

ClientEarth response to FCA/FRC Discussion Paper 19/1 Building a regulatory framework for effective stewardship

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 financial risks for a wide spectrum of market participants, including companies, investors, company directors, their professional advisers and regulators.

In January 2019, the Financial Conduct Authority (**FCA**) and the Financial Reporting Council (**FRC**) published a joint discussion paper seeking input on how best to encourage the institutional investment community to engage more actively in stewardship of the assets in which they invest (the **Discussion Paper**). This document provides ClientEarth's responses to the questions raised in the Discussion Paper.

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2 Key messages

- We are pleased that the FCA and FRC are placing greater emphasis on the importance of effective stewardship and agree that effective stewardship activities support the functioning of the UK's financial markets by enhancing their quality and integrity. We believe that effective stewardship is particularly important for mitigating (insofar as possible) systemic and macroeconomic risks associated with climate change, as well as impacts at the level of the individual company.
- It is, however, our view that the current proposals risk creating a two-tier system, with a widening gap between those adhering to the voluntary Stewardship Code on the one hand, and firms doing the minimum necessary for compliance with SRDII on the other. The current proposals also risk giving investors the misleading impression that stewardship is optional and not (as is the case) central to the effective discharge of investors' fiduciary duties.
- The UK regulatory framework should make clear that the exercise of stewardship rights and responsibilities is not optional. This should be done through making requirements for effective stewardship mandatory. In turn, this would enable effective regulatory oversight and appropriate remedial measures where firms are not taking their responsibilities seriously. At present, the voluntary nature of the Stewardship Code makes such oversight challenging.

3 Responses to questions

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

We strongly support the definition 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 because of the role stewardship has to play in the management of systemic risks to the economy (and consequently to beneficiaries’ investments). Indeed, we think that this aspect of stewardship deserves greater regulatory attention to ensure that firms are using their stewardship rights and responsibilities to mitigate (where possible) systematic and systemic risks such as climate change.

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)?

Investors’ effective stewardship should focus on efforts to mitigate systemic and macroeconomic risks that cannot be effectively managed through portfolio construction and asset allocation, with climate change meriting immediate prioritisation.

While traditional “bottom up” stewardship strategies are clearly important drivers of value for beneficiaries at the level of the individual company, investors can overlook the importance of engagement with risks at the wider portfolio or system level. Yet engagement with governments and regulators (as well as with individual companies) on system-wide issues is an important aspect of firms’ stewardship responsibilities that has the potential to achieve considerable value for beneficiaries.

As the ICGN highlights, the production of investment returns to meet liability obligations, within a prudent level of risk, is a 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 duty¹.

Climate change is an example of a systemic, macroeconomic risk that cannot be managed through portfolio construction or asset allocation alone². 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

¹ ICGN, ‘Guidance on Investor Fiduciary Duties’ (2018), p12

² See CISL, ‘Unhedgeable risk: How climate change sentiment impacts investment’ (2015), Mercer, ‘Investing in a time of climate change’ (2015)

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.

It follows that it is in beneficiaries' best interests³ (and we would argue required by asset owners' duties) that investment strategies support a swift transition to a low carbon economy that will help limit catastrophic global warming.

Mercer has characterised asset owners adopting this stance as "future makers"⁴, and outlines its conclusions that investing for a 2°C scenario is both an imperative and an opportunity: an imperative, since, for nearly all asset classes, regions and timeframes, a 2°C scenario leads to enhanced projected returns versus 3°C or 4°C and therefore a better outcome for investors; and an opportunity, since, although incumbent industries can suffer losses in a 2°C scenario, there are many notable investment opportunities enabled in a low carbon transition.

Considered investors are already investing in this way:

- **At asset owner level**, the Environment Agency Pension Fund committed in 2015 to ensuring that the Fund's investment portfolio and processes were compatible with keeping the global average temperature increase to below 2°C relative to pre-industrial levels. Its investment beliefs include beliefs that:
 - *Climate change presents a **systemic risk** to the ecological, societal and financial stability of every economy and country on the planet, with the potential to impact our members, employers and all our holdings in the portfolio.*
 - *Climate change is a **long term material financial risk** for the Fund, and therefore will impact our members, employers and all our holdings in the portfolio.*
 - *Considering the impacts of climate change is both our **legal duty** and is entirely consistent with **securing the long term returns** of the Fund and is therefore acting in the best long term interests of our members. **Selective risk-based disinvestment** is appropriate but **engagement for change** is an essential component in order to move to a low carbon economy⁵*
- **At asset manager level**, BNP Paribas Asset Management understands the importance of stewardship, explaining that its stewardship strategy includes public policy work:

