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Dear Sinead and Vicky

Consultation on clarifying and strengthening trustees' investment duties

Legal & General Investment Management (LGIM) is one of the largest international investors globally with over £983.3 billion of assets under management (as at 31 December 2017). LGIM manages the largest pools of asset for UK pension schemes comprising approximately of £634bn of defined benefit schemes and £68bn of defined contribution and workplace savings, as at 31 December 2017.

Over the past 40 years, LGIM has built a business through understanding what matters most to clients (both institutional and retail) and transforming this insight in to valuable, accessible investment products and solutions. This enables pension funds to meet their key long-term financial objective and ensure appropriate funds for pension members throughout retirement.

As a large and long term investor, we increasingly recognise that Environmental, Social and Governance (ESG) factors play a crucial role in determining asset prices and are important in identifying companies that will succeed in a rapidly changing world. Investing in a sustainable way is at the core of our business model, which involves engaging with companies, developing innovative products and evolving our investment process. Therefore, the opportunity to respond to this consultation by the Department of Work and Pensions (DWP) is very important to LGIM.

We believe the DWP needs to make clear to trustees that there are no legal barriers to consideration of ESG and that they will not be breaching their fiduciary duties if they do so. We support the statement from the Law Commission Report on the Fiduciary Duties of Investment Intermediaries that states "*there is no impediment to trustees taking account of ESG factors where they are, or may be, financially material.*"[1] In other words, fiduciary duty should not be a barrier to ESG integration. Rather, we believe it is a core component of the fiduciary duties owed

[1] http://www.lawcom.gov.uk/app/uploads/2015/03/lc350_fiduciary_duties.pdf, page 112

by the trustees to their beneficiaries. ESG is a fundamental part of the investment process not something additional, separate or client-specific.

We welcome the recognition by the DWP of the importance of trustees to better understand and integrate ESG issues when formulating their investment principles in members' interests.

LGIM fully endorses this clarification and would expect the DWP's proposals to be considered and implemented by trustees for Defined Benefit (DB) and Defined Contribution (DC) Schemes as soon as practically possible.

An important area which we believe the DWP should consider further is the distinction between the members' interests and members' views. Further debate and guidance would be needed in order for trustees to understand how best to develop a robust process for understanding and engaging pension scheme members. In saying this, however, we support the underlying concept of greater engagement between trustees and members to better align and connect the investment chain.

LGIM is also very supportive of the amendments to the Statement of Investment Principles (SIP) as being the key area of focus when examining how best to embed ESG considerations into investments. Through this procedure, the DB and DC investment chains are incentivised to create the proper structures and frameworks needed to consider these issues.

Our response to the consultation is divided in to two sections. Firstly, in Appendix A, we have directly answered your questions outlined in the paper. Secondly, in Appendix B, we have extracted a section of our submission to the Financial Reporting Council (FRC) relating to the Stewardship Code and the changes we believe are needed to enhance good stewardship in the UK market.

We hope the comments provided in our response are useful and welcome a direct meeting with the DWP should you like to discuss any issues in further detail.

Yours sincerely,

Emma Douglas
Head of DC
LGIM

Mark Johnson
Head of Institutional Clients
LGIM

<u>Appendix A</u> - *Response to DWP Consultation on clarifying and strengthening trustees investment duties*

1. We propose that the draft Regulations come into force approximately 1 year after laying, with the exception of the implementation report, which would come into force approximately 2 years after laying.

a) Do you agree with our proposals?
b) Do you agree that the draft Regulations meet the policy intent?

1.1. We support the proposals outlined in terms of timings for the Regulations to come into force and believe they are appropriate.

1.2. However, from our experience, implementation may even be quicker, as many schemes have progressed along this journey, with Environmental, Social and Governance (ESG) issues already being considered and formalised in investment beliefs. As such, we recommend the wording in guidance to further encourage those who can implement these proposals to do so as soon as possible.

2. 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?

2.1. We strongly support the proposal that requires trustees of both DB and DC schemes to state their policy in the SIP of how they have considered financially material ESG considerations, including climate change.

2.2. We are in agreement with the definition of ESG as opportunities and risks which affect the returns on investing in companies or other entities, whether positively or negatively. This definition is consistent with the Law Commission Report.

2.3. In addition, as highlighted in our opening letter, we support the Law Commission's statement that "there is no impediment to trustees taking account of ESG factors where they are, or may be, financially material."

2.4. That there is 'no impediment' does not mean, however, that trustees will be impelled to take positive steps to address this problem. In our experience, part of the reluctance stems from the tension between the limitations of some forms of ESG data versus the broad range of ESG issues and their perceived time horizons.

2.5. Therefore, we believe that the issue of materiality requires a nuanced approach for ESG considerations to be successfully integrated into SIPs.

2.6. We would caution against an over-reliance on back-tested ESG data as a standard of proof for materiality. Historically, both analyst and data coverage of ESG issues has been low. Therefore, as ESG data has not been systematically integrated in the investment process in the past, its full value might not be readily apparent. Going forward, however, we expect the growing availability of ESG data to make it increasingly possible for trustees to address material ESG issues quantitatively.

