

Response to the FRC/FCA Discussion Paper on Building a Regulatory Framework for Effective Stewardship

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Thank you for releasing this discussion paper. It is extremely welcome to see a joint effort by the FRC and FCA on the important issue of stewardship.

Before I answer the specific questions, I would appreciate the opportunity to comment on the academic evidence that is referenced in the discussion paper. First, I applaud the fact that the discussion paper seeks to base its statements on evidence. Second, I further applaud the fact that many of these papers are published in the very best peer-reviewed journals. This is a standard that all discussion papers should seek to emulate, particularly because there is substantial variation in the quality of available evidence.

However, not all the evidence is cited accurately. At times it seems that there is a particular view of stewardship which has influenced the interpretation of the papers; they have inferred implications that are actually not shown by the papers. In addition, the evidence is cited in a rather one-sided way. Even when focusing on articles published in the very best peer-reviewed journals, there are almost two sides to every issue.

Specific suggestions follow below. These are not at all intended to be “academic point scoring”, playing a game of “gotcha” to appear clever by pointing out a slight mistake in interpretation. Instead, it is because stewardship is such a critical issue for the UK economy and wider society that it is important to use the best evidence – and all the best evidence – to guide policy. In particular, I am limiting myself to issues which have policy implications, rather than only “academic” ones.

- Paragraph 3.7 cites a paper by Aghion, van Reenen, and Zingales (2013) for showing that “where asset managers engage more deeply with investee companies, these companies are more likely to pursue innovative strategies.” This is an excellent paper, but it does not mention the word “engage” or “engagement” at all. The paper in fact shows that companies with more institutional ownership engage in more innovative strategies. This is a critical distinction for policy because engagement is not the only way that investors can promote innovation, as I will explain in my answer to Q1.¹
- The same paragraph cites a paper by Hoepner et al. (2018) which shows that “such engagement can reduce downside risk.” In fact, this paper shows that particular forms of engagement reduce downside risk. These are engagements on “governance or strategy topics and when changes in firms’ environmental policies (especially on climate risk) are

¹ The closest the paper comes to mentioning engagement is the discussion of a 1992 proxy reform which allowed investors to coordinate. Certainly, such coordination could be in order to coordinate engagement, but the paper does not study whether investors ended up engaging deeply, rather what happened after the law was passed. Moreover, such coordination could be to share views on a company’s long-term value – which is the alternative stewardship mechanism of “monitoring” that I discuss in my response to Q1.

coupled with governance improvements.” This is important because what matters is not simply engagement activity, but engagement to be particularly focused and targeted. This distinction is critical for policy, because sometimes reforms are based on the idea that more engagement is better, but can lead to box-ticking approaches to engagement.

- Paragraph 3.8 refers to Schmidt and Fahlenbrach (2017), stating that it finds that “without the discipline of active investor engagement, a company’s management is more likely to become entrenched and engage in value-destroying M&A.” This is another good paper, but it studies the ownership by passive investors. This is different from how the paper is referenced for two reasons. First, it specifically studies index funds, and has no implications for engagement by active funds. Second, it studies *ownership* by index funds, not engagement. They speculate that these outcomes may be due to voting. If so, the results have implications for voting but not other forms of engagement.
- Paragraph 3.9 refers to a good paper by Dimson, Karakas and Li (2018), that “examines the impact of investment returns of active engagement ... the authors conclude that active shareholder engagement ... improves governance and performance.” As with Schmidt and Fahlenbrach (2017), this study is cited in a much more general way than what it actually shows. It studies the engagement activity of one single investor, so does not have implications for the value of engagement in general. In addition, it is a particularly large investor with specialist expertise in engagement. Engagement activity by investors whose expertise lies elsewhere (e.g. evaluating a company’s strategy and making informed buy and sell decisions) may not be so fruitful.

More generally, these paragraphs only present part of the picture. They give the impression that evidence shows that engagement always creates value. In fact, a comprehensive survey of the evidence on engagement found that “the success of institutional investor activism to date appears limited.”² Section 3 of “Thoughts for Change from the Steering Group of The Purposeful Company”, which is reproduced in the Appendix of this document, is a balanced summary of the evidence. In sum, it finds that only specific forms of engagement create value. Therefore, a regulatory framework for effective stewardship should not aim to simply increase engagement activity (either the number of investors who engage, or the number of issues on which a particular investor engages), but to promote targeted, focused forms of engagement on issues in which an investor has expertise.

While lots of evidence is cited on the benefits of engagement, there is no evidence cited in support of the argument in Paragraph 3.19, on the benefits of block ownership. There is substantial research on the effects of blockholders.³ The paragraph also states concerns about blockholders expropriating minority investors. While there is indeed evidence supporting this concern where blockholders become very large (e.g. a majority shareholder), I am aware of little evidence of such expropriation for the levels of block ownership that we see in the UK.

I now provide my responses to the specific questions. I do not attempt to answer them all but focus on the ones in which I have greatest expertise.

² Yermack, David (2010): “Shareholder Voting and Corporate Governance.” *Annual Review of Financial Economics* 2, 103-125.

