation.

CASE STUDY:

COLLABORATIVE ENGAGEMENT IN FIXED INCOME IN ACTION – INVESTMENT ASSOCIATION SPECIAL COMMITTEES

The IA maintains the long-standing Special Committee process which facilitates collaborative engagement between bond issuers and bondholders. Such discussions usually relate to proposed amendments to bond documentation, restructurings, or early repayments, but may cover a wide variety of issues. In all cases the aim of the Committee will be to find a solution that works for all parties involved. The IA Special Committee process has been active in responding to the coronavirus pandemic so that bondholders can support issuers to manage the strains on their covenants.

This process has become a highly valued part of the UK market structure. It gives bond issuers an opportunity to identify and engage with its debt investors in order to produce proposals that are acceptable to a broad range of holders, while for bondholders this engagement helps to protect the value of their investments and the interests of their clients. The Special Committee process fosters best practice and a culture of active creditor engagement in the corporate bond market.

Green bonds

Green bonds, both corporate and sovereign, could make an important contribution to the growing range of investment strategies in place to meet clients' investment objectives. They could also play an important role, alongside equity, in financing the investment that companies and governments will need to make a sustainable transition. Green bonds typically provide more opportunities for investors to input into the design, restrictions, agreements and structure of the bond. For green bonds, the opportunity to engage may take the form of a roadshow and may run for several weeks.

CASE STUDY: GREEN BONDS

To further the development of the green bond market, BlackRock has devised a proprietary green bond taxonomy which assesses bonds from 'Very Light Green' to 'Dark Green'. The shading is based on the bond's intended use of proceeds, associated environmental benefits, and its issuers' ongoing commitment to allocation and impact reporting.[xiii]

In addition to this, BlackRock is on the Green Bond Principles Executive Committee. The Green Bonds Principles are industry-developed guidelines for issuing green bonds. They call for transparency and promote integrity in the green bond market.[xiv]

Sovereign Debt

Sovereign debt is often highly valued, particularly in developed markets. Stewardship with respect to sovereign debt is primarily focused on pre-investment due diligence and monitoring. More involved engagement akin to the engagement seen in equity investment is more challenging. Affecting change can be difficult due to the highly dispersed nature of investment with one investor unlikely to hold a major proportion of the debt.

Opportunities for influence are more likely to come through emerging market debt, where major investors may be consulted on their expectations on a range of ESG criteria. Due diligence prior to investment is therefore typically the focus of stewardship in sovereign debt.

CASE STUDY: **SOVEREIGN DEBT**

In June 2020 a group of investors including Aviva, LGIM, and Aberdeen Standard Investments wrote an open letter to Brazilian policymakers, expressing concern about their exposure, through Brazilian sovereign bonds and investee companies exposed to Brazilian operations in their supply chain, to the damage caused by deforestation. Brazilian policymakers subsequently reached out to signatories, culminating in meetings between the Vice President, legislators and leading signatories of the letter.

Investors targeted five key outcomes:

1. Significant reduction in deforestation rates,
2. Enforcement of Brazil's Forest Code.
3. The Amazon's legal protections are maintained and cuts at enforcement agencies are reversed
4. Necessary steps are taken to prevent a repetition of the 2019 forest fires during the upcoming "fire season"
5. Public access to data on deforestation, forest cover, tenure and traceability of commodity supply chains.

Engagement is ongoing. However, following the meetings the Brazilian Government announced that it planned to ban setting fires in the Amazon for 120 days -an encouraging first step.

STEWARDSHIP IN REAL ESTATE AND INFRASTRUCTURE

This section includes various asset classes under the umbrella of 'real assets' which may be financed through debt or equity, directly or through intermediaries such as banks or multilateral organisations. While, real estate and infrastructure may be considered functionally very similar, stewardship approaches will vary depending on the structure of ownership and nature of the investment. Both are long-term in nature and illiquid. Once developed, a real estate or infrastructure project can be difficult to adapt. Due diligence is therefore an important focus for stewardship activities.

Direct investors are often responsible for the management of the asset, and therefore any focus on governance is internal rather than on an external management company. Many investors will take large ownership stakes in the real estate or infrastructure project, which often results in board positions, giving them a significant level of influence over the management of the asset. This approach provides investors a first line of defence and facilitates greater access to information. However, this set-up means the investor must manage any conflicts of interest as their duty as a board member and director will be to the asset itself. Once these overall governance concerns are addressed, ongoing engagement is primarily focused on social and environmental issues.

When investing in real estate and infrastructure via intermediaries, for example, banks, governments and multilateral organisations, the primary opportunity to influence is via the counterparty at the origination of the investment. Energy use and environmental impact is often a key focus for stewardship engagement in these asset classes given this is a significant source of regulatory risk and opportunity. For example, real estate is likely to be a key focus for reducing greenhouse gas emissions as governments seek to deliver on commitments to become net zero given the built environment is estimated to contribute up to 40% of the UK's greenhouse gas emissions[xv]. This will involve costly retrofitting programmes for assets that are not energy efficient which may significantly impact returns.

Infrastructure will play an important role in mitigation and adaptation in response to climate change and other sustainability considerations including access to water.

Social considerations, particularly relating to human rights and health and safety issues during construction are also a key focus. This is also a key focus for impact investors who wish to achieve positive social impacts through their investments as the built environment has a significant bearing on heath, community relations, homelessness and other social issues.

As the coronavirus pandemic has reinforced, the value of real estate and infrastructure is significantly impacted by changes to society and the environment which can lead to structural changes in the economy.

Global Real Estate Sustainability Index (GRESB) provides comparable, standardised and validated ESG data, including information on energy, greenhouse gas emissions, water and waste on real estate and infrastructure assets. Access to this data allows investors to highlight priority issues to the issuer and their own portfolio managers prior to and following investment. While GRESB is the de-facto standard for ESG in real estate, it is a process driven approach, with little focus on investment and broader societal and environmental outcomes. Investors often must put a lot of effort into getting ESG criteria embedded into these transactions, and, given the often private and competitive nature of these investments, this may not always be achieved. There is a broader need to establish a baseline level of standard ESG information in these assets.

There are key areas of public policy such as building and utilities regulations which will impact on the long-term sustainability of these asset classes; therefore, investors will also engage with policy makers on these issues.

Increasingly, investors are considering how they integrate their approach to stewardship in these asset classes with their fixed income and equity approaches. For example, they may consider the tenant base and whether they have any corresponding equity investments where they need to align their stewardship approach.

CASE STUDY: **REAL ESTATE**

Clifton Moor was acquired by Legal & General Investment Management's (LGIM) Industrial Fund (IPIF) in 2014. On acquisition, an Asset Sustainability Plan identified a wide range of initiatives that could lead to improvements in the ESG credentials of the asset, including lighting, waste management, environmental habitat improvements and various social initiatives.

LGIM sought to engage with the tenants on the estate (e.g. through bi-annual tenant surveys). LGIM is now able to report tenant-controlled aspects of sustainability to GRESB as part of their reporting process and is confident that landlord/tenant collaboration has been improved.

LGIM has upgraded lighting to LEDs (resulting in a 25% reduction in energy usage), initiated a waste management circular economy initiative within the estate, installed bird-boxes, fruit orchards and small wildflower areas and have engaged in social value initiatives including helping local schools and charities working with autistic people. The asset has won multiple awards including the JLL Responsible Property Management Property of the Year (Business Space); Award for Best Customer Engagement in 2018 and a Green Apple Award for waste management and social value and the JLL RPM Award.

CASE STUDY: **INFRASTRUCTURE**

Once invested in direct assets, Universities Superannuation Scheme (USS) follows an ESG review process using market leading frameworks. Consistent with its commitment to Responsible Property Investment, USS monitors the energy consumption on all of its assets where it has responsibility for the utility supplies.

Particular attention is given to 'Focus Sites', comprising eight assets covering two shopping centres and six offices held on a long-term basis. USS targeted a 30% reduction in energy intensity between 2010/11 and 2019/20. In fact, a 34% reduction in electricity and a 37% reduction in gas for the period 2011 to 2018 was achieved.

The Grand Arcade, Cambridge, comprises 450,000 square feet of retail space in central Cambridge. Since 2012/13, USS have undertaken a series of energy audits, prompting improved control of the building management system, upgrades to central air handling units and fans, plus replacement with more efficient LEDs for the front and back of house lighting.