2.7. 'ESG' covers a wide range of topics, the materiality of which will vary. To demonstrate the ways in which ESG can be financially material, we provide the following example:

FINANCIAL MATERIALITY

Like with all investments, it is impossible to predict with full precision what will materially impact financial outcomes in the future. ESG integration also has its limitations, which come mainly from lack of robust historical data and from inconsistency in how the data is applied. Hence academic research can show a mixed message on its financial implications. Broadly, however, studies identify the strongest correlation is between corporate governance and financial performance. For example, some governance failures (such as corporate fraud) tend to have an immediate negative effect on a company's stock. Sustainability standards show a weaker correlation to performance, but have been linked in some meta-studies to lower cost of capital for companies and improved operational performance.

Generally, ESG information tends to serve better as a mechanism for protecting against downside risk, rather than a new source of alpha. This is especially the case when many of the ESG opportunities can be easily priced in by the market (e.g. low-carbon products, operational efficiencies) as management will happily discuss this publicly. On the other hand, the market may take false comfort in the silence from a company, thus overlooking governance problems such as the lack of an independent board, supply chain issues or the weak protection of employee rights. To this end, incorporating ESG information can be seen as an insurance policy against future unpleasant surprises.

Furthermore, some ESG factors may not give a *particular* company ability to generate additional returns (*alpha*), but may have a material impact on the wider market (*beta*). Climate change is an example of such a broad trend that is rising rapidly on the investor agenda. If the market is to keep the current trajectory of investing in a fossil-fuel based energy system, the world will continue to warm up beyond the 2°C limit set by global governments as part of the Paris Agreement. Were this to happen, potential consequences include unprecedented extreme weather patterns impacting water, energy and agriculture, as well as increased migration and social unrest. This could have a significant impact on companies operating globally and therefore on the returns of investments in the future. Such forward-looking and uncertain market-wide impacts are often ignored in investment decision-making, but given the scale of the consequences, ESG considerations can help to stress-test the status quo and offer alternative options.

Lastly, there are ESG factors that are simply not financially material, or at least not yet. Of the ESG indicators that get disclosed by companies, many of them have shown little to no link to the bottom line (e.g. charity donations, employee volunteer days). ESG investing is not about taking all governance and societal concerns into account, but about addressing those which can have an impact on the returns or the market. Some non-material ESG or ethical considerations may also be considered by investors (e.g. due to pressure from beneficiaries), but it is important to separate which ESG factors are material, and which reflect personal values.

[2]

2.8. It is important to recognise that the notion of materiality is not fixed, and evolves in response to social and political pressures. For example, the planned phase-out or bans of single-use plastic products came as a result in changing consumer attitudes, but some large energy companies are now warning this will put pressure on oil demand. Similarly, the push for more transparency around remuneration began as a social issue, but can have material effects and be translated in to a monetary risk – the UK regulator has warned of 'unlimited' fines to companies that fail to report their gender pay gap data.

2.9. Therefore, we ask that the DWP encourages further discussion around different aspects of financial materiality, in order for trustees of pension schemes to not be misled by the limitations of current ESG data or research.

[2] Deutsche Bank/Hamburg University review of over 2000 academic studies on financial performance and ESG: https://www.db.com/newsroom_news/K15090_Academic_Insights_UK_EMEA_RZ_Online_EN_151216_R2a.pdf; Oxford University/Arabesque meta-study on sustainability standards: *https://arabesque.com/research/From_the_stockholder_to_the_stakeholder_web.pdf*

2.10. Furthermore, we believe that identifying *past examples* of financial materiality is not the only pre-requisite for the consideration of ESG issues. In some cases, the duty of prudence may require trustees not to wait for these factors to arise first and become financially material before they can be examined.

2.11. ESG issues may be forward-looking and therefore there may be opportunities for trustees to take active steps in their portfolio. For example, a study[3] from Cambridge University notes that, if investors delay action on climate change until it becomes inevitable, they may be exposed to 'unhedgeable risks' from the lack of sufficient asset classes – including low-carbon – to diversify into. Therefore, protection from future downside risk can be achieved by having strong ESG capabilities already built in to the process.

2.12. A separate barrier to progress comes from the fact that public debates around ESG investments tend to focus on the 'exclusion' of sectors from investment portfolios (such as tobacco). This ignores some of the core and fundamental motivations behind ESG integration, particularly when it comes to incentivising positive change. In reality, the spectrum of approaches to ESG investing is wider, including positive screening (in favour of companies with best-in-class ESG characteristics), thematic investing, as well as broader stewardship and company engagement to raise ESG standards at investee companies. All these variations in approaches need to be considered by trustees when taking account of ESG factors.

2.13. The result of the above is that the analysis of ESG issues should not be seen as a static 'add-on' to the investment process. For example, asset owners (or their designated managers) routinely engage with companies around the 'G' in ESG - governance - and we believe best practice should routinely incorporate other ESG topics. Engagement and stewardship will be particularly important as a counterpart to ESG issues that cannot be addressed through data alone (e.g. a company's environmental management might be relatively easily and reliably captured by carbon metrics but a company's treatment of their employees cannot be easily reduced to any single 'human capital' metric). ESG should be embedded deeply in the investment process for trustees, as intended by the Law Commission. In considering how best to discharge this obligation, trustees should be mindful of the spectrum of approaches described above, including but not limited to financial materiality.

2.14. LGIM believes that an important issue which needs addressing is the education of both DB and DC trustees. It is essential to provide a framework for understanding ESG risks and opportunities relevant to their investments. Other actors in the investment chain (such as investment consultants) also need to understand ESG factors because smaller DB and DC schemes have limited resources and may depend heavily on the advice given to them by consultants. LGIM has been active in promoting clarification on this issue by regularly presenting to clients on a one-on-one basis, at seminars and releasing ESG related material into the public domain.