We actively engage with regulators, helping to shape the markets in which we invest and the rules that guide and govern company behaviour. Public policy can affect the ability of long-term investors to generate sustainable returns and create value. It can also affect the sustainability and stability of financial markets, as well as social, environmental and economic systems. We have constructively and

³ While we focus here on the best financial interests of beneficiaries, it is also important to note that it is obviously also in the best interests of beneficiaries more broadly that investment strategies support a swift transition to a low carbon economy. The difference in quality of life associated with a 1.5°C versus a 3°C, 4°C or 5°C is a very real consideration that we believe fiduciaries' duties permit them to consider

⁴ Mercer (2019) Investing in a Time of Climate Change — The Sequel

⁵ See further <https://www.eapf.org.uk/investments/climate-change>

*effectively engaged with policymakers over many years, with a particular focus on corporate disclosure, climate policy and corporate governance.*⁶

In the same document, BNP Paribas sets out its objectives and targets in respect of the energy transition:

Our objective is to make a substantive contribution to the low-carbon energy transition. We have three targets to structure our work towards this objective:

- 1 To align our investment portfolios with the goals of the Paris Agreement by 2025.

- 2 To encourage our investee companies and countries to align their strategies with the goals of the Paris Agreement.

- 3 To encourage policymakers to adopt measures that align with the goals of the Paris Agreement.

We aim to align our portfolios, firstly, by reducing our exposure to fossil fuels while managing exposures in line with the well-below 2°C International Energy Agency (IEA) Sustainable Development Scenario (SDS). Of all the scenarios in line with the objectives of the Paris Agreement, this is the most reliable and widely used.¹¹ As part of that commitment, we are introducing an enhanced coal policy ..., further strengthening our existing approach. We will also measure our 'sustainable economic' investments, in line with the forthcoming EU taxonomy, once available.⁷

- **Investor coalitions** and collaborations such as the Institutional Investor Group on Climate Change (IIGCC) and the Climate Action 100+ are evidence of bodies of investors exercising stewardship in a manner intended to tackle climate risk at a wider, systemic level. The IIGCC is an investor group whose work includes helping shape sustainable finance and climate policy, while the Climate Action 100+ is a five-year initiative led by investors to engage over 160 companies across the global economy that have significant opportunities to drive the clean energy transition and help achieve the goals of the Paris Agreement.

While what it means to invest in support of the Paris goals will necessarily evolve, including with developing benchmarks⁸, it is clear that there are a number of steps investors should already be taking as part of their stewardship activities⁹ in order to discharge their duties. In the absence of

⁶ BNP Paribas Global Sustainability Strategy p12, available at <https://docfinder.bnpparibas-am.com/api/files/1FC9FC6C-0DA8-468E-90B3-016DDB5CD270>

⁷ BNP Paribas Global Sustainability Strategy, available at <https://docfinder.bnpparibas-am.com/api/files/1FC9FC6C-0DA8-468E-90B3-016DDB5CD270>. The footnote in the above quote notes that "The IEA does not provide a 1.5 degree scenario, and the IEA SDS acts as the closest aiming at a long-term global average temperature rise of 1.7-1.8 °C above pre-industrial levels. While we would like to see the IEA publish and regularly update a 1.5°C scenario and to adopt a more precautionary stance with regard to negative emissions technologies in its modelling, but the SDS is without doubt the most widely referenced Paris-compliant scenario for the global energy industry, and as such the clearest reference point for governments, companies, and investors concerned with aligning energy emissions with the Paris Agreement."

⁸ Including EU climate transition benchmarks (which aim to lower the carbon footprint of a standard investment portfolio) and EU Paris-aligned benchmarks (which have the more ambitious goal to select only components that contribute to attaining the 2°C reduction set out in the Paris climate agreement). We believe that the development of benchmarks is crucial for effective allocation and management of capital in line with the goals of the Paris Agreement, and would encourage the FCA to take an active interest in that development.

⁹ These include steps such as: setting expectations that investee companies disclose in line with the recommendations of the Taskforce on Climate-related Financial Disclosures and that investee companies' business plans be aligned with the goals of the Paris Agreement; and engaging with policy-makers to support effective climate mitigation policy.

regulatory attention, many institutional investors are failing to engage with climate risk whether as part of their stewardship activities or otherwise¹⁰. Clarification of legal requirements and increased regulatory oversight is badly needed to redress the balance.