As a consequence, total electricity use at the Centre was reduced by 697,000 kilowatt hours in 2018/19 compared to the 2012/13 baseline. This represents a 35% annualised reduction on the baseline from six years earlier; the equivalent of approximately 197 tonnes of CO2.

STEWARDSHIP IN PRIVATE MARKETS

Private companies play a key role in society, delivering employment and significant services to the economy. Recent years have seen asset owners wanting increased exposure to private markets.

Private companies choose not to access capital on public markets and therefore are not subject to the same governance and disclosure expectations and requirements as listed companies. Over the last few years, we have seen an increased focus on the need for private companies to demonstrate how they contribute to society. Large privately-run companies have a significant impact on the environment, society and the wider economy - public trust and confidence in financial markets is informed as much by the behaviours and actions of these companies as those of listed companies.

Regulators and other stakeholders have seen how corporate governance failures in privately-run companies undermine trust in the wider market and that asymmetric requirements on private and listed companies can disincentivise listing and hamper the competitiveness of the UK as a place to do business. This may be putting increasing pressure on shareholders to accept the erosion of effective governance practices at listed investee companies so that they can compete with their non-listed peers. This can also make the transition to listing status challenging as companies struggle to meet the heightened requirements that come with seeking capital on public markets.

GLOBAL ASSETS UNDER MANAGEMENT IN PRIVATE MARKETS INCREASED 20% IN 2019 TO

$7.3

TRILLION

A challenge for policy makers is to balance the flexibility permitted by the unlisted sector, recognising that these companies are actively not seeking capital on public markets, with the need for large private companies to step up to wider societal expectations on how they behave and treat their key stakeholders. In the recent wave of corporate governance reforms, policy makers met this challenge by introducing new reporting requirements for private companies.

First, they set out a requirement that large private companies (more than 2,000 employees or a turnover of more than £200 million and a balance sheet of £2 billion) should set out their corporate governance arrangements. A stakeholder coalition developed the Wates Corporate Governance Principles for Large Private Companies as a means for large private companies to meet this new requirement. The Principles were designed to "provide a tool to help large private companies look themselves in the mirror, to see where they have done well and where they can raise their corporate governance standards to a higher level." These principles recognise the significant impact that large privately-run companies have on UK productivity, employment and the provision of goods and services and therefore the responsibilities of these companies in terms of maintaining high governance standards.

The second new requirement was for large companies incorporated in the UK to report on how their directors have had regard to the matters set out in their Directors' Duties under s172 of the Companies Act. This includes how they have given regard to their stakeholders, including their employees, supply chains, and the communities and environment that they impact in their decision making.

Investors invest in private markets through direct investment in private companies, private equity funds, debt, real estate and infrastructure.

With direct ownership and relatively long-term investment time horizons, investors in private markets can often exert high levels of influence and have significant access to company management. Some private market investors indicate that the lack of disclosure from private companies on a wider range of ESG issues isn't a problem as they have high levels of access to the information that they need; other investors would like to spend more time engaging with these companies on strategic issues, rather than on getting access to information.

Investors will also engage with private companies undertaking an IPO. Public equity markets have received renewed interest as they have provided the flexibility for companies to raise capital at pace during the coronavirus pandemic. In recent years there have been a number of concerns regarding the quality of companies aiming to list on public markets, with those companies wanting to access public capital without taking on board investors' expectations on ESG issues that warrant the lower cost of capital from getting access to public investment. Investors can support companies to improve their governance throughout the company life cycle by setting clear expectations and offering flexibility as companies are undergoing significant transitions.

CASE STUDY: **PRIVATE MARKETS**

Roaring Meg is a 33,000m2 shopping park in Stevenage, owned by Aberdeen Standard Investments (ASI) and managed by property management firm Workman LLP. The Park is home to 25 retail and leisure units and 1.5 acres of woodland, as part of a much larger ancient woodland, known as Monk's Wood.

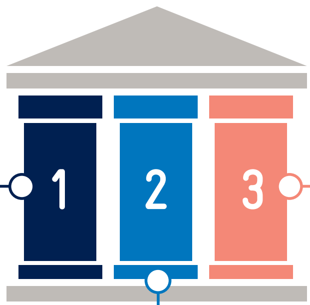
ASI has engaged with Workman to improve biodiversity and community opportunities linked to Roaring Meg's woodland, introducing beehives, restoring ancient hedgerows and supporting local schools to engage in the biodiversity initiatives.

To achieve this, Workman prepared letters for occupiers explaining the plans and works. The Park Manager hand delivered these to each occupier, opening up dialogue and discussing any questions or concerns as well as introducing new health and safety initiatives around the introduction of the bee apiary. Once due diligence was completed, the response was generally very positive, with occupiers welcoming the biodiversity and community projects.

The actions have enhanced the natural environment at Roaring Meg, creating new opportunities to attract visitors while increasing Stevenage's biodiversity. Over time ASI and Workman aim to bring these biodiversity and community initiatives together to further raise local awareness and to attract visitors by building links with local schools and developing educational resource to unlock the wider potential of the woodland for use by schools, local community groups and visitors.

3. RECOMMENDATIONS FOR STRENGTHENING STEWARDSHIP IN THE UK

STEWARDSHIP IS ALREADY AN IMPORTANT FEATURE OF THE INVESTMENT LANDSCAPE IN THE UK, BUT CONCERTED ACTION TO FURTHER STRENGTHEN THIS ROLE IS NEEDED TO ENSURE THAT THE UK MAINTAINS AND ENHANCES ITS POSITION AS A CENTRE FOR EXCELLENCE FOR INVESTMENT MANAGEMENT AND WORKS HARDER TO DELIVER FOR THE END INVESTOR. THE WORKING GROUPS HAVE BUILT 20 RECOMMENDATIONS TO ACHIEVE THIS AROUND THREE KEY PILLARS:



PILLAR 1:

STEWARDSHIP BEHAVIOURS

PRACTICAL STEPS FOR STRENGTHENING HOW STEWARDSHIP WORKS IN PRACTICE ACROSS THE FULL RANGE OF INVESTMENTS.

PILLAR 2:

STEWARDSHIP FOR CLIENTS AND SAVERS

DELIVERING ON THE PURPOSE OF THE INDUSTRY TO GENERATE SUSTAINABLE VALUE AND ACHIEVE CLIENTS' INVESTMENT GOALS.

PILLAR 3:

ECONOMY WIDE APPROACH TO STEWARDSHIP

ENSURING THE COLLECTIVE RESPONSIBILITY OF MARKET PARTICIPANTS AND STAKEHOLDERS.

1 STEWARDSHIP BEHAVIOURS

The revised Stewardship Code sets ambitious standards for improving the quality and effectiveness of stewardship. To strengthen the role of stewardship in the UK, a critical starting point is to encourage more signatories to the Stewardship Code. The Stewardship and Stakeholder Working Groups fully endorse the revised UK Stewardship Code and the need for institutional investors to adopt and enhance best practice in line with the Code. We support the market to go over and above the minimum regulatory requirements and to increase the number of signatories to the Stewardship Code. We also support signatories with more experience as stewards of assets to continue to push and evolve best practice, supporting those in the market who are newer to stewardship.

A cornerstone of best practice is the comprehensive integration of stewardship within and across investment firms, i.e. within and across different funds, products and asset classes. For large multi-asset houses this comprehensive approach should include a focus on how they are transmitting the same messages to the same companies across different types of securities. This systematic approach requires a shift in culture - it is essential that senior management support and promote the integration of stewardship into the investment process. This emphasis needs to be reinforced through governance and incentivisation approaches – the purpose of the business should support and guide their stewardship activities.

Culture and Governance

There is a concern that some investment managers don't prioritise stewardship in their governance and culture and don't comprehensively integrate stewardship across their investment process. This can result in a disconnect between stewardship teams and investment teams who may give different messages and views to companies. Company engagements can be used solely as an information gathering exercise by portfolio managers and while this has an important role to play in developing long-term constructive relationships between the investor and investee company, this can come at the cost of treating engagement as a purposeful activity that can improve investment outcomes. Stewardship can be perceived as an add-on rather than fundamental to the investment process. This results in accusations of 'greenwashing' where investors promote themselves as good stewards and responsible investors through their communication and marketing materials, but this isn't evidenced in how they fulfil stewardship in practice.