2.15. Lastly, there is a perception that the SIP is often viewed as a tick-box exercise. While similar disclosure is unavoidable, we would like to see best practice transparency being consistently applied across SIPs. To this end, we believe good disclosures in SIPs need to be highlighted and emphasised when best practice is identified.

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[3] https://www.cisl.cam.ac.uk/publications/sustainable-finance-publications/unhedgeable-risk

3. 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?

3.1. As a starting point, we believe it is important to emphasise and make a clear distinction between members' "views" and members' "interests". It is practically impossible to reflect members views, when:

1. the response rate to consultation/surveys is often low;
2. the members who tend to hold strong views on certain subject matters may not be representative of what the majority of members believe;
3. the news cycle may influence short-term views but not reflect long-term financial materiality;
4. it is difficult for young members to think about the impact on their investments because the prospect of retirement is so far in the future; and
5. there is often room for substantive disagreement between members in matters of ethics, not all of which will be relevant to investments.

Therefore, we believe that instead of putting such an impossible burden on trustees, we suggest a re-wording which focuses on members' "interests".

3.2. In saying this, we are fully supportive of the underlying objective – to facilitate communication between trustees and beneficiaries – as this can result in members being more engaged with their investments. For example, in October 2016, LGIM commissioned an online survey carried out by FTI Consulting, pooling 1,681 people. When asked the question 'how knowledgeable are you of the types of investments your savings are invested in by your pension managers?', 53% of respondents answered 'I am not knowledgeable but I would like to be'. 34% answered that they are knowledgeable and only 13% that they are not knowledgeable and don't want to be. From this it is clear that there is a knowledge gap of what type of investments people have made in their pension and would like to learn more.

3.3. In order to focus on members' interests, trustees should think more clearly about how ESG issues can impact the whole life of the portfolio, from enrolment through to retirement. This includes consideration of how addressing some of the ESG issues associated with their portfolio can alter the course of their investments, from both a financial and wider societal perspective. For example, promoting the respect for human rights at investee companies might also have the benefit of making members more likely to want to work for their company by aligning member and sponsor views.

3.4. One of the ways in which such considerations can be put in a framework is to use the findings from online surveys and focus groups that aim to ascertain the broad consensus in certain age groups and similar interest groups. As noted in 3.2. LGIM has carried out such surveys, but we have also found many other bodies which have conducted similar studies, thereby indicating a strong desire to incorporate ESG for younger generations.

3.5. We note that the Defined Contribution Investment Forum (DCIF) has also produced research for pension schemes trying to help demystify the subject of responsible investment and to illustrate the current attitudes towards ESG issues amongst DC pension holders.[4]

3.6. Therefore, pension schemes could collectively create a framework, with the widest sample pool, so that the burden is not bestowed on individual schemes to conduct research due to cost and resource concerns.

3.7. There is, moreover, broad support for certain social goals among governments and civil society worldwide. For example, the United Nations Sustainable Development Goals (SDGs) may provide a useful framework when thinking about the needs and views of members generally. These goals are promoted and implemented into international government policies which impact the public and society at large. As the public is impacted broadly by the same topics, the alignment of investments to SDGs could be used to reflect the broad needs and interest of members at large.

4. 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?

4.1. We agree at this current stage that trustees should not be mandated to state a policy in relation to social impact investment.

4.2. We believe a better definition of "social impact" needs to be articulated in the following areas:

1. The "S" in ESG (e.g. how companies manage employees and communicate to them);
2. The impact of company activities and products on societies (e.g. the impact of financing fossil fuel-based companies on greenhouse gas levels in the atmosphere); and
3. Social impact investing targeting specific goals (e.g. increasing employment, lending more loans to low-income families)

We agree that the decision of social impact investment rests with trustees, not government.

4.3. However, we do note that:

1. Social impact investment is already incorporated in some schemes (e.g. by the pension schemes of charities or some faith-based organisations);
2. It can be a powerful tool to measure the current social impact from investments like the default fund of DC schemes. For measuring carbon exposure and governance factors, data allows us to do this already; and

[4] https://www.dcif.co.uk/wp-content/uploads/2018/04/navigating-esg-final-lo-res.pdf

3. There are many funds with the purpose of creating positive social impact. Some would have very different risk/return profiles, while others would not be so differentiated from mainstream funds. Regulations should be encouraging schemes to look at the appropriate options for the pension fund, instead of creating the perception that the entire field of social impact investing is financially risky.

4.4. We recommend that regulators clarify this area for the purpose of making pension schemes understand their role, while promoting investments that have positive societal impacts without sacrificing financial goals.

5. 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.

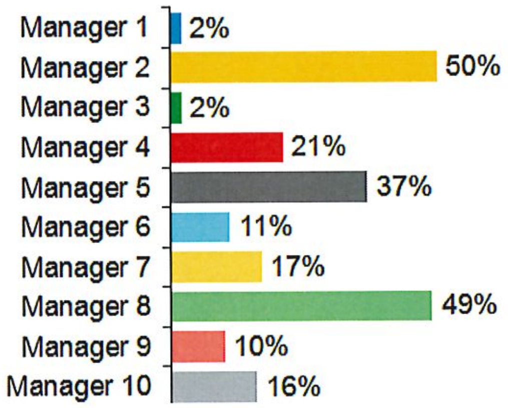
a) Do you agree with the policy proposal?
b) Do the draft Regulations meet the policy intent?