³ Edmans, Alex (2014): “Blockholders and Corporate Governance.” *Annual Review of Financial Economics* 6, 23-50; Edmans, Alex and Clifford G. Holderness (2017): “Blockholders: A Survey of Theory and Evidence.” *Handbook of the Economics of Corporate Governance*, 541-636.

Q1. Do you agree with the definition of stewardship set out here? If not, what alternative definition would you suggest?

The definition does a reasonably good job of covering the core areas of engagement responsibility. However, it makes the mistake of equating stewardship with engagement. Engagement is certainly one important dimension of stewardship, but there is another critical dimension: trading (also known as monitoring or exit). This is undertaking detailed analysis to decide what stocks to buy in the first place, and whether to subsequently retain or divest them

Trading is a critical stewardship mechanism for a number of reasons. First, the decision of which stocks to buy is fundamental to stewardship:

1. An investor can only engage with a company if it has a stake in it. Moreover, its effectiveness in engagement depends, in part, on the size of its stake. A larger stake gives an investor greater “skin-in-the-game” and thus *incentives* to engage; it also gives the investor more votes and thus *power* to engage.
2. An investor buying shares increases the stock price. If an investor buys shares because the company has invested in intangible assets (such as corporate culture, human capital, supplier relationships, and R&D capability), despite low short-term earnings, this has two benefits. *Ex post*, it increases that company’s stock price and reduces the risk that the CEO is fired due to poor short-term earnings. *Ex ante*, a CEO is more willing to invest for the long-term, and focus less on short-term earnings, if she knows that investors will buy her stock based on long-term factors.
3. Holding a stake in Company A has a significant opportunity cost – it prevents the investor reallocating its limited capital to Company B and thus being able to engage with Company B. An investor must therefore make its purchase decisions very carefully. It should not hold a stock simply by default, because it is part of the index. Doing so prevents it from having a more concentrated stake in another company. Every stock it owns should be a conviction holding, which the investor holds either because it believes in the company’s long-term strategy and purpose, or because it believes that it can improve its long-term strategy and purpose through engagement. Indeed, even if an investor has a positive holding of a stock, if it holds less than the benchmark, it loses from good company performance. It thus has disincentives to undertake productive engagement or informed voting.

There is already a major concern that supposedly “active” funds are actually closet indexers. A 2016 study by the European Securities and Markets Authority found that up to 15% of active funds may be closet indexers.⁴ The study was replicated the following year by the investor group Better Finance, which found that 165 out of 1,015 funds were potential closet indexers. The Stewardship Code must recognise the importance of carefully considering which stocks to hold, otherwise closet indexing may become worse. This in turn will aggravate the problem of the “ownerless corporation” – companies being disparately held by investors with little skin-in-the-game and spread too thinly to monitor and engage with the stocks they hold.

⁴ ESMA (2016): “Supervisory Work on Potential Closet Index Tracking.”

Some investors may indeed decide to hold only certain stocks, but make these decisions in box-ticking manner. For example, some socially responsible investors may rely excessively on screens, even though a stock that fails to tick the box for one dimension may outperform on other dimensions. Other investors devote substantial resources to these decisions, yet these decisions are not currently recognised as stewardship.

Second, the decision of whether to sell or retain a stock is fundamental to stewardship:

1. Some investors sell a stock as a knee-jerk reaction to low short-term earnings, even if these low earnings are due to long-term investment. *Ex post*, such selling reduces the company's stock price and increases the risk that the CEO is fired due to poor short-term earnings. *Ex ante*, the CEO focuses more on short-term earnings, because she knows that low earnings will lead to investor sales.
2. However, some investors deeply analyse a stock, looking beyond its short-term earnings towards its long-term value. This is what I mean by "monitoring". They will retain a stock, despite low short-term earnings, if these low earnings stem from long-run investment. Equally importantly, they will sell a stock, despite high short-term earnings, if these earnings stem from forsaking long-run investment. *Ex post*, such selling punishes CEOs who fail to invest for the long-term – hence it is also known as "governance through exit". For example, Ford announced record profits in 2015 followed by its second-highest profits in 2016. However, the stock price fell 21% over those two years due to concerns that Ford was investing insufficiently in electric cars and autonomous driving systems, contributing to Mark Fields being fired as CEO in May 2017. *Ex ante*, knowing that investors will sell their stake if the company has not invested sufficiently – even if short-term earnings are high – encourages the CEO to invest in the first place.
3. An investor may also sell not due to any company mismanagement, but because it has completed a successful engagement and wishes to take its limited capital to turn around another company. For example, after turning around Adobe, investor ValueAct then sold its stake and invested in Seagate. Contrary to popular belief, activist investors do not "pump-and-dump", i.e. push for changes that boost short-term profits at the expense of long-term value, and cash out before the value destruction arises. Large scale evidence suggests that activism creates even more value in the long-term than the short-term.⁵ Indeed, Adobe's shares rose even further after ValueAct's exit.