The Stewardship Code requires signatories to integrate stewardship with the investment process and ensure that their culture and governance promotes and incentivises systematic integration across and within different asset classes and geographies.

Recommendation 1:

The Working Groups endorse the UK Stewardship Code as the best in class marker of stewardship. We expect that investment managers will become signatories to the Code. The IA should work with its members to identify and support non-signatories to sign up.

Recommendation 2:

There needs to be a step change in investment managers' approach to the culture, governance and incentivisation of stewardship. The IA should work with the industry to achieve this change through the development of guidance and sharing of best practice.

We further recommend under Pillar 2, that asset owners should also redouble their efforts to becoming signatories to the Code.

The IA should engage with its members to review and set out different approaches to incentivising and embedding a culture of stewardship across different business models and investment strategies, building on learnings from the first round of annual stewardship reports in line with the revised Stewardship Code. This review should focus on:

- Demonstrating that stewardship has been integrated fully within and across the business.
- Use of audit and controls is one of the key indicators of the integration into the investment process.
- Supporting portfolio managers to understand and implement their stewardship role. The IA should work with the CFA Institute to identify where and how stewardship can be incorporated further into the CFA program and how the IA can support and promote investor education on stewardship amongst its membership.
- How firms incentivise and measure performance of individuals to encourage them to integrate stewardship. This should consider the use of KPIs and remuneration structures.
- How robust governance can support the effective management of conflicts of interest.

The IA will also use this review to input into the FCA's proposed work to consider further the role of firms' culture, governance and leadership in both the management of climate risks and the exercise of stewardship. The FCA expects to take forward this workstream as soon as capacity and resourcing allow in light of Covid-19.

Actions and review:

- *The IA will develop guidance in the second half of 2021 on governance, culture and incentivisation of stewardship.*

The IA will review this guidance biennially to ensure that it reflects current best practice and helps a wider group of asset managers to become signatories to the Stewardship Code.

Stewardship in different asset classes

Stewardship is not only the responsibility of shareholders of listed equity. There is a clear need to improve how stewardship works in practice in the full range of asset classes where best practice is less formalised and has received less public scrutiny.

Improving the culture of stewardship in different asset classes will require a multi-pronged approach, with different market participants taking responsibility for improving outcomes:

- Asset owners should set clear expectations for stewardship across the variety of their investment mandates.
- Investors should set clear expectations of bond issuers, private companies, real estate and infrastructure providers (and any intermediaries) and reinforce these expectations by making full use of the rights and responsibilities that come with ownership of securities.
- Company management should facilitate effective engagement with providers of capital.

As set out in Section 2, given the increasing importance of debt on company balance sheets and in asset owners' investment portfolios, and with 32% of assets under management in the investment industry allocated to fixed income, it is critical that investors make full use of the rights and responsibilities available to them as owners of corporate debt to influence investment outcomes. The Code includes specific expectations on investors approach to exercising rights and responsibilities in fixed income. To meet these, investors should set clearer expectations of bond issuers so that they can hold them to account and make better use of escalation tools to influence company behaviour.

Recommendation 3:

Bondholders should make full use of the rights available to them, living up to their responsibilities as stewards. The IA should work with industry to develop guidance on how stewardship in fixed income can be improved – to support the industry to set expectations of bond issuers and hold them to account, and to overcome any barriers to engagement with issuers.

The IA's guidance will:

- Set out the commitments that bond investors will make on how they will engage with corporate issuers and facilitate long-term engagements.
- Support the development of collaborative engagement in corporate debt so it can be better used as an escalation tool. This will build on the Investment Association's Special Committee process and will also consider how to overcome perceived and actual barriers to collaborative engagement in fixed income.
- Set investor expectations of corporate issuers' approach to engagement with bondholders focusing on:
  - Developing a *long-term* relationship with investors, not just around the time period of issuance and reissuance.
  - Facilitating investor access to the board and senior leadership team.
  - Improving disclosures, including how bond covenants and documentation can reflect ESG criteria and the information required for investors to fulfil their stewardship obligations.
- Outline the role that advisory and development banks can play in advising issuers appropriately on the expectations of investment managers.

Actions and review:

- *Preparation of the IA guidance in the first half of 2021.*
- *Review of guidance and practice after 24 months.*
- *Based on the success of such guidance, consider the extension to other areas, such as developing stewardship expectations in sovereign and private debt.*

Potential Future Workstreams

Some stakeholders have raised concerns that the Market Abuse Regulations (MAR) and Competition law obligations are a barrier to collaborative engagement as it is unclear which activities will be permitted. These concerns have been broadly overcome in the equities space, where healthy investor action takes place in collaborative fora. The Investor Forum has played an important role in supporting this development. There are outstanding concerns about the permissibility of collaborative engagement amongst bondholders. The IA's Special Committee provides structured opportunities for collaborative engagement amongst bondholders, illustrating that these concerns can be overcome. Nevertheless, there remains nervousness amongst some investors about inadvertently falling foul of competition law and market abuse regulations when trying to live up to their stewardship responsibilities in fixed income.

The FCA has said previously that it does not think that compliance with MAR and competition law obligations should be regarded as a barrier to investors engaging collaboratively in pursuit of their stewardship objectives, if they consider carefully how to do this and make appropriate adjustments[xvi]. However, the FCA has also said that it is happy to discuss any specific examples of problems that investors or issuers have found, and that it will consider if it is appropriate to provide further guidance. Industry participants should gather evidence of any specific barriers poised by MAR or competition law to stewardship in fixed income or collaborative engagement.

Subject to its analysis of such evidence and the potential for harm or market inefficiency, the FCA has indicated that it could consider the need for any additional guidance.

As we set out in Section 2, the nascent state of bondholder stewardship is related in part to the limited degree of rights that come with ownership of debt securities to effectively hold management to account. It will be important to closely monitor how improvements are made in the oversight of bond issuers as investors embrace the expanded scope of the Code. However, it is not clear that bondholder rights are fit for purpose when we consider the capital structure of companies today. There are some voting rights that shareholders have which materially impact outcomes for debtholders but over which they have no say. As stewardship in fixed income develops, it will be important to have a debate about the appropriateness of existing bondholder rights to hold company management to account. This debate should consider the range of barriers that may exist to bondholders living up to their responsibilities as stewards, and whether their rights could be strengthened (for example through increased access to documentation, management, amendments to the regulatory framework to allay concerns regarding the permissibility of collaborative engagement or extended voting rights).

Careful consideration of the balance of shareholder and bondholder protections set out in company law, against the degree of risk that investors take on and the capital structure of companies today, is needed to form a view on whether these rights are still fit for purpose. This debate will also need to consider the differing time horizons and investment philosophies of debt and equity holders. Granting additional rights could lead to differing and competing pressures on company boards, leading to tensions between the directors and different providers of capital.

Private companies' role in society and market integrity

Investors have substantial opportunity to influence the behaviours of private companies, using their influence as long-term and significant providers of capital. Recent corporate governance reforms focused on private companies, which resulted in the development of the Wates Principles of Corporate Governance for large private companies, provide an opportunity for investors to reinforce their expectations of private companies, upholding them to standards which will enhance and promote their long-term value. While anecdotally a significant amount of engagement occurs in private markets, public facing disclosures about stewardship in this asset class are nascent and we are yet to see the full impact of the introduction of the Wates Corporate Governance Principles. This lack of transparency means that a full picture of market practice and how it needs to improve is challenging to identify at this stage. The recent increases in asset owners' allocation to private assets and the potential for stewardship in this asset class demands greater transparency.

Through their Stewardship Code disclosures, investors should demonstrate how they discharge their stewardship obligations in private markets. As a result, we expect to see investors reinforcing their expectations of private companies, both in terms of their governance and their wider societal and environmental impact and engagement with their stakeholders.

Recommendation 4:
More emphasis is needed on stewardship in private markets. Asset owners and investment managers should identify common criteria for best practice stewardship in private asset classes. The IA should consider the quality of UK Stewardship Code disclosures in relation to private markets and identify how to progress best practice stewardship in this asset class.

In the next section, we identify enhanced disclosure expectations for private companies.

Actions and review:

- *Review of the annual stewardship reports with respect to private markets in the second half of 2021.*
- *Work with industry to identify areas for significant improvement and any barriers to improvement.*

Requisitioning resolutions

When engagement and voting on standard resolutions does not lead to the desired change in company behaviours, an important stewardship escalation tool for shareholders is the ability to requisition resolutions or meetings. These require companies to take certain actions or respond to the concerns of a group of shareholders where this is not directly or specifically addressed through normal resolutions required by company law.

