



Stewardship Codes, Standards & ESG Engagement Styles

ESG & Sustainability Transformation

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12/2023

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Regulators are convinced that engagement adds value, not just within investment portfolios but for markets as a whole. In his powerful 2008 report on the financial crisis, Sir David Walker stated:

Before the recent crisis phase there appears to have been a widespread acquiescence by institutional investors and the market in the gearing up of the balance sheets of banks ... as a means of boosting returns on equity.

The limited institutional efforts at engagement with several UK banks appear to have had little impact in restraining management before the recent crisis phase.

Regulatory interest in stewardship has grown from the disappointment of that financial crisis. As an adjunct to the institutional investor soul-searching that followed the crisis, the Walker report ushered in a new era of shareholder engagement. The report formally called for the Financial Reporting Council (FRC) to issue a stewardship code to provide a framework for shareholder engagement and for this code to be reinforced by a Financial Services Authority (FSA, now the Financial Conduct Authority or FCA) requirement that any registered fund manager must make a statement as to whether and how it approached its principles.

Following consultation, in 2010 the FRC issued the world's first stewardship code —largely unchanged from the existing Statement of Principles on the Responsibilities of Institutional Shareholders and Agents issued by the Institutional Shareholders Committee in 2005 (itself built upon a 1991 document, The Responsibilities of Institutional Shareholders in the UK). Industry best practice had not delivered in the run-up to the financial crisis, but a code with regulatory backing was thought likely to have greater force. Industry acceptance of the code was relatively rapid, particularly among fund managers.

The 2010 Stewardship Code had seven principles: Institutional investors should:

- Publicly disclose their policy on how they will discharge their stewardship responsibilities;
- Have a robust policy on managing conflicts of interest in relation to stewardship and this policy should be publicly disclosed;
- Monitor their investee companies;
- Establish clear guidelines on when and how they will escalate their activities as a method of protecting and enhancing shareholder value;
- Be willing to act collectively with other investors where appropriate;
- Have a clear policy on voting and disclosure of voting activity; and
- Report periodically on their stewardship and voting activities.

This UK Code went through a further iteration in 2012, clarifying the distinction between the roles of asset owners (pension funds and the like) and their fund managers and other agents but leaving the principles themselves almost entirely unchanged. While some of the largest pension funds may seek to carry out stewardship activities themselves, most delegate this role, either by a specific contract or as part of their fund management services. Thus, the role of most asset owners is overseeing, challenging, and assessing the stewardship activities of their service providers.



The UK Stewardship Code model has been followed around the world, and at the time of writing, there are now such codes in 20 markets, either developed by stock exchanges or regulators or by investor bodies themselves keen to advance best practice. Among these are the following:

- Global—ICGN Global Stewardship Principles (2016).
- Europe—EFAMA Stewardship Code (2018).
- Australia—Australian Asset Owner Stewardship Code (2018).
- Brazil—AMEC Stewardship Code (2016).
- Japan—Principles for Responsible Institutional Investors (2020).
- Singapore—Singapore Stewardship Principles (SSP) for Responsible Investors (2016).
- United States—The Principles (2016).

It is notable that while there is great consistency between the principles in each of these codes, as they are modeled closely on the seven principles of the 2010 UK Code, conflicts of interest are dealt with very differently. It has been stated that those codes drafted by the fund management industry are more likely to downplay the issue of conflicts, while those codes with greater regulatory backing place greater emphasis on the issue. Perhaps most striking is the European Fund and Asset Management Association (EFAMA) Code, which is almost a direct copy of the 2012 UK Code except that it does not include a separate principle on conflicts and avoids the issue almost entirely.

UK Stewardship Code Revisions 2020:

The UK Stewardship Code went through a more fundamental redrafting to produce the 2020 version of the code, published in late 2019. The new code, which came into effect on 1 January 2020, includes 12 principles (plus an alternate 6 for service providers), where formerly there were 7, and three times the number of pages as the 2012 code. But the biggest change is not the growth of the document, but the increased ambition for practical delivery by signatories. The former focus on statements of intent no longer exists. Instead, investors are now expected to report annually on activity and, most importantly, on outcomes from that activity. The first such annual reports were expected to be delivered by the end of March, setting out policy, activity, and outcomes during 2020.

Merely reporting on activity is not enough; each of the new principles has associated outcomes that must be reported on and requires concrete examples of what has been delivered practically for clients and beneficiaries. Signatories will no longer fulfil the demands of the Code by publishing policy statements filled with ambitious assertions, instead they must deliver practical effects from their actions.

The 12 new principles fall into four categories but cover two distinct functions:

- Principles 1 through 8 address the foundations for stewardship.
- Principles 9 through 12 focus on the practical discharge of engagement responsibilities.

The need to report on concrete outcomes applies even to the foundational principles 1, 2, 3, 5, and 6 of the new code. These cover such structural issues within the investment institution as governance, culture, and conflicts of interest management. The outcomes that need to be disclosed in relation to these issues are evidence that those structures concretely work in practice in the clients' best interests.