The role of investor selling is one of the most fundamentally misunderstood aspects of corporate governance. It is often viewed as the antithesis of stewardship but can be a key stewardship mechanism. Many critics argue that selling is short-termist and thus propose mechanisms to lock investors in for the long-term, such as more voting rights, loyalty dividends, or lower capital gains tax for investors who hold their shares for longer. These proposals confuse the *holding period* of an investor with its *orientation*. The former is how long an investor holds shares before it sells. The latter is the basis – long-term value or short-term profits – that triggers an investor to sell.

⁵ Bebchuk, Lucian A., Alon Brav and Wei Jiang (2015): "The Long Term Effects of Hedge Fund Activism." *Columbia Law Review* 115, 1085-1155.

This mistake is made even by leading investors. Vanguard CEO Bill McNabb argued “*Our favourite holding period is forever. We’re going to hold your stock when you hit your quarterly earnings target. And we’ll hold it when you don’t. We’re going to hold your stock if we like you. And if we don’t. We’re going to hold your stock when everyone else is piling in. And when everyone else is running for the exits.*” Such a view is often heralded as being that of a patient investor. However, an investor who holds onto its shares for the long-term, regardless of how an enterprise is performing – whether it is creating value for society or exploiting it, or whether “we like you” or “we don’t” – should not be called a patient investor. It is an irresponsible investor who is failing to monitor the firm. Similarly, an investor should not automatically “hold your stock when you hit your quarterly earnings target”. It should investigate how it hit the target, and take action if the company did so by scrapping good investments.

Selling is thus not always bad (nor always good). Instead, what matters is the information that it is based on, which is what we mean by the investor’s *orientation*. If it sells based on short-term earnings, this is indeed damaging because the CEO then prioritises short-term earnings. However, if it sells based on long-term value, the CEO knows she will be held to account for long-term value. Indeed, Sir David Walker writes: “The second [misperception] is the notion that selling stock is evidence of short-termism... What matters is not whether an investor trades, but rather whether the trading decision is preceded by dialogue with the investee company relating to long-term strategic information or short-term information such as quarterly earnings updates.”⁶ This is why the stewardship mechanism of trading is also sometimes referred to as “monitoring”. An investor should monitor a stock in detail to decide whether to buy it in the first place, and after it has bought it, whether to hold onto it or sell it. Just as an investor should never buy a stock by default, because it is part of the index, it should never retain an existing holding by default, simply because it already owns it. It should constantly monitor whether the company is creating long-term value.

The criticism of selling is surprising because it is generally accepted that divestment is a legitimate governance mechanism. Investors sometimes have *generalised divestment* policies, which will involve selling a company (or not investing in it) due to the industry or country it is in, or another criterion that can be applied across all companies such as insufficient board diversity. However, there may be even greater need for investors to engage in *specialised divestment*, based on firm-specific factors such as a company’s contribution to society, intangible assets, and strategic direction. Customers can easily assess a firm’s industry or country and organise boycotts, but are less likely to be able to evaluate these deeper issues. So large investors have a particular role in such evaluations, given their access to management and financial incentives to monitor.

While “monitoring” is recognised as a stewardship mechanism, it is often seen as valuable only to guide an investor’s engagement decisions. Instead, monitoring plays a key role in ensuring that an investor does not engage in knee-jerk selling – but also that it does not engage in automatic retention simply because short-term earnings are high. It is crucially important to recognise this benefit of monitoring. If monitoring is seen only as a prelude to engagement, investors may only monitor in “intensive care” situations, where the company is underperforming and they are likely to take action. Instead, if investors accept that they should not retain an existing holding by default, then they will undertake monitoring routinely, as a matter of course. For example, the

⁶ Walker, David (2017): “Better shareholder stewardship is the key to greater productivity.” *The Telegraph*, October 27, 2017.

Investor Forum has recommended that companies hold Stewardship & Strategy Forums to discuss long-term issues with investors, and made a sample meeting agenda available on its website. While Rolls Royce held a successful one in 2016, uptake has been limited, potentially due to insufficient investor interest outside of “intensive care” situations. Emphasising the power of monitoring as a stewardship mechanism would encourage these regular dialogues between investors and companies about long-term issues.

However, it must be stressed that these regular dialogues are useful primarily for investors to understand the company, not to give investors regular opportunities to tell management what to do. As the Investment Association writes, “As shareholders they carry out an oversight role and focus on companies’ long-term strategy and performance *rather than micro-manage company executives*”⁷ (emphasis added.) Failing to recognise the role of monitoring in guiding trading may lead either to investors monitoring only in “intensive care” situations, or both monitoring and micro-managing regularly, distracting management from running the company.⁸

The Evidence for Monitoring/Trading as a Stewardship Mechanism

The criticism of short-term selling first appeared in the early 1990s when commentators advocated the Japanese model of long-term illiquid stakes. The underperformance of Japan over the intervening 25 years suggests that this model is not the panacea previously thought. While this underperformance may be for many reasons other than liquidity, there is evidence on the direct effect of liquidity on firm value. This evidence identifies causality by using the decimalization of the major U.S. stock exchanges in 2002 as an exogenous shock to liquidity. This led to prices being quoted in 1/100ths rather than 1/16ths of a dollar. For example, if a stock used to cost \$8 1/16 (= \$8.0625) to buy and \$8 to sell, post-decimalization it might cost \$8.01 to buy and \$8 to sell, significantly reducing the cost of trading. One study found that decimalization had a positive causal effect on firm value.⁹ A second found that this positive effect was particularly strong in firms with large blockholders and in firms where the manager’s wealth was particularly sensitive to the stock price (i.e. the manager was particularly sensitive to governance through exit).¹⁰ A third found that decimalization had a positive causal effect on block formation, and that

⁷ Investment Association (2018): “Stewardship In Practice.”