Historically, the use of requisitioned resolutions at UK listed companies has been relatively limited due to the resources required to requisition the resolution and rally other shareholders. The cost and effort involved in filing a resolution at a single company can rule this escalation tool out in practice. Barriers include the practical challenges of meeting the 100 shareholders or 5% threshold in order to requisition a resolution and ensuring that there is client approval to participate in a requisitioned resolution. There are also legal barriers in terms of verifying share ownership for these purposes in a heavily intermediated investment chain. The resource and cost involved in overcoming these barriers act as a disincentive to shareholders to coordinate this kind of activity.

In recent years, we have seen several successfully requisitioned resolutions through Climate Action 100 (CA100+), resulting in high carbon emitting companies making more proactive commitments to reduce greenhouse gas emissions and manage the risks associated with climate change. These collective approaches have reduced the burden on individual shareholders and have even led to boards supporting the requisitioned resolution, owing to recognition of the importance of the issue and the high level of support from a significant number of the company's shareholders.

The wording of a requisitioned resolution is crucial to gaining the support of shareholders – there is a balance to be struck between signalling investor views and directing management to a specific action. Shareholders are typically more likely to support a resolution requiring a set outcome that the board should meet rather than a resolution which directs the board to take a specific action or approach. The binding nature of the requisitioned resolutions mean that shareholders require legal certainty on this approach.

Recommendation 5:

Shareholders should use requisitioned resolutions more proactively as an escalation tool and develop model resolutions to escalate a range of critical concerns with investee companies, including on climate change. The industry should develop guidance to overcome existing barriers to requisitioning resolutions.

As a result of this we might expect to see the number, quality and success of requisitioned resolutions increase. However, we do not expect the outcome of this to be an excessive number of requisitioned resolutions or meetings, where shareholders are filing requisitioned resolutions prior to, or in lieu of, engagement or other forms of stewardship.

The industry should prepare guidance to assist institutional investors to requisition and support requisitioned resolutions and ensure this tool is effective where shareholders think it is an appropriate form of escalation. This guidance should consider internal processes and practices and what authorities might need to be included in client mandates for investment managers to use requisitioned resolutions on behalf of a client's assets.

The industry and legal advisers should work to develop model resolutions that have been pre-agreed amongst investors to escalate a range of critical concerns with investee companies. These model resolutions could be used as the building blocks to target specific companies on different issues. As a starting point, the industry should focus on developing model resolutions to address climate change in high risk sectors. The industry should work with stakeholders such as the IA, ClientEarth; ShareAction and Institutional Investors Group on Climate Change (IGCC) Climate Action 100+ to develop model resolutions on climate change for institutional investors to use when investee companies are not meeting shareholder expectations on managing the impact of climate change. The IIGCC has a significant work programme underway and it will be important to build on this work to support shareholder adoption.

The industry should then look to other issues arising from the current market environment and company specific issues which would warrant a similar model resolution.

Actions and review:

- *Development of guidance by end of 2021.*
- *Consider use of model resolutions in 2021 AGM season.*
- *Review need for other model resolutions.*

The Law Commission has recently published its intermediated securities scoping study[xvii]. The review sets out a number of legal issues in relation to the intermediated nature of securities ownership, and the varying rights which come with ownership. These findings may have implications for overcoming some of the legal barriers identified in requisitioning resolutions, including in relation to the thresholds required to requisition a resolution as set out in s338 of the Companies Act and implications for how the ultimate beneficiary can exercise any voting rights.

Recommendation 6:

Following the findings of the Law Commission review, Government should review the provisions on requisitioning shareholder resolutions in the Companies Act, examining whether the requirement for 100 shareholders who hold on average £100 of paid up capital, or the 5% threshold places an excessive barrier in practice on the use of this stewardship tool.

Following the publication of the Law Commission's review, the Government should consider how effective the current legal framework is, including whether the shareholder thresholds are at the right level and whether the binding nature of resolutions is efficient.

EXPECTATIONS OF COMPANIES

Here, we set out expectations of companies who have a role in facilitating better stewardship through enhanced disclosures on long-term value, better explanations of how their governance structures help them to be well run businesses and the role of the board of directors in engaging with shareholder concerns. Companies also need to better articulate their broader role in society and how they are delivering sustainable value for the economy and environment.

Setting expectations of companies in response to Covid-19 – outlining how investors will uphold them through stewardship

A significant number of companies will require additional capital from their shareholder and bondholders as the Covid crisis continues. As companies seek to recapitalise and, in some cases, restructure their business and operating models in response to changing consumer needs and structural changes in the economy, there is a significant opportunity to 'build back better'. There is a corresponding role for investors to support and challenge companies to promote this agenda for sustainable growth - focusing on long-term drivers of value creation so that they are more resilient and sustainable going forward.

Recommendation 7:

Investors should set out clear expectations of companies in post-Covid-19 recovery, particularly those that are seeking additional capital from investors. Investors should commit to using their stewardship responsibilities to ensure that companies are meeting these expectations.

The industry should identify and clearly communicate their priorities on the critical issues which can impact long-term value and will underpin sustainable economic recovery. These issues should include, but not be limited to, climate change and progress to Paris alignment, a wide range of social considerations including, but not limited to, stakeholder engagement, health, treatment of employees, diversity, equality and inequality. While investors have focused on a wide range of these issues in recent years and made significant progress on many of them, there is an unprecedented and significant opportunity for businesses to re-evaluate the sustainability of their business models and investors should support them to do so, building on existing work in this area.

The IA should support investment managers to work with asset owners and other stakeholders to collaborate on these key issues. This will include supporting evidence-based assessments of which key issues will promote and enhance long-term value and corporate resilience and communicating their financial materiality.

Actions and review:

- *IA to set out initial investor expectations in the first quarter of 2021.*
- *IA to review uptake of initial expectations in the 2021 AGM season and evolve approach for the 2022 AGM season.*

Historically, the company AGM was the cornerstone event each year enabling dialogue between directors and shareholders. It remains a critical occasion on account of the votes cast. However, institutional investors only very rarely attend or speak at shareholder meetings, preferring to vote by proxy days in advance of the meeting. Consequently, many listed companies, who often host poorly attended shareholder meetings with resolutions that are passed with little or no dissent, question whether such meetings are a good use of time and money.

Covid-19 led to large scale disruption of corporate AGMs in 2020. Corporates chose different routes to facilitate their AGMs in light of the pandemic, from holding closed meetings to app-based virtual AGMs. These events have led many stakeholders to reflect on AGMs and consider their format and function.

A range of organisations and interested parties are now asking if the company AGM could be modernised in a way that demonstrates the UK's commitment to continued thought-leadership and excellence in corporate governance. In an era where companies and institutional investors are emphasising the importance of a company's wider stakeholders in ensuring its long-term success, there may be opportunities to bring a wider range of voices together at a company's AGM in ways that meet the interests of a company's investors. Just as important, it should be possible to use technology to ensure greater access to and participation in AGMs by diverse shareholders, including institutional investors, thereby strengthening stewardship of companies in the years to come.

The FRC has recently published a review of how AGMs were impacted by the pandemic[xviii]. Following this review, they have announced they will "convene a Stakeholder Group which includes government, companies, and investors to consider recommendations for legislative change, propose alternative means to achieve flexibility, whilst maintaining the integrity of the AGM."

Recommendation 8:

We endorse the FRC's recent review of AGMs and support continuing work by the FRC into the requirements on companies in respect of shareholder meetings, particularly AGMs. The work should prioritise ways to ensure greater access to and participation in AGMs (including through the use of available technology) by diverse shareholders whilst retaining the accountability of directors to shareholders.

Actions and review:

Industry to engage with the FRC's review in 2021 and ensure learnings from the 2021 AGM season.

Reporting on long-term sustainable value

The quality of the information provided by companies is critical to supporting long-term, sustainable value. Annual reports, accounts and supplementary market announcements should provide investment managers with the relevant information to develop a real understanding of a business and its drivers, its financial strength, the quality of management and the material risks and opportunities they are managing to deliver long-term value to shareholders.

A key component of company disclosures should include material environmental, social and governance factors. The reliability of this information is essential for confidence in public markets and empowers stakeholders to hold companies to account in creating long-term value and making tangible progress towards sustainability goals.

