

ClientEarth response to Consultation on Proposed Revisions to the UK Stewardship Code

1 Introduction

ClientEarth is a non-profit environmental law organisation based in London, Brussels, Berlin, Warsaw, Madrid, New York and Beijing. ClientEarth's Climate Finance initiative conducts research and advocacy in relation to the legal implications of climate change-related risks for a wide spectrum of market participants, including companies, investors, company directors, their professional advisers and regulators.

In January 2019, the Financial Reporting Council (**FRC**) published a consultation (the **Consultation**) proposing revisions to the UK Stewardship Code (the **Code**). On 11 March 2019, the Secretary of State for Business, Energy and Industrial Strategy announced the Government's intention to replace the FRC with a new regulator called the Audit, Reporting and Governance Authority (**ARGA**). For the purposes of the Consultation, we will continue to refer to the FRC as the body overseeing the Code. This document provides ClientEarth's responses to the questions raised in the Consultation.

Please do not hesitate to contact Joanne Etherton, Climate Finance Project Lead, (jetherton@clientearth.org) for further information on anything contained in this response.

2 Key messages

We are very supportive of the proposed changes to the Code and the direction of travel represented. The expectation of investors to engage with the companies they invest in has developed substantially since the Code was first established in 2010. It is now widely recognised that stewardship and engagement by investors can play an important role in enhancing the value of investments for ultimate beneficiaries. In our view, stewardship is also relevant to the proper discharge of investors' fiduciary duties.

Recognition of the short-termism that has been 'baked' into the financial system has led to increased regulatory focus on setting appropriate investment time horizons and using these to set investment policy and valuation. See, for example, the Kay review in 2012, recent DWP changes to UK pensions law and the EU's legislative proposals as part of the Sustainable Finance Action Plan.

This focus is particularly relevant for long-term institutional investors such as pension funds. Legal duties on pension trustees to act in the best interests of beneficiaries require them to safeguard long-term value and we think the definition of stewardship used in the Code better recognises these duties. The definition also recognises the interconnectedness of creating 'sustainable value' for beneficiaries as well as for 'the economy and society'. We strongly support the new definition with its emphasis on the role of stewardship in addressing systemic

economic risks. The first iteration of the Code was a response to systemic issues in financial markets in 2008 and the role of investors in driving corporate strategy and governance to mitigate other systemic financial issues, notably climate change, is an important one today.

3 Responses to questions

Q1. Do the proposed Sections cover the core areas of stewardship responsibility? Please indicate what, if any, core stewardship responsibilities should be added or strengthened in the proposed Principles and Provisions.

We welcome the distinctions drawn between asset owners, asset managers and service providers; the requirement for signatories to consider stewardship beyond equities; and the explicit reference to ESG factors in the Code.

Subject to the concerns highlighted below, we consider that the Sections cover the core areas of stewardship. Our overarching concerns relating to the need for greater emphasis on signatories' legal duties and systemic risk to support the broad definition of "stewardship" are set out below, followed by suggestions for improvements of specific Principles and Provisions.

Definition of stewardship

We strongly support the formulation of "stewardship" as the "responsible allocation and management of capital across the institutional investment community to create sustainable value for beneficiaries, the economy and society." While we anticipate that some in the investment community may not support the explicit inclusion of "the economy" and "society" alongside beneficiaries, we think this is an important aspect of the formulation of stewardship. This is because of the role stewardship has to play in the management of systemic risks to the economy (and therefore to beneficiaries' investments).

It is our view that any concerns that market participants might have around the breadth of this definition should be allayed by placing greater emphasis within the Code on signatories' duties to beneficiaries including, in particular, their duties to manage systemic risk.

Signatories' duties

The Code should make clear that most signatories will have statutory and common law duties to act in the best interests of their beneficiaries or clients, to say nothing of any contractual duties that may exist. There should be no doubt that these duties necessarily extend to undertaking or advising on stewardship activities as formulated in the new Code.

While stewardship will most often be framed in terms of what is financially material (including in relation to ESG considerations), it is important to note that fiduciaries' duties support wider consideration of beneficiaries' interests. Though many in the financial world appear to believe that, in an investment context, acting in the "best interests" equates to maximising financial returns, this is clearly not the legal position¹. Rather, those in the investment chain should use

¹ See The Law Commission, 'Fiduciary Duties of Investment Intermediaries' (2014) at paragraph 5.52, Freshfields Bruckhaus Deringer, A legal framework for the integration of environmental, social and governance issues into institutional investment (2005) p 89

all available tools, including stewardship, to manage risks and return. Where risks are systemic, stewardship is particularly important.