⁸ Overall, it is difficult to come up with a perfect name for this stewardship mechanism. The academic literature refers to it as exit and engagement as voice. Personally, I believe that these are very clear terms and would recommend them. (The genesis is Albert Hirschman’s famous “Exit, Voice, and Loyalty” book). However, some people misunderstand “exit” to mean that investors are always selling. They are only selling if the company is destroying long-run value; if it is not, they retain their stake even if short-term earnings are low. Another name is trading, which reflects the fact that investors might buy a stock with low short-term earnings, if the long-term outlook is good. This is also good terminology, but some incorrectly believe that trading is always bad and that investors should hold onto their shares forever. Informed trading highlights that trading should be informed rather than based on a knee-jerk reaction. Monitoring also conveys this, although could lead to confusion as monitoring could be seen as part of engagement. Asset allocation highlights that investors should think very carefully about what stocks to hold, although some interpret this as the choice between equities and bonds, or between different sectors, rather than individual stocks. Stock selection or security selection could be an alternative.

⁹ Fang, Vivian W., Thomas H. Noe, and Sheri Tice (2009): “Stock Market Liquidity and Firm Value.” *Journal of Financial Economics* 94, 150-169.

¹⁰ Bharath, Sreedhar T., Sudarshan Jayaraman, and Venky Nagar (2013): “Exit as Governance: An Empirical Analysis.” *Journal of Finance* 68, 2515-2547.

governance through exit improves firm value.¹¹ For further evidence, see the *Harvard Business Review* article “The Answer to Short-Termism Isn’t Asking Investors To Be Patient.”

Taking A Step Back: What Is Stewardship?

The failure to recognise monitoring as a stewardship mechanism may result from a deeper problem, which is a misunderstanding of what stewardship is and the role it plays in the economy and society. Stewardship is often thought of as an investor’s responsibility to the companies it invest in, and to ensure that they do not go bankrupt. For example, society has blamed corporate failures, such as the 2007 financial crisis, on investors failing to supervise companies closely enough.¹² However, this is not what stewardship should be. The Merriam Dictionary definition of stewardship is “the careful and responsible management of something entrusted to one’s care.” What is entrusted to an investor’s care is savers’ money. Investors’ primary responsibilities are to savers – their clients – not to companies.

This is not just a semantic point, nor one which is simply an unfortunate consequence of using the term “stewardship” that could be addressed by using a different term. Instead, it fundamentally results from investors’ fiduciary duty, which is towards their savers. Investors have no more a responsibility to companies than do customers or workers. Certainly, members of society should often do far more than their legal responsibilities, and in many cases investors do fulfil their responsibilities to savers by engaging with companies and, by doing so, improving long-term returns to savers – just as customers may provide feedback to companies on their products, and workers may make suggestions to management. However, when a customer or worker decides whether to make suggestions, they balance the benefit of doing so with the cost of their own time. If the customer or worker chooses not to do so – and indeed decides that the best option is to switch to another company – they are not being irresponsible. Similarly, an investor must balance the time and resources used to engage with a company with other ways it can serve its savers – including potentially divesting the holding.

Thus, company failures are not the responsibility of investors, just as they are not the responsibility of customers or workers (even when they have ownership rights). Customers were not to blame for the near-collapse of the Co-operative Bank, nor were workers to blame for John Lewis’s 99% fall in profits in the first half of 2018. *Company failures are the responsibility of the board and senior management, and any “stewardship responsibility” is that of the board.* It is convenient for regulators to blame corporate failures on investors’ failure to steward – and potentially for divesting (as investors did from Carillion, saving their clients millions of pounds) – but this is unwarranted.

¹¹ Edmans, Alex, Vivian W. Fang, and Emanuel Zur (2013): “The Effect of Liquidity On Governance.” *Review of Financial Studies* 26, 1443-1482.

¹² The 2009 Walker Review into the UK financial crisis concluded that “The atmosphere of at least acquiescence in high leverage on the part of shareholders will have exacerbated critical problems encountered in some instances. ... [E]ven major fund managers appear to have been slow to act where issues of concern were identified in banks in which they were investors, and of limited effectiveness in seeking to address them either individually or collaboratively.”

