FRC Financial Reporting Council

Sinead Donnelly and Vicki Bird
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Strategy Policy and Analysis Group
Private Pensions and Arm's Length Bodies Directorate
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17 July 2018

Dear Sinead Donnelly and Vicki Bird

Response to the consultation on clarifying and strengthening trustees' investment duties

The Financial Reporting Council (FRC) welcomes the Department for Work and Pensions' (DWP) consultation on clarifying and strengthening trustees' investment duties.

The FRC's mission is to promote transparency and integrity in business. The FRC sets the UK Corporate Governance and Stewardship Codes and UK standards for accounting and actuarial work; monitors and takes action to promote the quality of corporate reporting; and operates independent enforcement arrangements for accountants and actuaries. As the Competent Authority for audit in the UK, the FRC sets auditing and ethical standards and monitors and enforces audit quality.

Effective stewardship benefits companies, investors and the economy as a whole – and the FRC welcomes the efforts by DWP to enhance stewardship responsibilities for pension fund trustees. By prioritising stewardship in their engagements with asset managers and service providers, trustees can play a significant role in influencing sustainable, long-term returns for their beneficiaries. Stewardship should be regarded as an integral component of any pension trustee's role, and the FRC will continue to advocate initiatives to improve good practice.

The FRC's response to selected consultation questions are attached to this letter. I am happy to discuss or clarify any of the points outlined in our response.

Yours sincerely

Paul George

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Q2: We propose to require all trustees of all schemes which are obliged to produce a SIP to state their policy in relation to financially material considerations including, but not limited to, those resulting from environmental, social and governance considerations, including climate change. a) Do you agree with the policy proposal? b) Do the draft Regulations meet the policy intent?

The FRC welcomes the inclusion of environmental, social and governance (ESG) considerations within the draft Regulations for trustees obliged to produce a statement of investment principles (SIP). ESG factors are internationally-recognised for the important role they play in effective investor stewardship, with a growing body of evidence demonstrating the role consideration of ESG factors can have in reducing down-side risk. The FRC intends to consult on including an explicit reference to ESG factors when it releases its consultation on the revised UK Stewardship Code later this year.

By requiring trustees to detail their policies in relation to 'financially material considerations', the draft Regulations emphasise the importance of investors assessing materiality when taking into account ESG considerations in the selection, retention and realisation of their investments. This requires a careful analysis by trustees as to those factors that are most pertinent to the long-term success of their investments, rather than stipulating a list of matters which may not necessarily be material to the investments concerned. It is for this reason that the FRC would advise against making an additional explicit reference to climate change in addition to ESG factors. While the FRC agrees with your assessment that climate change is a 'systemic and cross-cutting risk', there are several other recognised global risks that affect environmental, social and governance risks and opportunities, including social instability, cyber-attacks, and large-scale involuntary migration[1]. By isolating climate change, the Regulations may inadvertently focus attention on a risk that may not be as material to the investments subject to the statement of investment principles, thereby potentially obscuring more significant matters. Instead, the FRC would recommend retaining reference to ESG considerations as a whole.

Q3: When trustees prepare or revise a SIP, we propose that they should be required to prepare a statement, setting out how they will take account of scheme members' views. a) Do you agree with the policy proposal? b) Do the draft Regulations meet the policy intent?

Ultimate beneficiaries have a vital role to play in ensuring good-practice stewardship throughout the investment 'eco-system'. The FRC is supportive of regulatory efforts to inform and consult with beneficial owners about the most appropriate and effective stewardship of their capital, and for trustees to take such views into account when preparing or revising a SIP.

[1] World Economic Forum, *The Global Risks Report* (2018).

Q4. Do you agree with our proposal not to require trustees to state a policy in relation to social impact investment? If not, what change in legislation would you propose, and how would you address this risk of trustee confusion on this point?

While the FRC is supportive of the benefits of social impact investment in the UK, it agrees with the approach taken by DWP that it is not appropriate that the draft Regulations require trustees to state a specific policy in relation to social impact investment.

The FRC welcomed the recommendations of Elizabeth Corley's 2017 report *Growing a Culture of Social Impact Investment* and is supportive of its aim to give greater choice to individuals wishing to make social impact investments, most notably through the providers of savings, pensions and investments. The report recommended the FRC consult with investors and others on how signatories to the Stewardship Code can better evaluate the contribution that the social impact of business, including environmental factors, makes to the long-term sustainability and success of business; and monitor and engage with the work of Boards of Directors in discharging their responsibilities to wider stakeholders under section 172 of the Companies Act 2006.

As part of its consultation on the revised UK Corporate Governance Code, the FRC asked several preliminary questions on the future direction of the Stewardship Code, notably whether the Stewardship Code should refer more explicitly to ESG factors and broader social impact. The FRC received limited engagement on this issue from respondents to the consultation, with follow-up discussions indicating little appetite for the Stewardship Code to require explicit consideration of social impact investment. This however does not prevent investors from considering social impact investment within their portfolio. The FRC will likely consider how it can promote the concept of social impact investment, as well as broader sustainability considerations, within the revised Stewardship Code.

The FRC agrees that it is not appropriate to dictate to trustees which opportunities and risks they deem to be financially material when considering the allocation of capital to invest on behalf of their beneficiaries. Where social impact investing is material to the trustees' strategy, it would be disclosed under other requirements. The FRC supports DWP's decision not to require trustees to state a policy in relation to social impact investment, but rather allow trustees sufficient scope to undertake different investment approaches in the best interests of their beneficiaries.

Q5: We propose that trustees should be required to include their policy in relation to stewardship of the investments, (including monitoring, engagement and voting) in the SIP. a) Do you agree with the policy proposal? b) Do the draft Regulations meet the policy intent?