5.1. We agree that trustees should be required to include in the SIP their policy in relation to the stewardship of investments. Inclusion within the SIP will further clarify the important position of asset owners in the investment chain in influencing good stewardship throughout the market.

5.2. We note that many pension schemes assume that their investment managers or consultants fully exercise their stewardship duties as long as they are compliant to the UK Stewardship Code.

5.3. However there are many degrees to which stewardship responsibilities can be exercised. For instance, merely requesting confirmation of managers having voted the clients shares is not the goal. How they are voting (e.g. are they abstaining, and therefore forfeiting the right to vote on their clients behalf) is crucially more important.

5.4. We outline below the levels of support from the world's 10 largest asset managers for shareholder proposals on climate disclosure and environmental action at US companies during 2017.



(Source: LGIM chart using Ceres/Fund Votes data)

Please note LGIM voted in favour of the same resolutions in 95% of the cases, as we believe it is in the best interest of our clients to vote for more disclosure from companies on climate change-related issues.

5.5. Therefore, pensions scheme trustees should seek to better understand how the stewardship responsibilities of their investment managers is actually being exercised and embed this more robustly into how they select and monitor their investment managers.

5.6. Lastly, in its current form, neither the UK Corporate Governance nor Stewardship Codes take into account sustainability concerns such as environmental and social issues. Instead, the focus is mostly on governance-related matters and the disclosure of voting/engagement processes. We believe this should be broadened out to ensure that investment managers are incentivised to manage money in a way that takes into account how companies are held responsible from the perspective of societal impacts.

5.7. For more information of LGIMs thoughts of how stewardship can be further strengthened, please see Appendix B, LGIM proposals to FRC on the UK Stewardship Code.

6. 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?

6.1. We support the requirement for trustees to prepare an implementation statement as this will benefit members' understanding of the SIP and how it is connected with their financial interests.

6.2. Additional regulatory guidance on best practice examples may be helpful to support this objective.

6.3. Please see question 3 for our response on members' views.

7. 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 statement.

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

7.1. We support these proposals as the transparency of the SIP is important to promote accountability to scheme members and other stakeholders.

7.2. Therefore, we consider there are benefits to expanding this proposal to include large DB schemes as per the large DC schemes.

7.3. However, as stated previously, members' "views" are not possible to capture in their entirety and could be misleading (please refer to our answer in question 3 for more detail). Therefore, we would expect the statement to summarise how trustees have exercised their duties in the best interest of their members.

7.4. In addition, we believe the process would benefit from regulatory guidance in order to promote best practice in disclosures.

8. Do you have any comments on the business burdens and benefits, and wider non-monetised impacts we have estimated in the draft impact assessment?

8.1. From an investment manager perspective, the responsibility of exercising stewardship activities should not incur extra charges to the pension scheme.

8.2. We believe that ESG considerations should be embedded in the underlying philosophy of how the investment manager operates and should not be considered as something separate. This activity should be seen as business-as-usual and not something additional, separate or client-specific.

8.3. Therefore, trustees of pension schemes should include this as a core part of their investment manager selection process, with the costs being embedded as part of the investment management and consultant fees.

8.4. However, should the pension schemes decide to invest in different funds which require extra resources (e.g. company research, data points, bespoke reporting), this could lead to slight differentials in costs. In all cases, the scale for such demand would eventually minimise such costs and in such funds we believe our clients would ultimately benefit from this, thereby gaining more value out of the investment offering.

9. Do you have any other comments on our policy proposals, or on the draft Regulations which seek to achieve them?

9.1. We believe it is critical that ESG is properly defined for the benefit of pension schemes in the UK.

9.2. For example, we have outlined previously that clarification of definitions need to be made on 1) financial materiality; 2) ethical/moral judgements; and 3) social impacts, to eliminate the confusion in the market.

9.3. We support the recommendation that climate change be specifically mentioned and referenced in this proposal. It is a risk that is systemic to long-term investors and cannot be adequately covered by the current framework of ESG as understood by many pension schemes. There are many studies to support this, as highlighted by professional bodies such as the Institute and Faculty of Actuaries[5] and the Pensions and Lifetime Savings Association[6].

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[5] https://www.actuaries.org.uk/news-and-insights/media-centre/media-releases-and-statements/ifoa-warns-climate-change-financial-risks

[6] *https://www.plsa.co.uk/Policy-and-Research-Document-library-More-light-less-heat*

10. Do you agree that the revised Statutory Guidance clearly explains what is expected of trustees in meeting their duty to publish the SIP, implementation statement, and statement of members' views?

10.1. LGIM is very supportive of the revised statutory guidance of what is expected of trustees in meeting their fiduciary duty to publish the SIP and implementation statement.

10.2. However, as highlighted in question 3, a statement of members' views may be impractical and unworkable in reality. Therefore, we request that an emphasis is made on incorporating members' interests.

11. What evidence or views do you have of how well the other requirements in the SIP are working? What areas for further consideration and possible future change would you suggest?

11.1. We believe that the SIP can be utilised as a supportive tool to engage members of the pension scheme as well as place more accountability along the investment chain for trustees to play their part in exercising their duty.

11.2. For example, the inclusion of ESG considerations into the SIP could lead to an increase in engagement and participation from members for all schemes as more information would be communicated through public disclosures.