The market for ESG data has evolved rapidly in recent years. There are multiple frameworks used to promote better reporting by companies on the wider range of strategic and non-financial information. Both issuers and investors in different markets have their own preferences on which framework is most suitable for their needs. The incomparability and inconsistency of ESG information and the proliferation of standards and frameworks to solve for this has resulted in a wide range of market inefficiencies, including increased costs from duplicated reporting, verifying ESG data across the investment chain and ultimately the potential mispricing of assets. In some cases, companies are unsure which reporting standard to follow and what are the expectations of their investors.

The Sustainability Accounting Standards Board (SASB) and Taskforce for Climate Related Financial Disclosures (TCFD) already have a significant amount of traction with global investors and companies and are the basis on which many investors are developing their ESG integration processes. Both these standards are embedded in principles of materiality and strong governance, where the emphasis is on the company to identify the impact of material environmental, social and governance risks on their business model and strategy, and how these feature in their risk management, oversight and capital allocation plans. This emphasis ensures a dynamic rather than static consideration of sustainability factors, enabling focused engagement on how companies are transitioning their business model to a more sustainable footing. This sector specific approach and focus on governance and materiality provides essential information for investors to incorporate ESG information into their investment and stewardship processes and importantly, to be able to compare the long-term value of companies within sectors on a consistent basis. Work is underway to ensure that the metrics and indicators that support these disclosures are applicable in global markets.

In recent months, we have seen several announcements from the providers of different reporting frameworks noting their commitment to work together and work towards global harmonisation of reporting standards on the wider range of ESG factors. We have also seen increasing regulatory interest in these areas.

A non-exhaustive list of initiatives and consultations is set out below:

- FRC Discussion Paper: "The future of corporate reporting"[xix].
- IFRS Foundation consultation paper: "Sustainability reporting"[xx].
- World Economic Forum consultation paper "Measuring Stakeholder Capitalism: Towards Common Metrics and Consistent Reporting of Sustainable Value Creation" [xxi]
- Statement of intent to work together towards a common standard by 5 framework and standard setting institutions: CDP; CDSB; GRI; IIRC and SASB. Corresponding exchange of letters between standard setters and IOSCO's Sustainable Finance Task Force[xxii].
- EU commission work on the Non-Financial Reporting Directive, Taxonomy and Sustainable Finance Disclosure Regulations.

In early November, the UK Government issued an initial statement in response to the IFRS Foundation consultation paper, undersigned by the HM Treasury,[xxiii] DWP, BEIS, BoE, FCA, FRC, and TPR. In this statement the Government and regulators commit the UK to actively support the development of global disclosure standards. The statement supports the creation of a new Sustainability Standards Board, within the IFRS Foundation structure, to promote the integration of financial and non-financial reporting into a common architecture.

We welcome this progress and commitment to achieving global harmonisation. Global cohesion is not without its challenges and there are several steps that need to occur for it to become a reality. This will take time to achieve. Local regulators will need to endorse a common framework and ensure its applicability in different markets, recognising the variation in local governance and social norms and company law, while being careful to ensure that this does not result in significant divergence. We welcome the independent statements by the FRC and the FCA reinforcing their support for international harmonisation of reporting standards.

In the interim it is essential that progress is made towards more comparable and consistent disclosures to support investors to effectively incorporate information regarding long-term sustainable value creation into the investment process. We welcome the FRC's support for progress during this period and agree that "some of the existing frameworks can act as steps in supporting the market to move more quickly to meet the information needs of investors and other capital providers". They encourage UK public interest entities voluntarily to report against TCFD and to make use of SASB metrics with reference to their sector in their next reporting cycle.

The IA has already set out its support for TCFD and has asked UK listed companies to start making disclosures in line with TCFD so that they can meet the Government's expectations of disclosing against TCFD by 2022. The Working Groups support the FCA's proposals to introduce a TCFD requirement into the UK's listing rules[xxiv]. We are encouraged by the commitments to mandatory TCFD reporting across the investment chain by 2025, as set out by the UK's Joint-Government-Regulator TCFD Taskforce[xxv].

Recommendation 9:

Regulators and investors should continue to support ongoing international efforts to enhance and harmonise corporate reporting standards for sustainability, including those at IOSCO, IFRS and an alliance of the leading standard setters. Pending an international standard, industry and regulators should consider steps to promote further voluntary adoption of existing widely accepted frameworks and standards such as TCFD, SASB and GRI. The UK asset management industry supports the early adoption of TCFD by investee companies and the use of other reporting standards, such as SASB, as a stepping stone until an international reporting standard is developed

The harmonisation of global standards will ensure comparability of disclosures across large multinational companies and ensure coherence of these disclosures throughout their supply chains. This coherence is critical to investors who invest in global markets – having different emerging practices amongst different regions will not help support effective investment decisions and comparability of investee companies globally. Work towards convergence should accelerate and build on existing initiatives and at pace, to reflect 1) the growing demand from society and investors for more meaningful and comparable data; and 2) a growing request from businesses for harmonisation and simplification of reporting commitments.

Actions and review:

- *The IA will set expectations of UK listed companies to report against sustainability frameworks. The IA will advance its expectations of UK listed companies on TCFD reporting in 2021.*
- *The IA will engage with international stakeholders to support the development of global standardisation that meets the needs of global investors.*

The focus of sustainability reporting has so far been concentrated on listed entities, however as discussed in Section 2, large private companies have a significant impact on sustainability outcomes and consumer confidence in financial markets.

The Working Group support the Wates Principles of Corporate Governance for Large Private Companies and we encourage their use as the appropriate means for large private companies to demonstrate their approach to corporate governance. The IA and our members will feed into the expected reviews of how the Wates Principles and reporting on Directors' Duties have been implemented.

Recommendation 10:
Large private companies should ensure that they are meeting investor, government and stakeholder expectations to demonstrate their governance arrangements and impact on stakeholders through improving their disclosures against the Wates Principles and s172 Directors' Duties reporting requirements.

The IA will work with its membership to set out more clearly our expectations of large private companies as investors in these companies.

The urgency of climate change demands that all market participants and stakeholders play their part in contributing to a more sustainable economy. Large private companies play a key role in this agenda in terms of managing climate risk and contributing to solutions. Greater transparency around climate risk across society and the financial system enables stakeholders, including investors, to assess the impact that individual companies have on climate change and how they are responding to Government ambitions to be net zero by 2050. It will also allow investors to accurately price this risk and ensures transparent disclosures to clients about the overall impact of their portfolios.

Recommendation 11:
The UK Government should amend company law to require all large UK incorporated companies (public and private) to report in line with TCFD. Companies should also have regard to industry endorsed disclosure frameworks and investors should reinforce this expectation through their stewardship activity.

We support the need for large private companies to report in line with TCFD. To achieve this, the Government should review the appropriate legislation so that all large UK incorporated companies (both listed and unlisted) are required to report against TCFD. This will allow the impact of climate change on individual companies to be assessed and ensure that climate risks are comprehensively priced into the financial system across both public and private companies. Following the announcement of UK's Joint Government-Regulator TCFD Taskforce Roadmap towards mandatory climate-related disclosures, the industry will contribute to the debate through the proposed BEIS consultation on the appropriate scope of private companies for this reporting requirement.

In the future, it may be appropriate to consider the wider range of sustainability disclosures from private companies and we would encourage large private companies to have regard to the ongoing dialogue about harmonisation of sustainability frameworks.

Actions and review:

- *UK government to consider how company law can be updated to provide a statutory underpin to TCFD disclosures.*
- *FRC, Coalition of Wates Principles and wider stakeholders to review the quality of reporting against the Wates Principles and Directors' Duties by private companies.*
- *Industry to monitor the uptake in TCFD and SASB reporting by large private companies and to set out further expectations in 2022.*

Corporate Governance Code - Comply or Explain regime

The comply or explain regime is an important cornerstone of the UK Corporate Governance Code (CG Code).

The UK Listing Rules require companies to make a statement on how they have applied the Principles of the CG Code, in a manner that would enable shareholders to evaluate how the Principles have been applied, taking into account the particular circumstances of the Company, its purpose and strategy. The application of the Principles is supported by 41 provisions and supporting guidance. These provisions operate on a 'comply or explain' basis. A 'comply or explain' compliance basis gives companies the opportunity to communicate with shareholders and explain how their governance structure is aligned with their business model and how it helps them to deliver their strategy and generate long-term returns for investors. It is important that companies feel that they can explain where they believe a deviation from the Provisions of the CG Code is in the best interests of the company and its shareholders.