The FRC believes that trustees owe a responsibility for stewardship to their beneficiaries, regardless of the size of their scheme – and would encourage all trustees ensure that their pension funds are signatories to the Stewardship Code.

The FRC supports amendments to the draft Regulations to encourage a broader definition of stewardship for occupational trustee schemes. The current Stewardship Code notes that ‘stewardship aims to promote the long term success of companies in such a way that the ultimate providers of capital also prosper.’[2] As the FRC looks to revise the Stewardship Code in late 2018, it will carefully consider the important role that pension funds, their trustees, and their ultimate beneficiaries play in promoting effective stewardship across the investment eco-system.

The FRC agrees that it is right for the draft Regulations to recognise broader stewardship responsibilities in relation to investments where trustees do not have voting rights. The FRC acknowledged this in its initial consultation on the future direction of the Stewardship Code earlier this year, where it consulted on how the Stewardship Code could take account of some investors’ wider views of responsible investment, receiving broad agreement for the Code to encompass an increased range of asset classes that do not have voting rights, such as fixed income assets, debt securities and infrastructure.

Amendments within the draft Regulations to broaden stewardship activity of trustees from voting to include monitoring and engagement are a welcome addition to emphasise the importance of stewardship in the sustainable management of pension trust funds. The implementation of the European Shareholder Rights’ Directive, due to be transposed into UK law prior to the UK leaving the European Union, will establish a reporting requirement for ‘baseline’ stewardship disclosures within the UK investment market. The Directive applies to ‘institutional investors’[3], with article 3g(1)(a)-(b) setting out the requirements of institutional investors to develop and publicly disclose an engagement policy on a ‘comply or explain’ basis. This policy should describe how institutional investors monitor companies on relevant matters (including strategy, financial and non-financial performance and risk, capital structure, social and environmental impact and corporate governance). Institutional investors should also detail how they conduct dialogue with investee companies, exercise voting rights and other rights attached to shares, cooperate with other shareholders, communicate with relevant stakeholders of the investee companies and manage actual and potential conflicts of interests in relation to their engagement. Institutional investors will also be required to disclose how their engagement policy has been implemented, including a general description of voting behaviour, an explanation of the most significant votes and the use of the services of proxy advisors.

While most elements of the proposed regulatory changes (particularly in relation to voting rights, monitoring and engagement) cover the requirements of the Directive, amendments to the Regulations do not appear to satisfy the requirements that institutional investors publicly disclose within an engagement policy how they manage actual and potential conflicts of interest in relation to their engagement. The FRC would

[2] UK Stewardship Code, (2012) p.1.

[3] Institutional Investor defined in Article 1(2)(b) of Directive (EU) 2017/828 of the European Parliament and of the Council of 17 May 2017.

encourage DWP and the Pensions Regulator to liaise with the Department for Business, Energy, and Industrial Strategy who are manging the implementation of the Directive, to ensure symmetry between the requirements of the new Directive and the regulatory framework for pension trustees within the UK.

The proposed draft Regulations do not extend the requirement for reporting on stewardship for schemes with a default arrangement, as proposed by the Law Commission. This not only risks inconsistencies with the reporting requirements and disclosures arising out of the Shareholder Rights Directive but signals that beneficiaries of default schemes are somehow owed a lower standard of stewardship than to those beneficiaries of schemes with more than 100 members, who are required to produce a SIP. The FRC does not believe that trustees of schemes with less than 100 members have limited leverage to undertake effective stewardship for their beneficiaries, and the consultation itself notes that 'even relatively small schemes can have some impact through the consideration of stewardship.'[4] The FRC supports the notion that a trustee's fiduciary duty 'should consider their approach to stewardship of the investments, to maximise financial returns for the scheme members over the long term', and does not believe that stewardship should be regarded as unnecessary or unduly burdensome, but rather an integral part of their responsibilities as trustees.

Q6: When trustees of relevant schemes produce their annual report, we propose that they should be required to: - prepare a statement setting out how they have implemented the policies in the SIP, and explaining and giving reasons for any change made to the SIP, and - include this implementation statement and the latest statement outlining how trustees will take account of members' views in the annual report. a) Do you agree with the policy proposal? b) Do the draft Regulations meet the policy intent?

The FRC supports the proposed regulatory amendments that will require trustees to consider how they have implemented the policies detailed within their SIP, and prepare a statement detailing this within their annual report.

The FRC is encouraged by the requirement for trustees to consider how they have implemented their SIPs. This amendment is not only consistent with article 3g(b) of the Shareholder Rights Directive but requires trustees to reflect and carefully assess how investment decisions have been made, as well as identify opportunities for improvement and refinement of their investment policies. This will hopefully reduce the 'tick box' approach to the development of SIPs and highlight to trustees that they are not able to discharge their stewardship responsibilities to their beneficiaries by relying on investment consultants to determine the effectiveness of their investment policies.

Q7: We propose that trustees of relevant schemes should be required to publish the SIP, the implementation report and the statement setting out how they will take account of members' views online and inform members of this in the annual benefits

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[4] Department for Works and Pensions, *Consulting on clarifying and strengthening trustees' investment duties,* (2018), p.28.

statement. a) Do you agree with the policy proposal? b) Do the draft Regulations meet the policy intent?

The FRC believes requiring trustees to publicly assess the implementation of their SIP and give explanations and reasons for any changes made to their investment policies during the scheme year, is an effective method of increasing information flows to the market and improving the knowledge and capacity of engaged scheme members. It is hoped over time such disclosures will contribute to increasing awareness of the importance of responsible stewardship in the pension market.