11.3. Particularly in DC schemes, transparent and clear communication on what is provided in the default fund, in terms of ESG considerations, could be enlightening to the members and help them to make better informed choices. This could lead to greater contributions as members feel more aligned and connected with where their pension is invested.

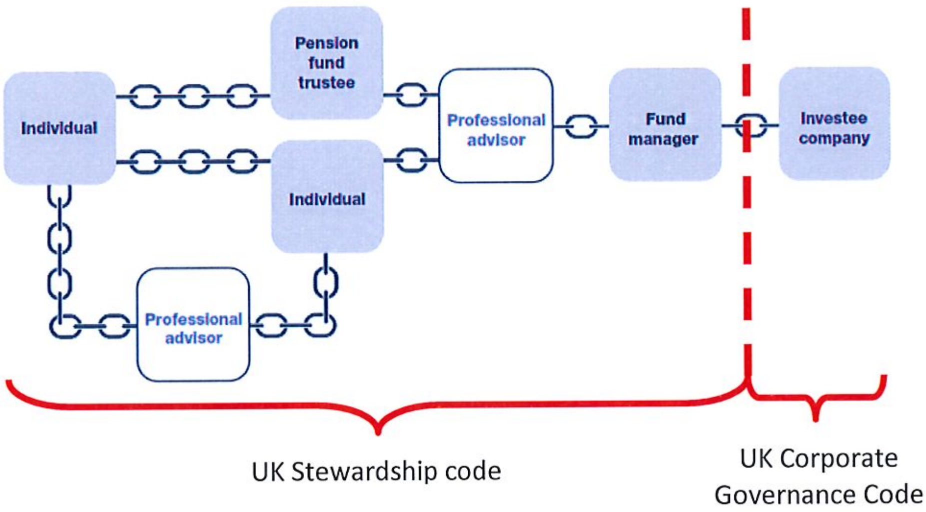
11.4. However, the SIP alone cannot be used as the only tool to communicate the importance of ESG considerations. Therefore, we would support DWP in promoting other communication methods which may be used to engage members more widely on ESG topics.

APPENDIX B – *LGIMs response to the FRC on the UK Stewardship Code*

INTRODUCTION

LGIM believes that good stewardship connects all parties along the investment chain from the savers and citizens who provide capital for investment, to companies whose function in the economy is to create wealth and distribute this back to its citizens.

The picture below is a diagram simplifying the connections along the investment chain and how inter-connected different parties are to the functioning of the whole system.



Source: Tomorrow's Company, Better Stewardship, An agenda for concerted action, page 7; annotation by LGIM

The Tomorrow's Company defines stewardship as *"the active and responsible management of entrusted resources now and in the longer term, so as to hand them on in better condition"*. LGIM supports this definition and believes a concerted effort from all parties is needed to develop a critical mass to make the stewardship system effective.

LGIM's PROPOSAL FOR REFORM TO THE STEWARDSHIP CODE

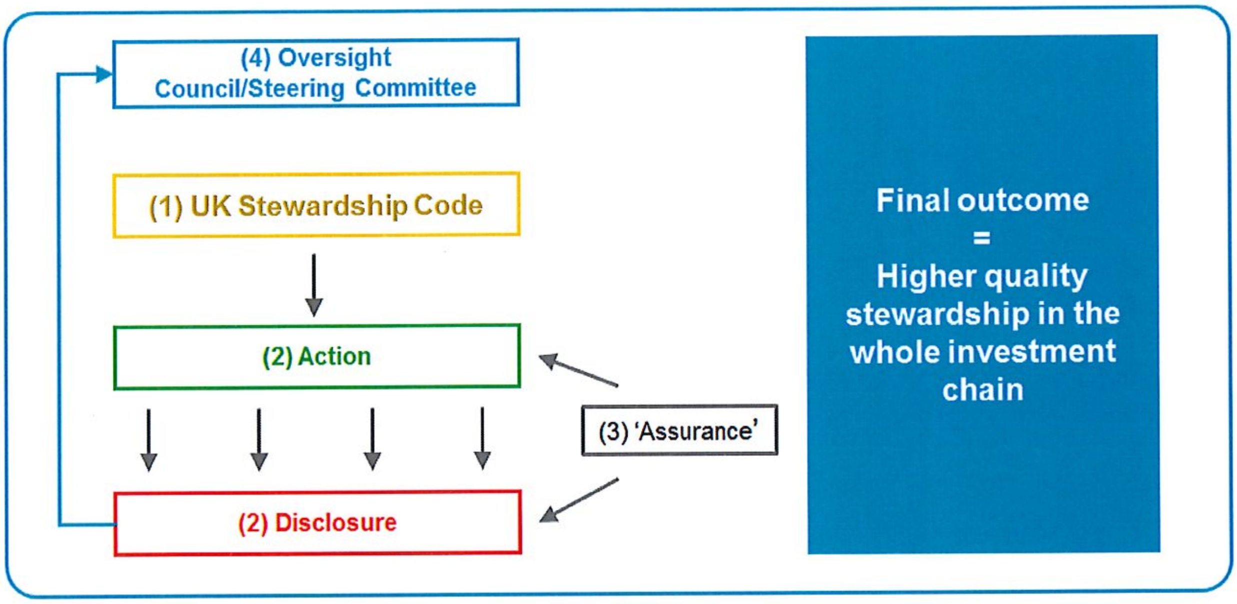
As an asset manager and participant in the investment chain above, LGIM believes it is our duty to be good stewards of our client's capital. We do not consider this to be onerous and being good stewards is a fundamental part of what we do already for all of our clients globally across all our assets.