However, too many companies state that they are in full compliance with the Provisions of the UK Corporate Governance Code rather than choosing the right governance structure for their business and explaining against the Provisions where it is appropriate to do so. Most companies either comply fully or where they do deviate from the Provisions, the quality of the explanations is typically poor. The quality of explanations for full compliance with the provisions also often fails to identify why implementing those provisions is appropriate for their business.

Companies often see compliance or stated compliance as an easier approach than explaining a deviation from the Provisions. We have heard that proxy advisers' and shareholders' approach to engaging with these explanations can be too risk averse, disincentivising companies from choosing the best governance structure for their business model. On the other hand, where companies deviate from the Provisions of the CG Code, shareholders often find that the explanations are not very informative about why their alternative approach makes sense for the company's business model. Investors want such explanations to be well-reasoned, clearly linked to the strategy of the company and to outline how risks of diverging from the Provisions of the CG Code have been minimised.

If shareholders are not sufficiently engaged, they may not be able to challenge companies effectively. Similarly, if companies are not clear in their explanations, they run the risk of being poorly understood by investors. Proxy advisors play an important role as well. When analysing company governance approaches and explanations, proxy advisors need to take a considered approach. Many companies feel that proxy advisors do not consider their individual circumstances and that some proxy advisors take a "tick box approach" to compliance with the Corporate Governance Code.

Recommendation 12:

Companies, asset managers and their advisors need to take responsibility for reinforcing the Corporate Governance Code's Comply or Explain regime and ensuring that the quality of explanations improves. Investors should set out their support for the Comply or Explain regime and reinforce this with their engagement and voting approach. Investors should set out the attributes of a high-quality explanation.

The IA will develop guidance setting out investor expectations and support for the Comply or Explain regime. This would highlight the importance of companies adopting the governance approach which is most appropriate for their business and strategy as well as expectations regarding the improved quality of explanations where companies do and do not adopt the Provisions of the CG Code.

The guidance will also set out how investment managers will commit to judging high quality explanations in line with this guidance and ultimately hold companies to account for this quality through their voting behaviour.

Investors should work with their proxy advisors to ensure that they take a holistic approach to assessing a company's explanation and produce robust voting recommendations where companies have poor explanations to support more proactive and consistent engagement with the quality of explanations by investors.

Actions and review:

- *The IA is to produce a statement of support for Comply or Explain and guidance on expectations for explanations by Q3 2021.*
- *The IA will review the quality and uptake of explanations 2 years after the guidance has been produced to ensure that it has led to a change in behaviours.*

Role of board directors in promoting and responding to good stewardship

As stewards of investor capital, company directors have a significant role to play in ensuring alignment of company strategy to long-term sustainable value creation. Non Executive Directors (NEDs) play a key role in providing independent oversight of the executives' role and responsibilities as company directors and are voted in by shareholders to protect their interests. Despite this, many NEDs lack a clear view and understanding of shareholder priorities and the evolving approach to stewardship in the UK. While these priorities may be communicated through individual engagements on thematic issues, there is often a lack of understanding as to the reasons for engagement and the overall stewardship objectives. Similarly, many corporate boards don't understand well the investment philosophy or approach of institutional investors. Boards can be too reliant on the feedback of the corporate brokers and their members would often benefit from more direct feedback from shareholders.

Recommendation 13:

The FRC, in collaboration with key stakeholders, should develop free-to-use resources for company directors to deepen their understanding of stewardship and the UK Stewardship Codes. This programme should focus on the shift in expectations arising from the more expansive definition of stewardship embedded in the new Stewardship Code and the need for constructive engagement between investors and investee companies.

As the regulator with responsibility for both the Corporate Governance Code and the UK Stewardship Code, the FRC is strongly placed to lead on a programme of thematic conversations and events for investors and company directors that strengthen understanding of risks, responsibilities and pathways to recovery in a post-Covid world.

Actions and review:

In 2021, FRC to commission or directly develop a set of resources aimed at company directors to raise awareness of the expectations that the UK Stewardship Code sets for investors, and the opportunity and expectations this presents for companies and their directors when engaging with investors.

2 STEWARDSHIP FOR CLIENTS AND SAVERS

These recommendations challenge the industry to put clients and the end users of capital at the heart of stewardship; supporting them to have a tangible sense of ownership and engagement with their investments. This is critical to delivering on the purpose of the industry to generate sustainable returns for the end users of capital but can also support wider societal benefits of investment.

These recommendations look at strengthening the relationship between asset owners and investment managers to ensure that demand for best in class stewardship drives up standards. The recommendations also consider how to promote stewardship amongst pension funds and how to more effectively engage the end saver in the investment process.

Strengthening the relationship between asset owners and investment managers

The relationship between asset owners and investment managers is fundamental to driving effective stewardship. This relationship sets the tone for the way in which investment managers make investment decisions and act as stewards of the assets they are invested in and ultimately how they create sustainable value on behalf of savers.

How investment managers respond to client demand, engage clients on their expectations on stewardship, and demonstrate how they are meeting their investment objectives is crucial to achieving successful stewardship outcomes. Investment managers need to take proactive steps to understand the stewardship priorities of asset owners and how these underpin their investment objectives.

There has been increasing focus on stewardship and ESG in the asset owner community in recent years. This has been driven in part by regulatory changes for pension funds, formally requiring them to set out their approach to stewardship as part of their Statement of Investment Principles, and how they have met these Principles in yearly implementation statements. This has resulted in increased scrutiny of their manager's approach to stewardship and ESG integration. However, overall, investment managers find that stewardship is currently not a core focus of their relationship with their clients. Stewardship is not usually a defining factor of their selection process, instead it is typically treated as a hygiene factor, with other considerations such as cost and recent performance driving selection. While managers are starting to see stewardship, expectations feature in contractual arrangement more often, this is by no means the norm.

The FCA identified these issues as part of their Feedback Statement on their Discussion Paper for Building a Regulatory Framework for Effective Stewardship. An industry workshop hosted by the FCA, FRC, TPR and DWP (the joint-regulator workshop) followed. Participants identified the importance of addressing the focus on stewardship in the relationship between asset owners and managers. The working groups agree that stewardship should be a key feature at every stage in the relationship between asset owners and investment managers:

- Stewardship should be an important factor in the selection process that informs appointment decisions. There needs to be more effective incentivisation and demand for stewardship which is included in selection decisions. This demand directs investment managers to dedicate resource to stewardship activities and ultimately drives up standards as investment managers compete to differentiate themselves from their peers.
- Expectations on stewardship should be agreed and clearly set out. Investment managers should seek to understand their asset owner's stewardship expectations and they should seek to incorporate these expectations in their contractual arrangements.
- Ongoing oversight and performance assessment should include an assessment of the quality of stewardship outcomes and whether it continues to support the end beneficiaries' investment objectives. To facilitate this, investment managers should proactively demonstrate the outcomes of their stewardship activities to their clients. They should be transparent about the aims of these activities and held accountable by their clients for the outcomes.

Recommendation 14:

The Working Groups support the IA's and PLSA's commitment to establish a new steering group to explore how to embed a focus on long-term factors including stewardship in the relationships between asset owners and investment managers.

The IA and PLSA's steering group will aim to give clarity on how a long-term focus can be achieved right through from selection, to appointment, the contractual relationship that underpins this (including the investment mandate) and ongoing oversight and performance assessment.

It will consider the behaviours and actions that both asset owners and investment managers should undertake, with collective responsibility, to improve the focus on stewardship in their relationships.

It will consider a range of issues including, but not limited to, those issues identified by the joint-regulator workshop:

- How managers can take proactive steps to understand and deliver on their clients' stewardship priorities.
- How the contractual relationship and any non-contractual arrangements embed a long-term focus, including consideration of model mandates.
- The role of asset owners in ensuring that stewardship plays a key role in their approach to manager selection and ongoing performance and oversight assessment.
- Information flows between asset managers and asset owners regarding stewardship, including with respect to voting disclosures.

The steering group will include representatives from investment managers and asset owners as well as other key stakeholders such as lawyers and consultants. The steering group will be co-chaired by a representative from an investment manager and an asset owner who will be commissioned with identifying actions that both asset managers and asset owners can take to improve this relationship.