One further area which we believe requires increased attention by investors in their stewardship activities is engagement with company auditors and audit committees. Despite auditors being investors' 'eyes and ears' inside a company and ultimately accountable to shareholders (who vote on remuneration and reappointment), institutional investors have seldom exercised their legal rights to address poor quality audits or broader concerns with corporate reporting.¹¹

As a recent report by the IIGCC has made clear, this issue is also particularly relevant in relation to climate change due to significant investor concern about the quality of climate change-related information being disclosed by companies (including potential overstatements of capital and performance in company accounts), and corresponding failures by auditors to address these issues in their audits.¹²

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.

While we broadly agree with the key attributes described, we consider that the following attributes should also be included:

- The need for stewardship to be exercised to mitigate (insofar as possible) macroeconomic and systemic risk, including making representations to policy-makers where policy change is needed to mitigate those risks. Just as investors must manage investment risks to the portfolio as a whole, so they should exercise their stewardship rights and responsibilities with a view to the management of risks which affect the whole portfolio, taking into account appropriate time horizons. Climate change clearly falls into this category of risk.
- The need for stewardship and engagement strategies on particular themes to include measurable "milestones" and escalation strategies.
- The importance of stewardship for all assets under management. While many asset managers place importance on stewardship in the context of specialist "ESG", or "ethical" themed funds, it is important to emphasise that these duties apply to all assets under management. Stewardship is a mainstream requirement to be exercised in respect of all assets under management, not just a nice "add on" suitable only for some funds.

¹⁰ 48% of those attending "An Inconvenient Asset" in March 2019, Plenary 7 of the Pensions & Lifetime Savings Association (PLSA) flagship investment conference stated that they had never heard of the TCFD. Clearly, any understanding of climate change issues in investments needs at least some familiarity with TCFD, and this lack of understanding amongst what is likely to be the more engaged membership of the PLSA is deeply troubling.

¹¹ The Investment Association public register of significant shareholder opposition shows that despite significant recent concern about audit quality in the UK, shareholders have only very rarely opposed auditor reappointments: <https://www.theinvestmentassociation.org/publicregister.html>

¹² See IIGCC, 'Voting for better climate risk reporting: the role of auditors and audit committees' (2018) <https://www.iigcc.org/download/iigcc-2018-voting-and-climate-risk/?wpdmdl=917&refresh=5cc1cfedd68c81556205549>

Q4. What do you think is the appropriate institutional, geographical and asset class scope of stewardship? How can challenges associated with issues such as the coordination of stewardship activities across asset classes, or the exercise of effective stewardship across borders, be overcome?

Given its stated importance to market quality and the delivery of long-term value¹³, we do not consider that stewardship should be limited to particular institutions, geographies or asset classes.

In terms of institutions, there is a need for an understanding of good stewardship to be embedded throughout the investment chain. We are, for example, aware that investment consultants' failure to integrate ESG considerations into their standard service provision (instead typically offering an ESG "add-on" at additional cost) is effectively preventing the proper consideration of financially material ESG factors such as climate change by asset owners relying on those consultants to identify relevant issues for consideration. As the Discussion Paper notes, the CMA has recommended that the Government extend the regulatory perimeter to capture all the activities of investment consultants, and we support that recommendation.

Q6. To what extent do you agree with the key barriers to achieving effective stewardship identified in this DP? What do you believe are the most significant challenges in achieving effective stewardship? We would particularly welcome views on the investment required to embed effective stewardship in investment decision-making.

We agree with the key barriers to achieving effective stewardship as described under the broad headings of incentives and costs, misaligned incentives and the flow of information. However, another key barrier to achieving effective stewardship lies both in the way many asset managers have historically viewed the exercise of stewardship and the manner in which that is reflected in standard form Investment Management Agreements (IMAs). IMAs often provide for asset managers' complete discretion on the exercise of rights and responsibilities attaching to shares, including for example establishing voting guidelines, using proxy voting services and even deciding whether to exercise rights¹⁴.

The degree of discretion retained by Investment Managers in this way is at odds both with the obligations asset managers owe to their clients, and with the obligations their asset owner clients owe to beneficiaries. Indeed, where standard form agreements such as the Investment Association's Model IMA are accepted by pension fund trustees without amendment, such agreements risk putting trustees in breach of duty. This could be the case where an IMA will result in a mismatch between an asset manager's policy and the trustees' own policy on stewardship (which trustees consider to be in the best interests of their beneficiaries).