Arguably, the duties of those who invest on behalf of others go much further. While the Law Commission concluded in 2014 that, at that time, there was “no duty on pension trustees or other investors to undertake stewardship activities”, much has changed since that conclusion was reached. Amendments to the Occupational Pension Schemes (Investment) Regulations 2005 (the **Investment Regulations**) mean that SIPs must be updated before October this year to include trustees’ policies in relation to undertaking engagement activities. Industry understanding and practice has also evolved considerably.

At the very least, trustees must now formulate their policies on stewardship and engagement, which should include their role in managing risk and return. However, our view is that, where engagement can improve outcomes for beneficiaries, fiduciaries have a duty to undertake (or delegate) the exercise of stewardship activities in the best interests of beneficiaries. There can be no doubt that this applies to outcomes which are financial in nature. We would also argue that the duty should apply in relation “quality of life” outcomes, which may not be purely financial in nature but may include factors such as the physical impacts of climate change.

Systemic risk

As the ICGN² highlights, the production of investment returns to meet liability obligations, within a prudent level of risk, is the core obligation of investor fiduciaries, and it follows that consideration of systemic risk is embedded in fiduciary duty. Mitigating any potential effects to investments from systemic risk should be considered as part of that duty.

Climate change is an example of a systemic, macroeconomic risk that cannot be managed through portfolio construction or asset allocation alone³. Because unmitigated climate change will result in losses throughout the economy, across asset classes and sectors, beneficiaries’ interests will clearly best be met (and therefore fiduciaries’ duties best discharged) through efforts to ensure that warming is kept to a minimum. This should be seen as nothing more than effective risk management by fiduciaries in which stewardship has a clear role to play exerting pressure both on investee companies and on government and policy makers with the aim that losses associated with the worst excesses of climate change do not materialise.

The concept of “universal ownership” is relevant here: large institutional investors have an interest in the wellbeing of the economy as a whole (as a result of their highly diversified portfolios and long term investment). It is therefore in beneficiaries’ (and the economy’s) interests for such “universal owners” to adopt a system-level perspective and act collectively to influence company strategy and government policy to reduce financial risk from systemic impacts such as climate change⁴.

The relegation of systemic risk to the Guidance to Provision 2 significantly underplays its importance. Management of systemic risk should, at a minimum, be included as a Principle.

² ICGN, ‘Guidance on Investor Fiduciary Duties’ (2018), p12

³ See CISL, ‘Unhedgeable risk: How climate change sentiment impacts investment’ (2015), Mercer, ‘Investing in a time of climate change’ (2015)

⁴ On the concept of universal ownership and implications for modern portfolio theory, see: Jim Hawley and Jon Lukomnik, ‘The third, systems stage of corporate governance: Why institutional investors need to move beyond modern portfolio theory’ (2018); Thamotheram, R. and Wildsmith, H. ‘Increasing Long-Term Market Returns: Realizing the Potential of Collective Pension Fund Action’, Corporate Governance: An International Review (2007); UNEP FI, ‘Universal Ownership, ‘Why environmental externalities matter to institutional investors’ (2011)

Better still, its importance should be reflected throughout the Code. This would also reflect high prominence given to this issue in the ICGN's recent publication on fiduciary duty⁵ and ICGN Stewardship Principle 6.3.

Comments on specific Principles and Provisions

Our view is that the Code should contain more specific references to climate change. While we welcome the explicit reference to climate change in Principle E (which reflects the DWP's emphasis in its amended investment regulations), it would be helpful for further explanation to be given in the provisions. In particular, a reference to the TCFD recommendations would be of value.

We believe that disclosure of engagement policies and escalation strategies by signatories is an important aspect of effective stewardship. This should be reflected in the Principles in Section 4, which we suggest means that Principle I should be replaced with Provision 17. Principle I should be included as a Provision with the following additions (in bold), "Signatories must communicate clearly **their engagement and escalation policies** with clients and beneficiaries."

The Code should also require signatories to describe their escalation strategy, where a company does not respond to their concerns over time. For example, Provision 19 could be strengthened to read (changes in bold) "Signatories should describe what methods they use for engagement, **including escalation strategies**, to enhance the value of assets".

Q2. Do the Principles set sufficiently high expectations of effective stewardship for all signatories to the Code?

While we are very supportive of the revised Code and think it has the potential to greatly improve standards of stewardship by UK asset owners, asset managers and service providers, we do believe that more could be done to encourage the use of stewardship as a tool for preserving value across the economy. An important aspect of embedding the expectations set out in the Code throughout the UK financial market is a rigorous enforcement approach (see our response to Q5 below).

Q3. Do you support 'apply and explain' for the Principles and 'comply or explain' for the Provisions?