The Investment Association has offered secretariat support to this project and the PLSA have also committed to support the working group and provide input from their membership.

Actions and review:

- *Establishment of the Steering Group in Q4 2020.*
- *Initial recommendations of the group to be published in H1 2021.*
- *Expected to produce guidance produced by H2 2021.*
- *Review of implementation of the guidance after 18/24 months.*

Engagement with clients and savers

The largest institutional clients segment of UK investment managers are pension funds which make up 43% of all assets under management[xxvi]. Stewardship must be undertaken in scheme members' best interests. To best achieve this, investors must understand the investment and stewardship objectives of their beneficiaries so that asset owners, investment managers and ultimately companies can deliver on them.

Asset owner signatories to the UK Stewardship Code are already required to explain how the needs of beneficiaries have been reflected in stewardship and investment, aligned with the appropriate investment time horizon. Pension schemes are also starting to make use of technology to enable a cost-effective approach to engaging their members on stewardship, analysing their views and communicating back to them about stewardship activities undertaken for their benefit. We support the use of technology to enable schemes to better understand members' views and perspectives on stewardship. However, investment managers do not always have a clear view of their client's stewardship priorities, nor do asset owners of their end beneficiaries. This can contribute to a sense of disenfranchisement from clients and beneficiaries in the investment process and a lack of understanding of the role and purpose of stewardship.

Recommendation 15:

UK pension schemes should be required to explain how their stewardship policies and activities are in scheme members' best interests. TPR should issue related guidance on how trustees might evidence that their stewardship policies and activities are in members' best interests.

As we set out in Recommendation 15, considering the relationship between asset owners and asset managers, there is a parallel expectation that investment managers should take account of client needs and communicate how they have done so, as set out in Principle 6 of the UK Stewardship Code.

Significant industry effort is underway to engage and communicate the value of stewardship and the responsible investment characteristics of funds to retail investors. The IA's Responsible Investment Framework seeks to bring clarity and consistency to how responsible investment is communicated to savers and other stakeholders – both at the level of an investment firms' activities and at a fund level[xxvii]. Building on this Framework, the industry is now developing best practice on the communication of responsible investment at fund level. This also builds on the expectations set out by the FCA in their Policy Statement 19/4 on communication of non-financial objectives as well as existing IA guidance on communication at fund level. We note that incoming EU sustainable finance rules are also bringing significant new expectations on fund-level disclosures relating to sustainability characteristics as well as on engagement with retail savers on their preferences for such characteristics. The applicability of these regulations in the UK market post-Brexit is yet to be determined.

We encourage HMT and the FCA to continue their focus on the need to engage retail investors with stewardship and sustainability considerations as it considers the application of the sustainable finance package post–Brexit.

Actions and review:

- *TPR to issue guidance in 2021.*
- *Review of effectiveness of requirement in 2024.*

CASE STUDY:
TECH FOR ENGAGING PENSION SAVERS – BRINGING STEWARDSHIP CLOSER TO PEOPLE

Tumelo, an impact-focused financial technology firm, is helping pension savers to engage with companies as shareholders. Tumelo's platform shows retail investors and pension scheme members which companies they are invested in through their funds and portfolios, and asks for their opinion on ESG issues. This allows pension savers to have a say on shareholder proposals coming up at company AGMs and allows them to suggest questions that their fund managers can ask in the course of company engagements.

A 3-month pilot with pension members at two FTSE 100 companies has shown how Tumelo's platform can help to build and sustain interest in investing amongst previously disengaged savers while enhancing UK stewardship:

1. The pilot showed that users are reassured by investment transparency, with users reporting a reduced sense of anxiety and a comfort in seeing the detail and diversification of their pension fund holdings.
2. It proved that users care enough about ESG topics to give their opinion on company stewardship. During the pilot, 1,500 pension members placed over 3,800 vote preferences on 75 shareholder proposals at companies in their pension fund.
3. The pilot showed that pension scheme members want to participate in stewardship on an on-going basis. 32% of users returned to vote monthly. On average users spent over 5 minutes each time they used the platform.

   Users want their vote preference to have an impact. Users like to see what fund managers have voted and why and to know the final vote outcome at the AGM.

Some pension funds have had historically low engagement with the stewardship agenda, with pension trustees lacking an understanding or focus on the benefits of stewardship. With the new Code representing a significant step up in ambition, there is a risk that pension funds will sign up in small numbers due to a perception that it is overly burdensome or challenging for schemes.

Recommendation 16:

A dedicated council of UK pension schemes should be established to promote and facilitate high standards of stewardship of pension assets. Members of the council should either be signatories of the UK Stewardship Code or have publicly committed to signing the Code within two years of joining the council.

The council would be jointly launched by ministers in HM Treasury, DWP, and Department for Communities and Local Government (DCLG) with responsibility for ongoing facilitation of the council and its secretariat sitting with DWP. As the regulator with lead responsibility for the Code, the FRC would be fully involved in both the launch and subsequent running of the council.

An annual event will be held for members of the council and their key stakeholders to celebrate and highlight stewardship activities within the UK pensions sector, covering both public and private schemes, including innovation in aspects of stewardship.

A small secretariat will be established to provide practical ongoing support to members of the council in matters relating to their stewardship of assets and their application of the Code Principles. The secretariat will enable schemes to co-ordinate and share ideas in respect of topical and time-sensitive stewardship issues and will also facilitate the sharing of learning and relevant research on stewardship. FRC and PLSA representatives will participate in meetings of the council.

All UK occupational pension schemes will be encouraged to join the council with encouragement given to larger schemes (i.e. those with over £1bn of AUM) including TPR-authorised Master Trusts, larger corporate schemes and local authority funds. The expectation is that these more advanced schemes, as members of the council, will help raise standards of stewardship in the UK for the benefit of other schemes and their members. Council members will also be encouraged to provide guidance, support and to share good practice in stewardship with non-members.

The recommendation does not include contract based schemes at this time, recognising the significant work underway in the development of Independent Governance Committees and ensuring they take account of stewardship and ESG considerations.

Review:

- *Establishment of council by June 2021.*
- *We expect to see a significant increase in pension fund signatories to the Code.*
- *Review council and uptake after 24 months.*

3 ECONOMY WIDE APPROACH TO STEWARDSHIP

These recommendations challenge different market participants to recognise their collective responsibility for improving stewardship in the UK and for ensuring that stewardship leads to the best outcomes for clients, beneficiaries and wider benefits for the economy, society and the environment. We look at the wider range of stakeholders such as government, regulators, proxy advisers, index providers and investment consultants who all have a role to engage in and promote better stewardship.

The UK's governance and stewardship standards are seen as some of the best in the world. The UK has long been regarded as a leader in stewardship and corporate governance and enjoys a high level of investor confidence, attracting the capital of both domestic and overseas investors to UK equities. Higher governance standards and effective shareholder engagement are seen by overseas investors as representing lower risk, meaning companies can raise capital at a lower cost than competitors in markets which are perceived to have lower standards.

Maintaining these high standards and ensuring that companies and shareholders are working together to promote the integrity of the market over the long-term, should add value to the UK economy, maintaining the UK's position as a competitive market to list and invest.

There is a collective responsibility for all market participants to continue to promote these high standards. The UK has demonstrated this collective responsibility in its approach to the green finance agenda – different government departments collaborating with industry to ensure that the impact of climate change is being effectively managed by asset owners, investment managers and companies.

This collective responsibility takes on new meaning as we consider the challenges of rebuilding our economy following the impact of the coronavirus pandemic and how we address the challenge of climate change and facilitating a sustainable transition. It is only by working together we can ensure that our companies and capital markets support a recovery that serves the needs of society and savers, today and over the long-term.

Regulators, index providers, investment consultants, credit rating agencies and proxy advisers all have important roles to play in ensuring the quality of markets and listing standards. Investment managers and asset owners have a role to play in highlighting those areas where standards or listing regimes need to be strengthened to protect savers. Ultimately, it is Government's responsibility to make policy decisions and market interventions where there are conflicts between competing priorities that affect their citizens and resources. Investment managers can more efficiently price in policy risks where there are clear signals from Government about their plans and priorities.

System wide approach to stewardship

In order to meet heightened expectations of stewardship practice, it is essential that investors have the appropriate rights and responsibilities to influence their investments.