Principles 7 and 8 require the integration of ESG factors into the investment process and include an effective oversight of service providers. The disclosures of related outcomes need



to be explanations of how these processes have delivered effectively on behalf of clients and beneficiaries.

Principles 9 through 12 cover engagement (and voting) activities. The intended outcome of these principles (that must be part of the annual reporting) is to show substantive change at companies (or other investee assets) as a result of the engagement activity. The disclosure of at least some voting outcomes, not just the investor's voting activity, is also expected.

Perhaps the most challenging of the 12 is principle 4, which charges signatories with identifying and responding to market wide and systemic risks. Some investment institutions already recognize their obligation on behalf of beneficiaries and clients to maintain and promote well-functioning markets and social and environmental systems, but for many this may feel like a significant additional burden. The requirement to "disclose an assessment of their effectiveness in identifying and responding to" such risks imposes a new and significant burden even for those who already recognize this as being a stewardship responsibility. Only the Australian Asset Owner Stewardship Code, developed by the industry body Australian Council of Superannuation Investors (ACSI), had a similar expectation in place, in its principle 5:

Asset owners should encourage better alignment of the operation of the financial system and regulatory policy with the interests of long-term investors. (ACSI 2018)

While this new UK Code may prove as much of a model for global stewardship codes as its predecessors, the latest country to propose changes is Japan, which has not followed the UK's example closely. There is a move to require reporting on the outcomes of engagement activity, but this is downplayed and given little prominence so may have only a limited impact (the contrast to how central this is to the new UK Code is significant). Beyond this, the latest changes made to the Japanese Code were as follows:

- To extend coverage to all asset classes, not only equity;
- To incorporate sustainability and ESG;
- To add encouragement for asset owners to become involved in stewardship and provide a little more clarity on their role in the stewardship hierarchy; and
- To clarify the position of service providers in the hierarchy and add higher expectations of proxy advisers.

UK Stewardship Code Provisions:

Other than the new UK Stewardship Code, the principles of all the codes around the world are remarkably similar. Typically, there are six or seven principles, with the first often requiring investors to have a public policy regarding stewardship, and the last noting the need for honest and open reporting of stewardship activities. The main body of the principles between these two usually call for:

- Regular monitoring of investee companies;
- Active engagement where relevant (sometimes termed "escalation," or sometimes escalation is deemed worthy of a separate principle of its own); and
- Thoughtfully intelligent voting.

The two principles that are sometimes but not always present (though they appear in the UK Code in both its former and current iterations) require the following:



- Investors are required to manage their conflicts of interest regarding stewardship matters; and
- The escalation of stewardship activity to include a willingness to act collectively with other institutional investors.

The collective engagement issue is controversial because there are concerns about the creation of concert parties (groups of shareholders so influential that they in effect take control of companies without mounting a formal takeover). This is not the intention of collective engagement, as is shown by the related discussion in this section.

Stewardship codes are usually now expressed to apply to all asset classes, but their language tends to reveal an initial focus in practice on public equity investment. The stewardship thought process, both by regulators and by investors, and the practical delivery of stewardship actions by those investors, is most developed in public equities.

In 2016, the FRC went through a process of assessing the quality of the UK Code signatories (against the then-extant Code, the 2012 version). This was not based on the substance of the stewardship activity delivered but simply on the basis of the stewardship statements published by each signatory in response to principle 1. The regulator gave signatories an indication of which tier (1, 2, or 3) the quality of these disclosures placed them in, which led to a rapid improvement in the quality of disclosures.

The final results of this process showed that out of the 300 signatories in total, 120 were deemed to be tier 1 and best practice (“Signatories provide a good quality and transparent description of their approach to stewardship and explanations of an alternative approach where necessary”), compared with the 40 deemed by the FRC to be in that category in their initial assessment of Code disclosures at the start of the process. It is not yet clear whether or how the FRC will conduct a tiering process in relation to the new Code. If it does do so, the tougher expectations (and particularly the focus on outcomes) in the new 2020 Code seem likely to lead to a greater differentiation being drawn between signatories.

The number of stewardship codes in Europe is likely to increase significantly following the Shareholder Rights Directive II that came into force in June 2019. Among other things, SRD II, as it is known, will raise expectations in each country about the level of stewardship carried out by local investors. This is likely to supersede such initiatives as the voluntary EFAMA Code (updated in 2018 from the original 2011 version) and may move European markets towards expanding expectations that have regulatory backing. While by name, it is about shareholder rights, the directive in reality is more about shareholder responsibilities.

Expectations with regard to stewardship are set by legislation as well as codes. Foremost among these is the US ERISA legislation, the Employee Retirement Income Security Act of 1974. Among the Act’s requirements, a number are relevant to stewardship, in particular, that advisers should act as fiduciaries in relation to the beneficiaries (under the US regime, fund management firms are deemed to be advisers and so subject to this standard). Among the obligations expected under fiduciary duty (as narrowly defined in the Act; it is worth noting that “fiduciary duty” refers to the general common law understanding of that duty and not this US-legislated definition) is that the fund will vote at investee company general meetings and engage with companies.