In order for the Stewardship Code to work effectively, its focus should be on delivering long term investment returns of the underlying assets whilst recognising the distinctions of different parts in the investment chain.

Therefore, we consider the revised Stewardship Code should function in a way to develop the critical mass and the right information flows across the investment chain. There are four key areas where we believe the Stewardship Code can be enhanced and further improved to achieve this aim:

(1) Content of the Code;
(2) Disclosure by signatories;
(3) Assurance; and
(4) Oversight/Enforcement.

Improvements in each of these areas are needed in order to strengthen the whole system for better stewardship by UK based asset managers. This is displayed diagrammatically below with supporting explanations in the relevant sections.



Source: LGIM Governance of Stewardship

1) CONTENT OF THE STEWARDSHIP CODE

LGIM believes that the content of the Code should be significantly expanded to reflect the definition of stewardship as set out above. This requires a holistic approach to be taken into account when developing the Stewardship Code principles and ensuring its application reflects the underlying objective of improving long-term investment returns flowing back to the individual. Below we outline key considerations for the FRC to improve the Code's content for all signatories:

a) *Recognising the different categories of the investment chain*

LGIM supports the FRC in developing separate guidance to the Code for the different parts of the investment chain. The aim of this guidance would be to set standards and provide direction for participants of how the Stewardship Code principles apply.

We do not believe that a separate code needs to be established. It is important to keep the Code as simple as possible in order to illustrate a holistic approach to stewardship in the whole market. Furthermore, having one code demonstrates a collective approach and common language to stewardship. The FRC should keep a principle-based approach in the Stewardship Code, which is supported through comply or explain disclosures, to connect the related activities of different parts of the investment chain.

b) *Management of conflicts of interest*

We believe there are barriers and conflicts in the asset management industry which prevents institutional investors from fully exercising their stewardship duties to clients. This includes potential as well as actual conflicts. For an asset manager, transparency of where stewardship power lies within the firm and who makes the final decision is important as it will determine how seriously stewardship is taken and conflicts are managed.

We recommend additional wording in Principle 5 requesting signatories to set out clearly where conflicts may occur including:

- Parent company
- Clients
- Investee companies
- Between different investment teams internally (e.g. long vs. short term/ debt vs. equity)
- Advisory services
- Other business lines

In addition, the FRC should explicitly highlight in Principle 5 that the public conflicts of interest policy should detail the mitigation actions used to minimise the impact of conflicts. Furthermore, when conflicts do occur, or could be perceived to occur, the policy should explain how conflicts are managed and overseen. This could be explained in the policy using an anonymised example.

We encourage a mechanism being developed to allow for the reporting of concerns where the conflict of interest policy is not followed. This would provide the necessary strengthening of the stewardship systems. We suggest a formal and external whistleblowing system being developed to provide a channel for those who are concerned that the stewardship decisions taken within their company were not in the best interests of clients.

c) *Consideration of Environmental and Social issues*
When examining stewardship, LGIM believes a more holistic approach of responsible investment should be taken into account which extends beyond voting and engagement disclosure. We request the FRC expands the Stewardship Code to include broader environmental and social issues in order to fully capture how stewardship is considered by participants in the investment chain. This small change would embed consideration of material issues such as diversity and climate change which impact companies in the long term into the Code.

Additionally this includes:

- engagement and voting on environmental and social matters
- how material environmental and social matters are identified
- the integration of ESG considerations into the investment process
- how integrated into business models, future product developments and/or capital allocation

d) Long term vs. short term stewardship

The key activities of stewardship should focus on material issues that will impact the long term value of investments, reflecting most end beneficial owner's investment horizons. This does not mean that attention should be removed from the short term but more thought should be taken on the long term consequences of stewards' actions.

At LGIM, we encourage companies to focus on delivering long term value rather than meet short-term profit expectations. Because we are invested for the long term, we can be persistent in our engagements on a topic, in order to bring about real and positive change to create sustainable investor value. For example we have advocated for companies to cease quarterly reporting if not legally required because we believe it distracts management from considering the performance of the company over the long term. Therefore, our focus on the long term aligns our interest with our clients who represent the next part of the investment chain.

We request that the FRC explicitly highlights that stewardship activities are focused on the long term. This would align the Stewardship Code with the Corporate Governance Code in addition to embedding long term capital into the stewardship activities across the whole investment chain.

e) Influencing and improving the market as a whole

The Stewardship Code is currently solely focused on individual company engagement. However, participants in the investment chain often hold a whole universe of assets and companies. Therefore, they equally have a responsibility to ensure that global markets operate efficiently and uphold the highest standards to protect the integrity of the financial market over the longer term.

The remit of the Code should be expanded to recognise the role of stewardship in improving the system as a whole.

f) Coverage of investments

Our fiduciary and stewardship responsibilities to our clients extend across all of their assets that we manage. As detailed in the introduction, the definition of stewardship is not restricted, but includes all assets and resources managed on someone else's behalf. Many asset owners are reducing the proportion of equity they hold to meet their liabilities and therefore an expanded Stewardship Code is needed to ensure these assets are equally covered under this framework.