We are supportive of the new requirement for Principles to be followed on an "apply and explain" basis, provided sufficient measures are taken to prevent the adoption of boilerplate language by signatories.

We recognise that not all of the Provisions are relevant to each signatory so it is appropriate that these are implemented on a "comply or explain" basis, provided that decisions not to comply are thoroughly explained in reporting mechanisms and subject to regular review and challenge, where appropriate.

⁵ ICGN, 'Guidance on Investor Fiduciary Duties' (2018), p11

However, our view is that the most effective way to ensure that meaningful stewardship is carried out throughout the investment chain is to make it mandatory. A proportionate approach to mandation could help to reinforce the expectation that stewardship of assets is now required rather than best practice.

Q4. How could the Guidance best support the Principles and Provisions? What else should be included?

Consistency of language across the Principles, Provisions and Guidance will assist signatories with complying with the Code. For example, as currently drafted, material ESG factors are referred to in several parts of the Code but different examples specifically drawn out to indicate what ESG means ('climate change' in Principle E and 'culture, remuneration and diversity' in Guidance notes 14 and 18). We are very supportive of the specific inclusion of climate change in a Principle, as this is a cross-cutting issue and has been recognised as such in the amended Investment Regulations (see our response to Q1 above). However, to avoid confusion as to what is covered by the term ESG and to demonstrate the breadth of issues that may be included it may be helpful to include an explanation of ESG in the introduction to the Code, providing a range of examples, which should include climate change as a cross-cutting systemic issue.

Less substantive but still important is the layout of the Guidance. In our view, the Guidance would be easier to read and assimilate with the corresponding Principles and Provisions if they were published together, as one section. In recognition that many regular users of the Code will refer to an online version, we would suggest using the FCA Handbook as a template as this makes good use of pop-out boxes for definitions and cross-references to other relevant rules.

Q5. Do you support the proposed approach to introduce an annual Activities and Outcomes Report? If so, what should signatories be expected to include in the report to enable the FRC to identify stewardship effectiveness?

We support a much greater emphasis on demonstrating how signatories have complied with the Code, however more detail on the expected content of the activities and outcomes report and the consequences for poor reporting would be helpful.

As well as providing a source of information to clients and beneficiaries, reporting should be subject to a degree of oversight from the FRC. More careful oversight would help to ensure that 'boilerplate' reporting does not develop and that explanations of non-compliance with Provisions can be challenged and interrogated appropriately. In order for this oversight to be effective, it will be necessary for the FRC to have additional powers of enforcement, beyond the ability to suspend or remove signatories.

The Consultation refers to a scoring system which would involve the FRC evaluating reports and then communicating an overall score. It is not clear whether this score would be made public or whether only the associated tiering system would be published. We are not convinced that scores or tiering are the best ways to ensure that signatories fulfil their fiduciary or other duties to engage in stewardship activities. Scoring can reinforce 'herd' mentality

whereby signatories simply aim to be neither the best nor the worst performers. It could also undermine efforts to communicate stewardship as a duty, rather than merely voluntary best practice.

We would support the provision of some guidance to investors on what form the activities and outcomes report should take. Whilst conscious of the desire to avoid too much conformity in reporting, we feel that it would be useful to the clients and beneficiaries using the information in the reports to have some consistency in the level of reporting undertaken.

Q6. Do you agree with the proposed schedule for implementation of the 2019 Code and requirements to provide a Policy and Practice Statement, and an annual Activities and Outcomes Report?

Yes – the new Code should be implemented as soon as practicable and should complement other recent changes for institutional investors, e.g. the requirement for occupational pension schemes to include a policy on stewardship in their SIPs from October 2019.

Q7. Do the proposed revisions to the Code and reporting requirements address the Kingman Review recommendations? Does the FRC require further powers to make the Code effective and, if so, what should those be?

The Government's intention to put in place ARGAs as a statutory authority with stronger powers will allow it to better address the concerns expressed in the Kingman Review. We share the concern that boilerplate disclosure does not equate with effective stewardship. In our view, stronger enforcement powers would enable the FRC/ ARGAs to ensure that the Code is viewed as a meaningful set of rules. In our view, this would also require the Code to become compulsory rather than a voluntary standard which relies on market expectations.

Q8. Do you agree that signatories should be required to disclose their organisational purpose, values, strategy and culture?

Establishing and disclosing information on a signatory's organisational purpose, values strategy and culture would be valuable for two reasons.

Firstly, this information would be useful for asset owners in understanding which asset managers and service providers would be best placed to understand and effectively implement their own investment mandates. Asset owners such as pension funds are increasingly putting in place investment beliefs, which set out their overarching strategic aims and approach. Without comparable qualitative information from other types of signatories it may be hard for asset owners to differentiate which asset managers and service providers share their approach.

