



Corporate Governance and Stewardship
Financial Reporting Council
8th Floor
125 London Wall
London
EC2Y 5AS

Mander House
Mander Centre
Wolverhampton
WV1 3NB

By email to stewardshipcode@frc.co.uk

March 2019

Dear Sir or Madam,

LGPS Central Limited (LGPS Central) welcomes the opportunity to respond to the Financial Reporting Council's (FRC) consultation on proposed revisions the UK Stewardship Code (the Code).

LGPS Central was established as part of the programme of pooling local authority pension fund assets in order to reduce costs and provide access to asset classes such as direct infrastructure. We currently manage around £20bn on behalf of our partner funds.

We have a clear commitment to operating and investing in a responsible manner. Stewardship is one of three pillars in our *Responsible Investment & Engagement Framework*. We have long argued for a more robust and progressive version of the Code, and we are pleased to provide our views below.

In our consultation response, we wish to emphasise the following points:

1. *Definition of stewardship*

We wholeheartedly welcome the proposed definition of stewardship employed in the draft revised Code. The strengths of the definition are that it:

- a. Applies to asset classes beyond listed equities. Were it to fail to do so, a significant portion of an institutional investor's portfolio will be unaffected by improvements in stewardship. We strongly urge the FRC to ensure the Code encourages application of stewardship across all major asset classes.
- b. Refers to capital allocation decisions, not just "what happens afterwards".
- c. Recognises of the ultimate stakeholders in investment decision-making, i.e. beneficiaries, the economy, and society.

2. *Material ESG factors including climate change*

We welcome the explicit and specific reference to "material ESG factors, including

climate change”. This has many benefits to long-term investors (and beneficiaries, the economy and society). The new language is clear, and it aligns with the DWP’s recent government response on *Clarifying and Strengthening Trustees’ Investment Duties*¹. It would be unwelcome to have contradictory regulatory language. We have debated internally whether climate change ought to be ‘elevated’ above other ESG risks by being mentioned specifically. We have concluded that it should be mentioned specifically owing to its magnitude and universality (i.e. as a long-term risk factor), and also owing to the fact that if it were not mentioned, UK stewardship might regress to an old-fashioned version of itself, featuring little more than an annual chat with a remuneration committee Chair. The new language leaves no room for doubt as to the increased ambition of the new Code. We are strong supporters of the Green Finance Initiative’s (GFI) position in this regard.

3. *Inclusion of more guidance, leveraging existing work, e.g. TCFD*

We believe the guidance could be improved by suggesting reference materials to signatories, particularly asset classes and issues newly covered by the Code. In particular we recommend that the guidance refers to the recommendations of the Taskforce on Climate-related Financial Disclosures (TCFD) as (currently) the best-practice framework for disclosing on climate change issues. In addition, guidance for newly covered asset classes could signpost to the good work done by the UN PRI (most major asset classes), BVCA (private equity), and GRESB (infrastructure and real estate), among others.

4. *Requirement to explain ‘why’*

We believe the Code improves on its previous iteration in terms of the requirement of signatories to say ‘what’ and ‘how’ a signatory is doing by way of different aspects of stewardship. There is not, however, sufficient emphasis on *why* a signatory has elected to design and resource its stewardship approach in a particular way. As investors that could invest in funds managed by a fellow Code signatory, we are interested not just in what a signatory is doing by way of stewardship, but why that might add value to the investment strategy under consideration.

5. *Resource-constrained asset owners*

It is important to consider whether the progressive nature of the revised Code could come at a cost of reducing the signatory base – we are thinking primarily of resource-constrained asset owners – owing to the perception of excessive reporting burden. To be clear, we support the increased scope of stewardship and the annual reporting requirements, but we would urge the FRC to consider ‘phasing in’ the reporting requirements for asset owners, and taking a considered view when it comes to rating or assessing the reports. We would recommend a piloting project for stewardship reporting (and the assessment of such reports). We recommend that the language in the Code be made clear that it is appropriate for asset owners, particularly smaller resource-constrained asset owners, to have a model of stewardship whereby ownership and responsibility remains with the signatory, but

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https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/739331/response-clarifying-and-strengthening-trustees-investment-duties.pdf

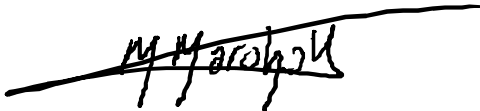
where it is permissible to have high quality implementation of stewardship via appointed contractors, with oversight by the signatory.

We applaud the consultation work undertaken by the FRC and we are looking forward to the publication of the consultation responses of other members of the investment industry. Were the FRC to receive responses that seek to dilute the definition of stewardship, or to downplay the relevance of ESG factors and climate change, we would urge the FRC to consider whose interests are being served by such views: it is unlikely to be beneficiaries, the economy, or society.

Our additional comments are provided with respect to the consultation questions below.

Should you wish to contact LGPS Central about this consultation response, please do not hesitate to get in touch.

Yours sincerely,

A handwritten signature in black ink, appearing to read "Michael Marshall", is written over a horizontal line that extends across the width of the signature.

Michael Marshall
Director of Responsible Investment & Engagement, LGPS Central Limited

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

A1. Yes, with the caveats offered below.