A second, related, misunderstanding is the view that good “stewardship” involves ensuring the company’s longevity. This may well be what management and regulators want, but it is not always what society wants. Within large companies, it is well accepted that the responsibility of management is to close down underperforming divisions and open new ones. Keeping an underperforming division alive has a substantial opportunity cost – it prevents a company’s financial, human, and physical resources being reallocated to new, faster-growing divisions. Similarly, keeping alive a company that is no longer serving the current needs of society has a substantial opportunity cost – it prevents society’s financial, human, and physical resources being relocated to new companies that are better placed to address society’s challenges and needs.

Society should have no problem with the decline of tobacco companies, coal companies, and even high-street retailers of books and music. Coal companies used to serve a social purpose, before greener sources of energy were found; high-street retail used to be the best way to sell books and music, before online platforms were established. Nowadays, society is best served with greener sources of energy, and using scarce high-street space to sell products that customers wish to try out first, or non-retail purposes (e.g. restaurants). By continuing past their sell-by-date, companies can destroy substantial value. Kodak wasted \$5 billion buying Sterling Drug, a pharmaceuticals company, attempting to stay alive by moving into an unrelated industry, after it started to fall behind in digital cameras.

Indeed, the emotive word “failure” is unhelpful as it suggests that it is something to be avoided. “Closure” is more accurate, just as a headquarters opens and closes new divisions or branches. (Of course, those making closure decisions should minimise the resulting losses, to the extent possible – for example, by reallocating workers to a different division or via outplacement and retraining.) Consider the following quote:

“The ruthlessness of venture capitalists in killing bad ideas ... is far more important to their success than the ability to identify diamonds in the rough. The arm’s length system plants a thousand flowers, uproots hundreds when they do not thrive, and nurtures only a few to bloom. New opportunities abound, while old, tired ways of doing business are ruthlessly eliminated. The system’s strength, then, is that it is not heavily biased towards preserving the privileges of incumbent firms and workers.”¹³

This quote may seem to be that of a ruthless capitalist, but is from Raghuraj Rajan, the former Governor of the Central Bank of India, in his book *Fault Lines*. This book finds fault in many aspects of the capitalist system – but allowing the closure of companies that no longer serve their purpose is not one. Another excellent treatment of the distinction between long-term survival and long-term value maximisation is legal scholar and practitioner J. B. Heaton’s “The Long-Term in Corporate Law.”¹⁴

Coming back to what this means for stewardship, investors are responsible neither to savers nor to society for preventing companies from closing. Divesting from companies that no longer serve their purpose, itself serves both savers and society. It is critical for regulators to recognise this and not argue that investors have the responsibility to ensure the long-term survival of companies, nor label every corporate closure as a failure of stewardship. This point also highlights the error

¹³ Rajan, Raghuram G. (2011): “Fault Lines: How Hidden Fractures Still Threaten the World Economy.” Princeton University Press.

¹⁴ Heaton, J.B. (2017): “The Long-Term in Corporate Law.” *The Business Lawyer* 72, 353-366.

in arguments that workers should have control of a company since they have interest in preserving its long-term future. This may be true, but such preservation is not always in society's interest.

A Framework

How can a framework help ensure that investors make their buy, hold and sell decisions based on long-term value rather than short-term earnings?

- It should recognise monitoring and trading as a critical stewardship mechanism. All of the language currently refers to engagement, without recognising the importance of carefully considering which companies to buy and sell. This decision in fact precedes engagement, because an investor cannot engage unless it holds a stake.
- An investor's stewardship policy should not only contain a policy of when and how to engage, but also a divestment policy describing what will cause it to sell a stock (e.g. the failure to invest in long-term intangible assets, or the failure to take action on climate change). Such a policy can be very powerful. The investor can then be held to account for only selling stocks in accordance with this policy, rather than because their earnings are low. Equally importantly, the investor can be held to account for ensuring that it does sell stocks in accordance with the policy (and if engagement fails to produce change) – rather than holding onto it because profits are high.
- The investor should then report on the extent to which it has fulfilled its divestment policy. In the Activities and Outcomes Report, it should discuss all major divestments and explain why they are in accordance with the policy. It could also consider discussing all major holdings and explain why it has continued to hold onto these positions (subject to doing so not giving away its investment philosophy to competitors).
- An investor must ensure that it has the resources and expertise to ensure that it is able to evaluate a company according to long-term factors. For example, for CEO pay, this means looking beyond a pay ratio and towards the extent to which CEO pay is linked to long-term value creation. Royal London Asset Management has an external advisory committee providing specialist expertise on these issues.
- An investor must ensure that it takes large stakes in the companies that it invests in. This will ensure that it has incentives to deeply understand a company and thus base future trading decisions on long-term value. Note that large stakes help enhance engagement as well as monitoring.
- The framework should recognise that measures such as “turnover” and “holding period” are nuanced. If it encourages asset owners to evaluate an asset manager according to these dimensions, it should not give the impression that high turnover and low holding periods are bad. What matters is the factors that lead to an investor selling. Low turnover and high holding periods can be bad if the investor is holding onto a stock regardless of whether it is creating long-term value for society.
- Similarly, the framework should be wary of terms such as “stewardship responsibilities”. Investors' stewardship responsibilities are to their clients, so more engagement and monitoring need not be better. Indeed, an investor that engages in neither engagement nor monitoring could still be said to be exercising good stewardship, if it has expertise in neither and its purpose is to provide savers with low-cost access to equity markets (without

which, they might put their money in bank accounts and not share in the wealth created by rising stock markets).