In the past, the legal interpretation of the Act was thought to discourage ESG stewardship because of a bulletin statement indicating that engagement and proxy use on environmental and social issues would be rare. But fresh interpretative statements from 2018 are more supportive of stewardship. The regulator’s views, set out in the US



Department of Labor's Field Assistance Bulletin No. 2018-01, confirm that fiduciaries can vote and use proxies if there is a reasonable expectation that such activities are likely to enhance the economic value of the investment after taking costs into account. The Bulletin added that engagement might be prudent for indexed portfolios where ESG issues represent significant operational risks and costs. There continues to be a clear view that engagement, and indeed ESG investing, needs a firm basis in value for beneficiaries—so engaging would not be permissible to achieve purely social policy goals without making a clear link to value.

ESG Engagement Styles:

Some asset owners will choose to engage with companies directly, through team members who act as stewards of the investment portfolios. Others expect their external fund managers to deliver this work, either through the portfolio managers who also take stewardship responsibility, or through stewardship specialists (or some combination of the two). Engagement activities can also be entirely outsourced to specialist stewardship service providers.

Almost all institutional investors lean at least in part on one group of these service providers, the proxy voting advisory firms. These proxy advisers offer analysis and (in most cases) voting recommendations across many public companies, and almost all institutions hire them to provide the framework that ensures their voting decisions are delivered. Most also pay for their advice on those voting decisions.

Other stewardship service providers offer various degrees of engagement services, by effectively stepping into the shoes of the investor to engage on their behalf. By aggregating the interests of clients, the scale that is necessary to be present and visible enough in dialogue and engagement with company management and boards can be built. Boards can offer a form of collective engagement, enabling investors to have a greater reach and influence by working alongside others and sharing precious resources. Collaborative engagement can also take place through industry initiatives and collaboration platforms, such as one offered by the PRI or by the Investor Forum in the UK.

ESG Engagement Styles: Top-Down and Bottom-Up

To an extent, engagement styles vary depending on the heritage of stewardship teams. There is a distinction in mindset and approach between those teams with a history of governance-led engagement and those that have worked more on the environmental and social side.

The most obvious distinction is as material E and S issues arise from the nature of a company's business activities, teams with this heritage tend to be organized by sector, whereas as G is determined more by national law and codes, and such teams are usually split according to geography. Engagement style also follows this structure to some extent. Teams tend to focus on individual environmental and social issues and to pursue those vigorously across sectors or markets as a whole. This can encompass trying to establish better practice standards and highlighting leading practice as well as targeting those perceived as laggards. The dialogue would tend to start with investor relations or sustainability teams and then be escalated upwards, both to senior management and to the board level. Firms with a governance heritage tend to focus on individual companies, starting with the chair (often with the assistance of the company secretary) and working through the board and down to management from there.



These are generalizations, but they illustrate the distinction between top-down and bottom-up activity. Most investment houses mix the two, though company-focused, bottom-up engagement fits most naturally with active investment approaches, particularly those with concentrated portfolios; whereas issues-based, top-down engagement tends to align more closely with passive or otherwise broadly diversified investment portfolios.

ESG Engagement Styles: Issue-Based and Company-Focused

Passive investors, and others with broadly diversified portfolios, typically start with an issue, whether identified by the team from news or broader analysis or through a screening or other research provider, and seek to engage with all the companies impacted by that issue (which may be a sector as a whole, or even broader). Usually, the starting point is a letter written to all those impacted, which is then followed up by dialogue. Active investors, particularly those with focused portfolios, start with the company itself and its business issues and develop a tailored engagement approach cutting across a range of issues, often with the investment teams taking a leading role. Companies selected for this approach are often identified from investment underperformers or ones that trigger other financial or ESG metrics. The starting point is typically to seek a direct discussion with senior management and then the board.

Larry Fink's annual letter to CEOs setting out BlackRock's engagement plans is an example of the issue-based approach taken by passive investors. In the 2019 letter, Fink wrote that their priorities for the year were:

Governance (G), including your company's approach to board diversity; corporate strategy and capital allocation; compensation that promotes long-termism; environmental risks and opportunities (E); and human capital management (S). These priorities reflect our commitment to engaging around issues that influence a company's prospects not over the next quarter, but over the long horizons that our clients are planning for.

Issue-based approaches to engagement are often accompanied by examples of what best practice in a particular area looks like. These may be developed in advance of the first engagement dialogues but usually come out of the engagement process with those companies that are deemed to have leading practices. By expecting all companies in a given sector to adopt these best practices, investors may over time move sector or industry practice forward overall. Company-focused engagement seeks to improve practice across a number of relevant ESG issues at an individual company; the aim is to enhance performance of the portfolio overall, in terms of both ESG and investment performance.

To learn more about ESG and sustainability-related models, don't hesitate to contact [**YTT Consulting!**](#)

