Everything you need to know about the FRC Stewardship Code 2019 update

In October 2019, the Financial Reporting Council (FRC) published its long awaited update to the UK Stewardship Code. The new Code applies from 1 January 2020.

In this paper, we look at key changes to the code and provide insights for audit leaders across all sectors to consider.

Summary of changes

The 2019 update is a "substantial and ambitious revision" according to the FRC. It integrates expectations for stewardship and investment with a strong focus on activities and outcomes rather than policy statements.

The Code is primarily aimed at institutional investors and sets out principles of good practice for engaging with the companies in which they invest to deliver sustainable value for investors, the economy and society as a whole.

Although it reads very much as a financial services Code it is important and applicable for all sectors.

It is a "comply or explain" addition to the regulatory baseline for stewardship implemented by the Shareholder Rights Directive II and is intended to drive behaviours to exceed minimum standards.

A major update to the previous 2012 version, the Code:

- Focuses on principles
- Emphasises that stewardship is about sustainable value
- Take a holistic approach to the investment community
- Clearly separates expectations for asset owners/managers and service providers
- Reinforces the importance of ongoing engagement
- Increases transparency
- Heightens environmental, social and governance issues, including climate change
- Navigates easily
- Fortifies reporting requirements.

According to Business secretary, Andrea Leadsom: “this Code is an important piece of work by the Financial Reporting Council under its new leadership. It recognises the essential role of effective stewardship in supporting stronger corporate governance, diversity and social environmental priorities. I urge asset managers and owners to lead by example and sign up.”

Drivers of change

A succession of corporate failures and scandals has led to a major shake-up of corporate governance including the 2018 UK Corporate Governance Code and Guidance on Board Effectiveness, the Kingman and Brydon reviews and the succession of the FRC by a new Audit, Reporting and Governance Authority (ARGA). The new Stewardship Code addresses the latest thinking and recommendations to date.

In our information age people have much greater expectations of business and government than in previous decades. Shareholders, including savers and pensioners understand the consequences of investment decisions and have a voice; particularly on contentious issues such as climate change or executive pay.

A key aspect of the new Code is the requirement for fund managers to explain how they have aligned their voting policies with the views of their clients. This is a major challenge given the potential range of views.

Could your future AGMs be more controversial than usual?

Will your stakeholders start demanding that your organisations voice is heard?

Impact for internal audit in different sectors

Listed companies

The Code has always encouraged active investor engagement in listed companies. It is not a new concept, however, the profile of stewardship has increased significantly and with it the expectations of paying more than lip-service to the Code.

Audit leaders in listed companies should expect their board of directors to be engaging with investors on traditional topics such as strategy, performance, risk and corporate governance but also environmental, social and governance issues, including climate change. It is possible that directors will be challenged and held to account more in the future than has previously been experienced.

What processes does your organisation have in place to manage this?

How is information approved for external communications?

Has the board and senior management received public relations training?

The climate crisis and environmental issues are particularly high profile. Is this something your organisation is effectively managing to remain a viable option for investors?

What about other issues such as human rights, bribery and corruption, gender pay, diversity, animal welfare, poverty…the list is endless. The question is knowing what matters to your investors to ensure your organisation remains an attractive investment. Whatever the issues are, shouldn't they feature in your audit planning process to understand what assurance the board receives, needs and the role of internal audit?

Organisations with investment portfolios

Across all sectors, organisations with cash seek to invest their funds to maximise returns often using third party services to manage assets (shares). In addition to the risk of loss from counterparty risk, this exposes an organisation to reputational risk. It may be financially astute to invest in company X as it promises high returns for low risk, however if they engage in unethical, unsustainable or even unlawful practices not only could this increase reputational risk through association but it goes against the ethos of good stewardship.

The new Code raises expectations and organisations should not expect their service provider (fund manager) to be a buffer between investment decisions and negative reputational consequences.

Investors are accountable for their investment decisions; including how they exercise voting rights.

What is your organisation's investment strategy?

How robust are the communications between your organisation and its investment partners?

How will your organisation ensure fund managers vote according to your own corporate values?

Does your organisation understand its stewardship obligations?

Pension schemes

The collapse of retailer BHS in 2016 led to one of the biggest pension scandals in recent history. It highlighted the fragility of the relationship between pension fund managers and the employee.

The new Code requires internally managed funds to be subject to the same rigour as asset owners and managers. It is a significant increase in accountability and reporting requirements.

What are the arrangements for your organisation's pension schemes?

How robust are the communications between pension trustees, advisors and investment teams (either in-house or third party)?

Do you know who your Pension Regulator contact is?

Some companies employ their own specialists to manage an investment portfolio rather than use fund managers. This makes it much more straightforward to ensure that the organisations values are at the forefront of decision making.

How important is reputation to your organisation?

Should your organisation consider taking ownership of investment decisions in house?

Reporting requirement

The word onerous often rears its head when new reporting requirements are introduced and rarely is the news welcomed behind the closed doors of any organisation.

Reporting only applies to a limited set of stakeholders; asset owners, asset managers and service providers.

Relevant institutions have previously been required to produce a statement of commitment which was then assessed by the FRC. This has been replaced by an annual Stewardship Report which will enable institutions to become signatories to the Code.

Should your organisation only engage with those institutions that are signatories?

How will you ensure your treasury function pays due attention to the quality of reporting by the asset managers it engages with?

Asset ownership and management is a specialist area but one that is now centre stage as it is a key aspect of sustainability, geopolitics, conflict, organised crime and society. Talk to the treasury director if you are uncertain. It is better to ask if you are unsure of its impact than for the board to be lacking in assurance that it didn't know it needed, or for internal audit to provide misleading false assurance because of the lack of understanding.

Closing thoughts

The 2019 Stewardship Code presents an opportunity for audit leaders to engage with governance and risk leaders to continue the journey of improving the organisation's governance, risk management and internal controls to help the board and executive management to protect the assets, reputation and sustainability of the organisation.

Are you taking the opportunity?

"We are looking for widespread adoption by the investment community, reinforcing the attractiveness of the UK as a place to do business and delivering real benefits to the economy, the environment and society more broadly."

Simon Dingemans, FRC Chair