Q2. Are there any particular areas which you consider that investors' effective stewardship should focus on to help improve outcomes for the benefit of beneficiaries, the economy and society (eg ESG outcomes, innovative R&D, sustainability in operations, executive pay)?

I support the fact that the question highlights the importance of stewardship improving outcomes not only for the benefit of beneficiaries, but also society. However, there is a common belief that the best way to ensure that companies serve society is to split the pie differently – reduce investors' (and executives') slice so that a larger slice can be given to stakeholders.

Pie-Splitting



This explains some of the furore surrounding CEO pay and actions, such as share buybacks, that allegedly benefit investors at the expense of stakeholders. However, the best type of stewardship grows the pie, creating more value for both investors and stakeholders alike. High CEO pay need not take slices away from stakeholders, but may be a by-product of creating more value for society. Share buybacks may arise because a company has been successful, generated a lot of cash, taken all of its value-creating investments, and is now allowing its surplus capital to be deployed elsewhere in the economy.

Pie-Growing



Thus, stewardship should focus on pie-growing activities such as innovative R&D, investment in intangible assets (including stakeholder relationships), and ensuring that a company does not coast and stick with the status quo (as with Kodak). Reform of executive pay should not focus on pie-splitting (e.g. changing the pay ratio) but ensure that pay supports pie-growing, i.e. the executive is tied to long-run, sustainable value creation.

Q3. To what extent do the proposed key attributes capture what constitutes effective stewardship? Which attributes do you consider to be most important? Are there other attributes that we should consider? If so, please describe.

Similar to my response to Q1, these proposed key attributes do a reasonable job of capturing what constitutes effective engagement, but stewardship includes not only engagement but monitoring and trading. This is not recognised by Table 1. For example, point 2 mentions “active monitoring of assets” but only to guide “constructive dialogue with issuers.” Instead, active monitoring should be undertaken before an investor chooses to buy a stock. This will ensure that it is buying the stock either because it believes in its long-term strategy and purpose or believes that it can improve them, rather than by default because it is part of the index. After buying the stock, active monitoring ensures that the company does not sell the stock as a knee-jerk reaction to short-term earnings, nor retain the stock by default despite it destroying long-term value.

A potential addition is as follows:

Key attribute	Example activities/behaviours
<p>Trading and retention decisions that are based on detailed analysis</p> <p>Detailed analysis of a company’s long-term strategy, purpose, and value creation, and ensuring that the outcome of this analysis guides the decision of whether to buy, hold, or sell a stock</p>	<p>Asset managers’ stewardship policy contains a statement of their divestment policy – the criteria that will lead to it selling a stock.</p> <p>Asset managers ensure that major disposals are only taken in accordance with this divestment policy, rather than (for example) due to low short-term earnings. They also ensure that they engage and, if necessary, divest, if the criteria are satisfied.</p> <p>Asset owners’ stewardship policy contains a statement of the factors that may cause them to terminate a mandate, and what will not (e.g. poor short-term performance). Asset owners provide regular feedback to asset managers on these factors, and ensure that mandates are only terminated on the basis of these factors and if the asset manager has failed to respond to feedback.</p>

Q5. We welcome examples of how firms with different objectives and investment strategies approach stewardship. In particular, we welcome input on how stewardship practices differ across active and index-tracker funds, in the following areas: ii: what investments firms have made in stewardship resources

As mentioned in my answer to Q1, a very important aspect of stewardship is deciding whether an investor should buy a company, and whether it should subsequently divest it. These decisions are very difficult because most companies perform well on some dimensions and not others. For example, reasonable people may disagree as to whether Amazon creates value for society – it has a poor record for treating workers, but provides customers access to a wide range of products at low prices and allows used products to be sold second-hand rather than dumped. A box-ticking approach will lead to a company being screened out for not ticking the box on a particular dimension even if it outperforms on many others.

Royal London Asset Management has a Responsible Investment Advisory Committee (which I serve on) to provide external expertise for its five sustainable funds. The committee not only evaluates individual stocks, but also provides general stewardship advice such as which environmental issues to engage on or choose stocks on the basis of (based on science and asset owner demand), and how best to reform executive pay. These are specialist issues and external expertise is valuable.

An external committee is particularly important for “responsible investors” because it is almost always possible to justify a company as being responsible after the fact – even if the company was chosen due to its short-term profit potential. Since a company is rarely irresponsible on every dimension, one can pick the stakeholder issue on which it performs best and argue that it is responsible on this basis. This is an example of confirmation bias – having a viewpoint and then searching for evidence to support that viewpoint. An external view is useful to challenge such confirmation bias.

Q8. To what extent are there are issues with proxy advisers that are not adequately addressed by SRD II? What measures would be an effective and proportionate response to any remaining issues?