Leaving to one side the very real risks that this state of affairs poses for asset owners, its implications for the quality of service asset managers provide to their clients is clearly unsatisfactory. A related issue is the inconsistent approach taken by asset managers to providing disaggregated voting rights for investors in pooled funds. This has the effect of acting as a barrier to asset owners' effective implementation of their stewardship policies by declining to vote clients' shares as directed. We believe this issue merits regulatory attention in its own

¹³ Paragraph 3.6

¹⁴ See for example Clause 19 of the Investment Association's, Model Discretionary Investment Management Agreement (May 2018) Available at https://www.theinvestmentassociation.org/assets/files/Model_IMA_report_website_version_1.pdf

right, as it represents a failure of asset managers to follow their clients' instructions to exercise voting rights in what they believe to be the best interests of beneficiaries.

As the FCA will be aware, where pension trustees delegate their investment function to an investment manager, investment managers are also subject to duties under the pensions legislation. In particular, investment managers must exercise their discretion in accordance with the Investment Regulations¹⁵. These in turn include requirements that (a) scheme assets are invested in the best interests of members and beneficiaries, and (b) the powers of investment or the discretion, must be exercised in a manner calculated to ensure the security, quality, liquidity and profitability of the portfolio as a whole. Mismatches between asset owner and asset manager policies on stewardship – or, indeed, failures by asset owners to exercise rights and responsibilities effectively – could also have the result that asset managers will be in breach of their own duties under the pensions legislation.

We would also note the challenges emanating from:

- confusion amongst some asset owners as to distinctions between ESG, ethical investing, and how stewardship fits in. Related to this is the lack of clarity around the extent to which stewardship activities are required by investors' duties.
- difficulties assessing effectiveness of stewardship between asset managers, including lack of transparency as to governance, resourcing, incentives, and extent to which stewardship strategies have targets and escalation strategies.
- investment consultants' failure to integrate ESG considerations into their standard service provision (see further our response to Q4 above).
- concerns around collective engagement resulting in the creation of concert parties under the City Code on Takeovers and Mergers or triggering group filing requirements under Section 13 of the US Securities Exchange Act.

Q7. To what extent do you consider that the proposed balance between regulatory rules and the Stewardship Code will raise stewardship standards and encourage a market for effective stewardship?

We have concerns that the proposed balance risks creating a two-tier system, with a widening gap between those adhering to the voluntary Stewardship Code on the one hand, and firms doing the minimum necessary for compliance with SRDII on the other. Related to this, we are concerned that it will also result in effective stewardship being viewed as optional when in fact those in a fiduciary relationship¹⁶ will in many cases have a duty to engage in effective stewardship.

In our view, such a duty arises where firms have a duty to act in the best interests of their clients and effective stewardship would be in the best interests of those clients¹⁷. While the focus, form and extent of stewardship (either directly or via well implemented delegation to asset managers) will vary according to the size of firm, we consider that it will be rare for firms not to have a

¹⁵ Pensions Act 1995, s 36(1); Occupational Pension Schemes (Investment) Regulations 2005, reg 4

¹⁶ For the avoidance of doubt, we include within that category asset managers and others in the investment chain who invest other people's money.

¹⁷ While the most obvious obligation will arise where stewardship is in the best *financial* interests of clients, there may also be cases where stewardship will additionally be in the broader interests of clients – such as where beneficiaries are individuals and a particular stewardship strategy procures objective quality of life benefits to those beneficiaries (once again, mitigating catastrophic climate change is an obvious example).

positive duty to carry out effective stewardship. While this view is taken by some market participants, there is clearly uncertainty about the scope and content of this duty and further clarification would therefore be helpful.

As is already the case in other jurisdictions¹⁸, the UK regulatory framework should make clear that the exercise of stewardship rights and responsibilities is mandatory for firms. This should be done by strengthening COBS Rule 2.2.3 to make commitment to the Stewardship Code mandatory, or by an equivalent update to the regulatory framework

While the proposed implementation of SRDII would require life insurers and asset managers to: (a) develop and publicly disclose a policy on shareholder engagement or to explain why they have chosen not to do so; and (b) publicly disclose, annually, how they have implemented any engagement policy, along with certain detailed information¹⁹ it is our view that these rules do not go far enough in mandating the key attributes of effective stewardship in the interests of clients and beneficiaries, and the Stewardship Code should be made mandatory through strengthening COBS Rule 2.2.3.

Q8. To what extent are there are issues with proxy advisers that are not adequately addressed by SRD II and proposed revisions to the Stewardship Code?