As the UK has been negotiating its exit from the European Union, it has needed to assess the competitiveness of its capital markets, ensuring that the UK is an attractive market in which to list and invest post-Brexit. A key question has been whether the UK's listing regime attracts innovative and high value companies who would make a significant contribution to employment and productivity.

To maintain the UK's position as a home for the world's most innovative companies, it is critical that policy makers consider investor rights, corporate governance expectations and stewardship expectations in tandem. Different government departments and their regulators have responsibility for different parts of the investment chain. BEIS, HMT, DWP and the FRC, FCA and TPR are the primary actors. This fragmented regulatory landscape for stewardship and corporate governance could result in disconnected expectations of companies and investors and act to undermine the competitiveness of the UK market as a place to do business. In the last 2 years, we have seen the regulators come together to develop a joint FCA and FRC discussion paper on stewardship and we are aware that a wider group of regulators and government departments meet to share thoughts and expectations on how stewardship is implemented across the investment chain.

The listing rules, corporate governance and stewardship regimes and expectations need to be viewed holistically by Government, regulators, companies, investment managers and asset owners to ensure that they are consistently seeking the same aim. This will help to ensure the same behaviours and incentives across the investment chain.

The Government, regulators and all market participants should ensure that the regulatory framework for companies, asset owners and asset managers sets a coherent approach to stewardship and corporate governance. A system wide approach to introducing new rules and requirements should be adopted to ensure that expectations of all market participants are consistent and aligned.

Co-ordination and co-operation amongst UK financial regulators in respect of stewardship standards has been a welcome feature of the last couple of years.

Whilst recognising the success of the working level engagement, there should be a high-level/senior group that reviews the strategic direction and collaboration of the implementation and regulation of stewardship across Government and regulators.

Recommendation 17:

Continuing the success of the working level collaboration that already exists, the cross regulatory forum on stewardship should be maintained and formalised as a standing forum on Stewardship for the FRC, FCA, TPR and the PRA and their sponsoring departments (BEIS, Treasury and DWP).

This should be complemented with senior level industry, government and regulator engagement on stewardship. The Asset Management Taskforce and other multi-stakeholder groups should be used as a senior level sounding board for this strategic direction of stewardship and its regulation and as a means to develop a response to specific corporate or market-based issues.

This forum should facilitate regular external engagement with market participants, building on the joint-regulator workshop that took place in February 2020. This external facing role would engage thematically on key stewardship priorities.

It is essential that this joined up government approach promotes and incentivises UK Government owned asset owners to demonstrate leadership on stewardship.

Recommendation 18:

Funded public service schemes (including Local Authority Pension Schemes and investment pools), other relevant asset owners in government and UK Government Investments (who advise the government on the management of certain assets) should embed stewardship in their own investment processes and become signatories to the UK Stewardship Code.

Actions and review:

- *FRC to identify UK Government asset owners and work with them to become signatories to the stewardship Code in 2021*
- *Regulatory group to announce their ongoing collaboration*

Role of other service providers to promoting good stewardship

There are several service providers supporting investors in their investment and stewardship activities. These include index providers, credit rating agencies and proxy advisors - they all have a role in helping to create a better ecosystem wide approach to stewardship.

Index providers have an important role to play in stewardship and promoting the integrity of the market. This role is especially important for index investment strategies, where performance is contingent on the behaviours of all companies in the index, but is also important for active investors, who typically benchmark performance against these indices. Index providers consult widely on the general rules for inclusion in each index and shareholders are proactively engaged in this process. For example, some may have numerous committees which look at the rules and approach of the index. These committees have very significant representation from their clients, investment managers. Index providers support the development of indices that meet investors' stewardship needs.

Credit Rating Agencies (CRAs) play an important role in informing bondholders about the creditworthiness of bond issuers. The quality of their analysis is critical in informing investment decisions and this quality was significantly called into question during the financial crisis of 2007-08. Increasingly, there is a need for CRAs to ensure that they are incorporating an assessment of a wider range of ESG factors in their assessment of companies. We expect this to improve as on-shored EU regulation will require disclosure and inclusion of ESG factors into ratings analysis and reports.

Proxy advisors play an important role in helping investment managers and asset owners to fulfil their stewardship responsibilities through research, facilitating voting or producing voting disclosure. Investment managers will use proxy voting services in different ways, from using their research as an input to their voting decisions or bespoke voting policies which will recommend a certain voting approach. The issues that proxy advisors consider are driven by their clients. Investors typically use voting analysis by proxy advisors as one input into their investment process, however there is a perception that some investment managers follow the default voting advice of their proxy advisors with little due diligence. Some companies have raised concerns with the approach that some proxy advisors take to engaging with companies around their research. All of the major proxy advisors in the UK market are signatories to the 2012 Code and we would encourage them to also commit to becoming signatories to the 2020 Code.

Recommendation 19:

All service providers in the stewardship investment chain, including proxy advisors, index providers, data providers and credit rating agencies should demonstrate how they support effective stewardship. We encourage them to do so by becoming signatories to the service provider principles of the UK Stewardship Code. The FRC should explore how the service provider principles can be applied to a wider range of market participants – both those who act in an advisory capacity and those who provide wider market services.

They should show their commitment to the Code and how they support their clients to meet their stewardship obligations. This would include how they engage with their clients to understand their stewardship requirements and support them to develop products and strategies to meet these requirements.

Review:

- *Review the commitment of major service providers to stewardship within 12 months of recommendation.*

The research undertaken on asset managers by consultants is highly influential both on asset owners and on managers themselves. Investment consultants are well placed to influence stewardship standards in the UK.

Following the joint-regulator workshop, the FCA noted the need for investment consultants to consider stewardship more systematically in asset management selection decisions and to provide more support and tailored advice to asset owners on an ongoing basis. They recommended that a cross-stakeholder group should undertake further work to:

- Assess investment consultants' service provision in respect of investor stewardship; and
- Identify definitive actions to agree minimum service standards, within the framework of the service provider principles of the Code.

Recommendation 20:

Investment consultants should demonstrate how they support effective stewardship through becoming signatories to the Code. We urge consulting firms to provide more active support to clients in raising the standard of their stewardship activities, including client oversight of asset managers, client engagement with managers on stewardship performance, and client engagement with beneficiaries regarding stewardship priorities. This should include consideration of alignment of stewardship approach of asset managers to the client's stewardship needs as a factor in the selection and recommendation of asset managers.

Consultants are encouraged to bring the new council of UK occupational pension schemes to the attention of clients and support those who sign up to be active members.

UK-based investment consulting firms have recently formed a sector wide Sustainability Working Group, which is looking at stewardship as one aspect of its work. We applaud this development and recommend that all UK-based consulting firms participate actively in this Working Group, resourcing it appropriately for meaningful positive impact. We encourage members of the Working Group to communicate about its work transparently and ensure it is receiving inputs from a wide range of stewardship actors.

We encourage consultants to emphasise the quality of stewardship activity in their assessment and formal scoring of relevant managers, and to be transparent about this both with asset managers and clients.

We encourage existing collaborative investor initiatives that facilitate stewardship of companies (e.g. CA100+) to involve investment consulting firms, recognising the value that they can bring as powerful influencers in the system.

Finally, as the Treasury takes forward the recommendation of the CMA to regulate the investment consulting sector, we recommend that consulting firms' ability to promote high standards of stewardship in capital markets be in focus for the FCA as the future regulator of these firms.

Actions and review:

- *FRC to review the number of Investment Consultant signatories to the Code in 2021.*
- *Clients of investment consultants to consider Code commitments as part of their appointment process.*

CONCLUSION

The industry is committed to work with the Asset Management Taskforce, Government, Regulators and a wide range of market participants to deliver on this step change to stewardship, ensuring that stewardship takes its place at the heart of the investment process.

As the Secretariat for this report, the IA will take forward a number of these recommendations, working with its membership and other key stakeholders to ensure their delivery and to review progress with the Asset Management Taskforce.

While the UK is considered world leading in stewardship and corporate governance, there is no room for complacency. The investment industry and society as a whole need to navigate the challenges of the next decade and beyond to continue to deliver sustainable value for savers. Climate change and post-Covid economic recovery will be key tests for the blueprint set out in this report. The role of the UK's investment industry post-Brexit is another challenge that investors must embrace to ensure that the UK maintains its world leading position in stewardship and responsible investment.

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