This response refers to two suggestions from Section 5 of “Thoughts for Change from the Steering Group of The Purposeful Company”.

First, advisers should avoid making recommendations based on strategic judgements that are properly the responsibility of their clients. Proxy advisers can usefully process information for clients in a way that adds to efficiency of stewardship. However, as emphasised in the BPP, the ultimate responsibility for voting judgements must remain with clients. If proxy advisers stray into making recommendations based on areas of strategic judgement, then this may result in investors out-sourcing judgement. In such cases they could highlight voting items as “For Strategic Judgement”.

Second, proxy agencies should subject screening methodologies to appropriate external review (for example by leading academics or other experts in the field) to ensure that they are robust in the context of available evidence. Otherwise, faulty screening methodologies may give rise to ineffective stewardship. An example is ISS’s pay-for-performance methodology, which is quite at odds in certain respects with well-established research methodologies. For example, when calculating CEO incentives, it ignores the incentives provided by existing shareholdings which are typically the main source of incentives. It also fails to adjust for size. Small companies typically pay their CEOs less, and also typically outperform large firms, so the lack of size adjustment leads to a negative relationship between pay and performance.¹⁵

¹⁵ For further detail, see Gosling, Tom (2017): “Shareholding Provides the Key for Linking Pay to Performance.” *LinkedIn Pulse*, October 24, 2017.

Appendix: Section 3 of “Thoughts for Change from the Steering Group of The Purposeful Company”

The Code should seek to promote approaches to investment that improve the long-term value of investee companies. Extensive evidence exists on how stewardship creates such value.

Stewardship may be “generalised”, applied on a standardised basis across companies, for example, such as engagement on ESG issues. Standardisation makes generalised stewardship relatively low-cost to implement. The risk is that it is subject to one-size-fits-all approaches and out-sourcing to proxy voting agencies or ESG index providers. As such, they can be a blunt instrument and not optimised to individual company circumstances. Indeed, this is one of the frustrations companies experience when faced with market-wide generalised approaches to stewardship. Alternatively, stewardship may be “specialised”, involving company-specific analysis or engagement.

Both generalised and specialised stewardship may be undertaken via engagement/voice, or monitoring/trading - the sale, threat of sale, or additional purchases. (Note that governance through “trading” is often referred to as governance through “exit”; we use “trading” here since it can involve buying as well as selling securities). The two mechanisms may be particularly powerful if used in tandem: the power of voice is enhanced by the threat of exit.

A brief summary of the evidence for the value of stewardship is as follows. The first three points focus more on generalised stewardship, the last three on specialised stewardship:

- Market-wide improvements in generalised stewardship, such as the passage of say-on-pay laws, laws that strengthen governance (such as Sarbanes-Oxley), and the implementation of superior governance practices by index funds, improves firm value and profitability.¹⁶
- Along the cross-section, firms with strong corporate governance - in particular, strong shareholder rights - outperform their peers.¹⁷
- Over the time series, improvements in corporate governance (such as strengthening shareholder rights and implementing long-term compensation) have a positive causal effect on long-term stock returns and profitability.¹⁸
- Blockholders are positively correlated with a number of measures of firm value, profitability, and investment, attributed to the role they play in specialised stewardship of those companies. In addition, trades of blocks between investors lead to significant

¹⁶ Correa, Ricardo and Ugur Lel (2016): ‘Say on Pay Laws, Executive Compensation, Pay Slice, and Firm Valuation Around the World’, *Journal of Financial Economics*; Chhaochharia, Vidhi and Yaniv Grinstein (2007): ‘Corporate Governance and Firm Value: The Impact of the 2002 Governance Rules’, *Journal of Finance*; Appel, Ian, Todd Gormley, and Donald Keim (2016): ‘Passive Investors, Not Passive Owners’, *Journal of Financial Economics*.

¹⁷ Gompers, Paul, Joy Ishii, and Andrew Metrick (2003): ‘Corporate Governance and Equity Prices’, *Quarterly Journal of Economics*; Masulis, Ronald, Cong Wang, and Fei Xie (2007): ‘Corporate Governance and Acquirer Returns’, *Journal of Finance*; Giroud, Xavier and Holger Mueller (2011): ‘Corporate Governance, Product Market Competition, and Equity Prices’, *Journal of Finance*; Bebhuk, Lucian, Alma Cohen, and Charles Wang (2013): ‘Learning and the Disappearing Association Between Governance and Returns’, *Journal of Financial Economics*. The final paper shows that corporate governance continued to be significantly correlated with firm value and operating performance in the 2000s, but the relationship with stock returns disappeared because investors now understand the value of governance and it became priced in.