Where asset owners and asset managers rely heavily on the advice and voting guidelines of proxy advisers, there is a risk that those advisers have considerable (and disproportionate) influence in the market. This is particularly concerning where research has shown that a significant number of asset managers have effectively delegated the exercise of their fiduciary voting obligations to their proxy advisors²⁰ and where, as the Discussion Paper notes, the market is dominated by just two proxy advisers.

While the proposed revisions to the Stewardship Code should to a large extent address these issues, the voluntary nature of the Code will make effective enforcement more difficult. Again, the importance of effective oversight militates in favour either of making the Stewardship Code mandatory or strengthening of mandatory stewardship requirements in the regulatory framework.

Q9. We welcome feedback on other specific aspects of the regulatory framework described above. In particular, we are interested in views on:

(i) Whether and to what extent the FCA's proposed rules for asset owners should be extended to SIPP operators?

We support the extension of the FCA's proposed rules for asset owners to SIPP operators.

¹⁸ In the US the position is much clearer; both the Securities and Exchange Commission (SEC) and the Department of Labor (DoL) have issued guidance stating that as fiduciaries, asset managers must vote proxies when doing so is in the best interests of their clients. See in respect of the SEC: <https://www.sec.gov/interps/legal/cfsib20.htm> and in respect of the DOL: <https://www.dol.gov/agencies/ebsa/employers-and-advisers/guidance/field-assistance-bulletins/2018-01>

¹⁹ including the most significant shareholder votes that they have participated in, how they use proxy advisors, and how they have cast votes at general meetings

²⁰ American Council for Capital Formation, *The Realities of Robo-voting* (2018): 82 of 175 asset managers (with over \$1.3 trillion AUM) voted consistently with ISS' recommendations 99% of the time, while all of them historically voted in line with recommendations 95% of the time, whether the matter in question was a management proposal or a shareholder proposal

(ii) The case for regulatory rules to expand the reach of stewardship beyond listed equity

We would support regulatory rules expanding the reach of stewardship beyond listed equity. In our experience, pension funds with a high proportion of non-equity asset classes (for example those heavily invested in bonds) in their portfolios sometimes take the view that they do not need to take action on systemic risks such as climate change or to engage in stewardship. Emphasizing the importance of stewardship beyond listed equity might help combat such perceptions.

(iii) Whether there is a role for UK regulators in encouraging overseas investors to engage in stewardship for their asset holdings in the UK

We would be in favour of UK regulators encouraging overseas investors to engage in stewardship for their asset holdings in the UK.

(iv) The extent to which additional rules might be necessary either to improve stewardship quality or prevent behaviours that might not be conducive to effective stewardship

As set out elsewhere in this response, it is our view that mandating stewardship is required to prevent the emergence of two tiers of stewardship in firms, prevent “free-riding”, ensure that firms take their rights and responsibilities seriously, and to facilitate effective oversight of firms’ approaches to stewardship.

While it is our view that that effective stewardship will in many cases be required by the existing law, clarity on this point would be helpful for firms.

(v) For differences between active and index-tracker strategies in the practice of stewardship, whether there are particular regulatory actions we should consider to address any perceived harms.

As the discussion paper notes, the inability to exit investments increases the incentive for passive investors to undertake stewardship activities. However, pressure on fees potentially increases incentives to free-ride on stewardship benefits provided by others rather than incur stewardship costs themselves, which is exacerbated by a lack of clarity around the extent of firms’ duties to carry out stewardship rights and responsibilities. It is our view that mandating the Stewardship Code, or making equivalent mandatory provision in the regulatory framework, is the only lever likely to address this harm.

(vi) Whether the FCA’s proposed rules to implement certain provisions of SRD II should apply on a mandatory, rather than ‘comply or explain’, basis.

We agree that the FCA’s proposed rules to implement certain provisions of SRD II should apply on a mandatory, rather than ‘comply or explain’, basis.

Indeed, and as set out above, we believe that regulation should send a clear message that the exercise of stewardship rights and responsibilities is not optional. In our view, this should be done by making the Stewardship Code mandatory. While the voluntary nature of the Stewardship Code at present makes any oversight of stewardship challenging, mandating stewardship would facilitate effective regulatory oversight and remediation where firms are falling below the standards expected of them by clients, beneficiaries and regulators.

More broadly, thought should be given to the impact on investors of the announcement on 11 March 2019 that the Government will replace the FRC with a new regulator called the Audit,

Reporting and Governance Authority. The lack of certainty around timescale and implications for oversight of the Stewardship Code reinforces our view that regulatory oversight of stewardship activities should sit with the FCA.

30 April 2019