At LGIM we already apply stewardship to our credit, property and infrastructure assets and we do this because we believe it is our core duty to do so. We request that the FRC expands the Stewardship Code to include other asset classes. As an additional benefit, we believe this will encourage many more participants in the investment chain to consider stewardship, further extending the benefits of good stewardship.

g) Stewardship outside the UK

As a global investor, we already apply our stewardship resource across all our investments and have committed to stewardship codes issued by other jurisdictions. However, the concept of stewardship is difficult to silo by region. Signatories either sign up to the belief that stewardship is undertaken for the benefit of clients/end beneficiary or not. Therefore, we would like to see the FRC include non-UK assets within the remit of the Stewardship Code.

h) Integration of ESG into the investment process

We believe that an important aspect of good stewardship is the integration of ESG issues into investment decisions. ESG issues are integral to LGIM's beliefs and therefore part of our fiduciary duty. Our ultimate goal is to protect and enhance the investment returns for the benefit of our clients' assets and we believe ESG is important as a long term driver of value.

LGIM requests that the FRC enhances its description of stewardship activities in the Code to include the integration of ESG in addition to voting, monitoring and engagement.

i) Defining the purpose of stewardship

LGIM supports the approach in which signatories define the purpose of stewardship as it relates to their own organisation. We would welcome guidance from the FRC as to what this may look like for each participant in the investment chain as highlighted above.

We do not believe that the disclosure of the purpose of stewardship at fund level is appropriate because it will lead to an excessive reporting obligation for the signatory. There are limited benefits reporting at fund level and for LGIM which manages approximately over 5000 different funds, this would be onerous and demanding.

2) DISCLOSURE

LGIM believes that it is essential all participants in the investment chain publicly demonstrate how they exercise their stewardship activities. It acts as a differentiator to how stewardship is undertaken by participants and reveals their approaches to how they are fulfilling their fiduciary duty. For LGIM this is particularly important for:

(i) our clients (so they can allocate assets);
(ii) client representatives (for advising our clients); and
(iii) for companies (to be able to fulfil their governance code requirements to engage).

The Stewardship Code should clearly set out the disclosure requirements of signatories. We believe the following additions to the Code in this regard would be welcomed:

a) Commitment to stewardship

Signatories' commitment to stewardship via their statement ought to be regularly reviewed, and if necessary updated, on an annual basis. The FRC should also require that the statements are clearly "dated" so that clients and external stakeholders can monitor compliance to the Stewardship Code.

b) Evidencing stewardship

LGIM supports an evidence based approach to demonstrate the activities of a signatory. The FRC should ensure that disclosure requirements focus on the action/outcomes of stewardship as well as the process.

The FRC should require that signatories publicly disclose:

- How voting rights have been exercised:
  - broken down by company meeting and resolution
  - the rationale behind the voting decision for contentious resolutions and when votes are against management recommendation
  - disclosure can be in arrears but should be timely e.g. monthly or quarterly

- How engagement has had an impact:
  - Named company examples of engagement
  - Disclosure of engagements outside of equities
  - Disclosure of engagements on public policy and wider market issues
  - Engagement on strategic, financial, E,S & G issues undertaken

- How policies are applied across different asset classes and geographies. Such disclosure ought to be public and reviewed at least on an annual basis.

- How stewardship is integrated in the investment process across different asset classes and updated at least on an annual basis; and

- How a conflict of interest was identified in relation to stewardship, managed and mitigated by the firm during the year. The example could be anonymised and should be updated at least on an annual basis.

3) ASSURANCE OF STEWARDSHIP STATEMENT

LGIM supports the aim and purpose of the assurance assessment in the Stewardship Code. By obtaining an independent opinion of the voting and engagement processes, signatories are able to demonstrate and validate how they undertake their stewardship activities.

However, we believe that the current system AAF01/06 can be further improved in its efficiency, breadth and consistency.

a) Assurance of all Stewardship Code Principles

The current assurance process covers five out of the seven stewardship principles (namely 1,2,4,6 and 7). This relates to disclosure of policies on engagement, the voting process and public reporting. LGIM would like to see assurance standards set for all the principles in the Code. The

FRC should also ensure that the external assurance review process includes the public evidence of stewardship provided by the signatory under all the principles.

b) *Consistencies in disclosure*

We believe it is important that the assurance statement clearly states the level of consistency between a signatory's policies with their public reporting on their stewardship activities. This will highlight any irregularities or contradictions between the public reporting disclosures produced by the signatory and misalignment with their Stewardship Code Statement.

c) *Assurance for different parts of the investment chain*

Stewardship is an evolving process for a signatory and a more complete assurance process of stewardship may include different assurance processes for different aspects of stewardship (e.g. for different participants in the investment chain). The FRC should investigate whether this is appropriate and set out guidance on this issue.

d) *Feedback mechanism*

The purpose of assurance is to improve information or the context of information so that decision makers make more informed and better decisions. When currently examining stewardship, as a signatory, we are assessed under our internal processes for voting and engagement. There is limited feedback of how we could improve our voting and engagement processes because standards are not set of what outcome is expected of a signatory in demonstrating their processes. LGIM would welcome a stronger assurance standard incorporating a feedback mechanism on how stewardship can be improved by the signatory.

e) *Other verification processes*

Given the costs of undertaking an external assurance process, it may not be appropriate for signatories to conduct one every year but instead have it every two years. In those circumstances, the FRC should request that an independent non-executive director within the asset management firm signs off the Stewardship Code statement for verification of adherence to all the Codes principles.