¹⁸ Cuñat, Vicente, Mireia Gine, and Maria Guadalupe (2012): ‘The Vote is Cast: The Effect of Corporate Governance on Shareholder Value’, *Journal of Finance*; Flammer, Caroline and Pratima Bansal (2017): ‘Does a Long-Term Orientation Create Value? Evidence From a Regression Discontinuity’, *Strategic Management Journal*.

increases in value, consistent with stewardship by the right blockholder (e.g. with expertise in the firm's industry) adding value.¹⁹

- Engagement by activist investors improves firm value, productivity, and innovation, demonstrating the value of governance through voice. In addition, the presence of a large investor is associated with improved firm value and profitability, even if is not exercising control – consistent with governance through trading. Relatedly, mutual funds earn higher returns when they trade more, contrary to views that high turnover is an undesirable characteristic of a fund.²⁰
- The evidence on governance through voice by other categories of investor is more mixed, and inconclusive as to whether widespread engagement of this type is effective. It may simply be that others investors' expertise does not lie in engagement, and so forcing all investors to engage may lead to unintended consequences (e.g. outsourcing to proxy agencies). Moreover, even for activist investors with expertise in engagement, the firm value improvement is higher when such engagement achieves a concrete outcome (such as a leadership change, change in strategy and so on) rather than less intentional engagement.

This evidence suggests that both engagement/voice and monitoring/trading, if used correctly, can significantly improve long-term firm value. In particular, blockholders, due to their large stakes, have incentives to bear the costs of engagement (overcoming the free-rider problem), and also gather information about a firm's long-term value to guide their trading decisions. Since UK shareholder structure is fragmented, methods for mimicking blockholders, perhaps through emphasising collective engagement, should be given high priority.

The research evidence gives rise to some important conclusions for the types of stewardship that should be promoted.

- Even if a blunt instrument, generalised stewardship that improves overall governance standards in the market is generally positive for value.
- Strong engagement by activist investors – often maligned for being short-term – can create beneficial long-term results.
- Blockholders help support firm value and profitability, suggesting that collective engagement mechanisms can be an important area of focus.
- Investors monitoring companies for long-term value considerations and providing discipline through exit (or threat of exit) and purchase (or prospect of purchase) are powerful instruments of good stewardship.
- However, there is little evidence that mere engagement 'activity' creates value, particularly if it is not intentional or if it is undertaken by investors who have little skin-in-the game or expertise in engagement.²¹

¹⁹ See Edmans, Alex and Clifford Holderness (2017): 'Blockholders: A Survey of Theory and Evidence', *Handbook of the Economics of Corporate Governance* for a summary of the evidence.

²⁰ Pastor, Lubos, Robert Stambaugh and Lucian Taylor (2017): 'Do Funds Make More When They Trade More', *Journal of Finance*.

²¹ Del Guercio, Diane and Jennifer Hawkins (1999): 'The Motivation and Impact of Pension Fund Activism', *Journal of Financial Economics*. Yermack, David (2010): 'Shareholder Voting and Corporate Governance', *Annual Review of Financial Economics*.

These results should not be surprising. Higher levels of engagement between investors and companies will not produce results unless it is coherent, intentional, and based on long-term value considerations. Stewardship should not be gauged by simple metrics that reward mere engagement activity, such as the number of meetings or voting levels (worse still, ‘vote against’ levels), but instead intentional, and often collective, stewardship based on long-term factors. Moreover, the relevant metrics will differ across investors, depending on their stewardship expertise, and a high level of a given metric could constitute good stewardship for one investor and poor stewardship for another.

It should be noted that this is not entirely aligned with what companies themselves consider to be good stewardship, and here there may be an expectations gap to be bridged. Some companies may view good stewardship as agreeing with its strategy, and a dissenting investor as one who has not taken the time to understand its strategy. However, an investor may have engaged extensively with a company and simply agrees to disagree. High-quality stewardship will usually involve engagement with companies, but may not involve engagement on every issue the company wants to discuss, still less agreement. Indeed, the evidence is that confrontational activism – which is typically not welcomed by companies – creates long-run value. Discussions with companies and investors suggests the need for improved dialogue between corporates and investors to move to a set of realistic and productive shared expectations for stewardship.

While stewardship is often equated with engagement, the evidence highlights that monitoring/trading can also play a significant role in improving a firm’s long-run value. For example, an investor who bases her investment decisions on a firm’s long-term value rather than short-term earnings, and is willing to sell her stake (or not invest in) a company that is currently profitable, but has a poor long-term outlook due to short-termism, encourages companies to focus more on the long-term. Indeed, investors with concentrated portfolios devote substantial resources to deciding which firms to hold and which to avoid, and this in turn encourages companies to take actions to attract a given shareholder base. Indeed, having attracted the ‘right’ shareholder base is believed to be a key reason why Unilever was able to fend off Kraft’s takeover approach in 2017.

In this context, the emphasis that most codes have stewardship through engagement, or engagement through voting, may be misguided. Investors will often have an area of specialism that would emphasise one dimension over another, and this should be recognised in the Code. The danger of applying blanket expectations is that investors will act in areas where they do not have expertise, or perhaps worse, outsource to proxy voting agencies. For example, a requirement for all investors to exercise their votes on all resolutions would almost certainly have the end result of increasing the influence of proxy voting agencies. The Code must acknowledge the different types of stewardship that can be undertaken.