Secondly, if they are not already in place, establishing organisational purpose and values will engage senior members of the organisation who sit outside responsible investment or stewardship teams. This is important as it promotes a sense of organisational purpose

throughout the business and increases the likelihood that core business decisions on issues such as remuneration and strategy will be linked to the agreed values.

Q9. The draft 2019 Code incorporates stewardship beyond listed equity. Should the Provisions and Guidance be further expanded to better reflect other asset classes? If so, please indicate how?

We are very supportive of the expansion of the Code to recognise that stewardship is relevant across a range of asset classes. In our engagement with asset owners we often encounter the misconception that stewardship is only relevant to those whose portfolios consist predominantly of actively managed equity investments. We think it is absolutely right that the Code set out the expectation that engagement should begin from the principle of the allocation and management of capital, as this recognises the varying forms in which companies, both private and public, secure financing from investors.

We also recognise that the Code should be a flexible and not overly prescriptive set of rules and that the types of assets invested in and the ways in which stewardship applies to these assets may develop over time. We therefore think that it would be useful to signatories to include examples of ways in which they could effectively steward different asset classes but that the primary means of understanding whether the activities undertaken have been effective will be through the activities and outcomes report.

Q10. Does the proposed Provision 1 provide sufficient transparency to clients and beneficiaries as to how stewardship practices may differ across funds? Should signatories be expected to list the extent to which the stewardship approach applies against all funds?

We do not propose to answer this question.

Q11. Is it appropriate to ask asset owners and asset managers to disclose their investment beliefs? Will this provide meaningful insight to beneficiaries, clients or prospective clients?

We think it is appropriate for asset owners and asset managers to disclose their investment beliefs, where these have been established. In our experience, many pension schemes already disclose their investment beliefs and these do provide meaningful insight to beneficiaries who are interested in understanding the strategic focus of the trustees.

Developing and disclosing investment beliefs is likely to be less familiar to asset managers, who may be more accustomed to thinking in terms of individual funds or mandates. However, we think that developing investment beliefs, even if at a relatively high level, will allow asset managers to align their core investment strategy and culture with those of their clients. As well as assisting clients choose an appropriate manager who will understand their approach to investing, the disclosure of investment beliefs at different points of the investment chain may help to promote understanding of new approaches to investment and drive innovation in providing suitable products and services across financial markets.

Q12. Does Section 3 set a sufficiently high expectation on signatories to monitor the agents that operate on their behalf?

As set out in our response to Q1, we believe that, as a general rule, asset owners have legal duties to protect and enhance the value of investments for beneficiaries and to act in their best interests, and that effective stewardship is part of how these duties are discharged. These core duties cannot simply be delegated to service providers.

In order to ensure that Section 3 represents a sufficient level of expectation for signatories, we believe it is critical that the meaning of ‘active monitoring’ is robustly assessed through the activities and outcomes report.

Q13. Do you support the Code’s use of ‘collaborative engagement’ rather than the term ‘collective engagement’? If not, please explain your reasons.

Yes, we support the intentional focus on the range of ways in which investors can use their influence as asset owners and that this may involve working with a range of different stakeholders. A focus on collaborative engagement may be particularly helpful in encouraging asset owners with small exposures to companies and smaller asset managers to consider that they still have a role to play in influencing companies’ strategies and business practises.

Q14. Should there be a mechanism for investors to escalate concerns about an investee company in confidence? What might the benefits be?

We do not propose to answer this question.

Q15. Should Section 5 be more specific about how signatories may demonstrate effective stewardship in asset classes other than listed equity?

See response to Q9 above.

Q16. Do the Service Provider Principles and Provisions set sufficiently high expectations of practice and reporting? How else could the Code encourage accurate and high-quality service provision where issues currently exist?

The inclusion of service providers within the Code is a real opportunity to address what we have identified as a significant barrier to sustainable investment in the UK pensions market: the enormous influence that investment consultants have over pension scheme trustees. To ensure that stewardship is practised effectively throughout the investment chain it is essential to hold investment consultants in particular to the same standard as other signatories to the Code. In recognition of this, we would recommend that a Principle be introduced which appropriately replicates Principle E and requires service providers to disclose how they consider ESG factors, including climate change, in the services they provide. Such a requirement would complement the recent changes to the Investment Regulations, which require scheme trustees to put in place policies on how they consider ESG, including climate change.

In order to further strengthen and clarify the role of service providers in ensuring effective stewardship, Provision 3 could be replaced with the following sentence taken from the related Guidance: “Signatories should explain what activities they undertake to support effective stewardship and positive outcomes that contribute to building a sustainable financial system, which both manages systemic risks and drives capital towards more sustainable investments.”

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