Ultimately, we believe that there is a need for examining the stewardship statement in a wider context to provide a more coherent assurance framework to assess signatories. The assurance statement should be structured so that it can be publicly disclosed and be used as an assessment tool. We would support a roundtable discussion with other interested parties on this topic.

4) OVERSIGHT/ENFORCEMENT

a) *Stewardship Council*

Although, institutional investors and asset owners become signatory to the Stewardship Code, there needs to be better oversight on the impact the Stewardship Code is having and how it is being applied by signatories.

LGIM views good stewardship as more than just about disclosure, voting and engagement. Ultimately, better stewardship entails the right connected behaviours and accountabilities by participants in the investment chain (e.g. asset owners, asset managers and companies) to create generate wealth and value. In order for this to be carried out and optimised, a strong supervision framework needs to be in place to facilitate and define the correct actions.

We request that the FRC forms a special committee/council to strengthen the governance and oversight of the Stewardship Code. This ensures better monitoring and enforcement of stewardship based on accountability, disclosure and incentives from all parties. Furthermore, a market level view needs to be taken in order to ensure that there is consistency among those in the investment chain and that the shared objective is achieved. Members should be made up of a body of high-level experts who understand market dynamics and how the investment chain fits together.

We note that Japan[7] has already established a council of experts to examine stewardship. Furthermore, in the draft consultation document of the Dutch Stewardship Code, it was highlighted that Eumedion would establish an independent Monitoring Committee for overseeing the application of its principles.[8]

Therefore, LGIM believes there are significant benefits for the UK Stewardship Code if a special committee/council was formed to debate the evolution of stewardship in the UK and to oversee the endorsement of the principles by signatories in order to promote its long term success.

b) *Whistleblowing mechanism to report poor stewardship*

A process should be established whereby breaches of public commitments to stewardship by signatories can be reported or highlighted to the FRC. This ensures that high standards of adherence to the Stewardship Code Principles is maintained and does not weaken the reputation of those carrying out good stewardship.

The FRC should set up a whistleblowing mechanism for reporting breaches of public commitments to stewardship for asset managers. This requires the FRC to work closely with the FCA given that the Conduct of Business Sourcebook (COBS) 2.2.3[9] commitment on disclosure to the Stewardship Code sits with them.

c) *Recognising best practice*

As highlighted in Section 2: Disclosure, LGIM supports an evidence based approach to demonstrate best practice in stewardship as it promotes education and raises the standard in the industry.

- Tiering

Whilst the tiering of signatories the FRC has developed aims to differentiate the quality of Stewardship Code statements, we believe that it should be significantly strengthened and consider evidence based disclosure rather than just disclosure of policy. Signatories in Tier 3 should also not be able to claim signatory status and referred to the enforcement mechanism (highlighted above) to ensure that the member does not taint the reputation of the Stewardship Code.

[7] http://www.fsa.go.jp/en/refer/councils/stewardship/index.html

[8] https://www.eumedion.nl/en/public/knowledgenetwork/best-practices/2017-09-consultation-document-stewardship-code.pdf

[9] https://www.handbook.fca.org.uk/handbook/COBS/2/2.html

- Gold Standard

The FRC should highlight best practice stewardship in-action. This can be done by awarding an annual 'gold standard' to a select few signatories who have not only disclosed their approach to Stewardship but have also clearly demonstrated how this has translated in enhancing the quality of engagement with companies. Rewarding different parts of the investment chain in carrying out stewardship also adds credibility to the system and provides an incentive to improve.

We note that the Institute of Company Secretaries and Administration (ICSA) present awards to investors aimed to show the difference the Stewardship Code has made to the quality and quantity of investor engagement. The FRC could use a similar methodology to publicly name the signatories in different parts of the investment chain who have shown leadership in Stewardship beyond disclosure.

5) OTHER ISSUES

Voting in pooled funds

We note that the FRC has requested views on the appropriateness for the Stewardship Code to support disclosure of signatories approach to direct voting in pooled funds. We are also aware of the Red-Line Voting initiative and their views on this issue. LGIM would be happy to share its analysis on split voting in pooled funds with the FRC for further consideration. However, below we have highlighted some initial points on the benefits of pooled funds and the challenges with direct voting.

Benefits of pooled funds
LGIMs pooled fund clients expect the benefits of pooling their assets. For example, financial costs are lowered as a result of opportunistic cross trading internally.

Voting and engagement are also interdependent processes. Clients share the overall costs of executing a vote and the weight and scale it provides to influence company behaviour. In addition, splitting the vote may mean that the effectiveness of engagement activities is diluted as a result of sending multiple messages to the same company.

Therefore, any divergence between the voting instructions cast and engagement will cause confusion and ultimately impact all the clients in the pooled fund.

Challenges of directing votes in pooled funds
LGIM has examined in detail the operational impact of implementing red-line voting policies. Our conclusions found that there was material execution risk for all our pooled clients because of the manual process behind instructing a vote and there was a risk that votes could be rejected if cast in error.

The analysis and audit costs associated with split voting are also significant.

We continue to explore ways to lower the barriers in the voting chain. Furthermore, in 2017, LGIM took part in an interview for a discussion paper commissioned by AMNT, which is supported by UKSIF and PRI, on segregated voting in pooled funds.

Given that this is an industry-wide issue we have requested that the Investment Association (IA) conducts a formal review on this matter as we believe it is significant for asset managers and asset owners. We would also welcome legal clarification of the impact on pooled funds for directing voting.