The draft is well constructed and has incorporated several progressive features including:

- Expanding the scope beyond listed equities
- Mirroring the corporate governance code
- Including reference to investment decisions, not just post-investment activities
- Activities and outcomes focus
- Focus on purpose, culture and values

We endorse the reference to “ESG factors including climate change” under Principle E. For consistency we think all references to ESG in the document should be accompanied by “including climate change”, for example in Provision 11. The new language is clear, and it aligns with the DWP’s recent government response on *Clarifying and Strengthening Trustees’ Investment Duties*². It would be unwelcome to have contradictory regulatory language. We have debated internally whether climate change ought to be ‘elevated’ above other ESG risks by being mentioned specifically. We have concluded that it should be mentioned specifically owing to its magnitude and universality (i.e. as a long-term risk factor), and also owing to the fact that if it were not mentioned, UK stewardship might regress to an old-fashioned version of itself, featuring little more than an annual chat with a remuneration committee Chair. The new language leaves no room for doubt as to the increased ambition of the new Code. We are strong supporters of the Green Finance Initiative’s (GFI) position in this regard.

We wholeheartedly welcome the proposed definition of stewardship employed in the draft revised Code. The strengths of the definition are that it:

- a) Applies to asset classes beyond listed equities. Were it to fail to do so, a significant portion of an institutional investor’s portfolio will be unaffected by improvements in stewardship. We strongly urge the FRC to ensure the Code encourages application of stewardship across all major asset classes.
- b) Refers to capital allocation decisions, not just “what happens afterwards”.
- c) Recognises of the ultimate stakeholders in investment decision-making, i.e. beneficiaries, the economy, and society.

We think the FRC should consider combining sections 3 and 4 into one section, as there is a deep connection between ‘monitoring’ and ‘engaging’ (there are links between the other sections too, e.g. ‘engaging’ and ‘voting’, but the link between sections 3 and 4 has particular profundity). In addition, would think that the combination and elimination of as

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https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/739331/response-clarifying-and-strengthening-trustees-investment-duties.pdf

many provisions as possible would reduce the apparent length of the new Code. E.g. provisions 21 and 17 could be combined, or provisions 11 and 13 could be combined.

We think that the *Service Providers Stewardship Code* needs more work, particularly in the guidance so that the expectations of different providers can be fleshed out. For example, consultants supporting manager selection and manager monitoring. We expand on this in A16 below.

Finally, assessment and enforcement are described in the consultation questions but not in the Code document. We think it would be useful to include some details of assessment and enforcement on pages 4-5 of the Code.

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

A2. Yes, subject to our comments below.

We refer back to our support in A1 for the proposed definition of stewardship, and our strong endorsement of the specific reference to “material ESG factors including climate change”. With regards to the latter, it is important that it is included as a principle, rather than a provision, in order to guarantee its status as “apply and explain” rather than “comply or explain”.

We believe the Code improves on its previous iteration in terms of the requirement of signatories to say ‘what’ and ‘how’ a signatory is doing by way of different aspects of stewardship. There is not, however, sufficient emphasis on *why* a signatory has elected to design and resource its stewardship approach in a particular way. As investors that could invest in funds managed by a fellow Code signatory, we are interested not just in what a signatory is doing by way of stewardship, but why that might add value to the investment strategy under consideration. This applies to provisions 18, 19, 20, 23, among others.

It is important to consider whether the progressive nature of the revised Code could come at a cost of reducing the signatory base – we are thinking primarily of resource-constrained asset owners – owing to the perception of excessive reporting burden. To be clear, we support the increased scope of stewardship and the annual reporting requirements, but we would urge the FRC to consider ‘phasing in’ the reporting requirements for asset owners, and taking a considered view when it comes to rating or assessing the reports. We would recommend a piloting project for stewardship reporting (and the assessment of such reports).

We recommend that the language in the Code be made clear that it is appropriate for asset owners, particularly smaller resource-constrained asset owners, to have a model of stewardship whereby ownership and responsibility remains with the signatory, but where it is permissible to have high quality implementation of stewardship via appointed contractors, with oversight by the signatory. This allows for an asset owner to delegate operational implementation of stewardship to an appropriate organisation with expertise and resources e.g. an LGPS asset pool. The same point can be made but with lesser concern

on other provisions for various implementation models, whilst accepting the principle that stewardship ‘responsibility cannot be delegated’.

Code (Annex A) p6: Provision 4 – implies that the steward expertise has to come from within the investor’s own workforce. We recognise that an investor who chooses an outsourced model must have enough expertise/ training to provide adequate oversight but feel the language of the actual provision needs to deemphasise the ‘own workforce’ element.

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

A3. Yes. We support greater structural consistency between the Code and the UK Corporate Governance Code.

We reiterate our remark in A2 that it is important that reference to “material ESG factors including climate change” is included as a principle, rather than a provision, in order to guarantee its status as “apply and explain” rather than “comply or explain”.

With regards to comply or explain, we believe it is important that signatories are not ‘marked down’ in the FRC assessments of Code statements and ongoing reporting signatories if a give credible explanation for non-compliance is offered.

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

A4: The Guidance needs more work to provide more support on the ‘how to’. We also support more guidance on other asset classes such as fixed interest and private markets. We would encourage references to best practice guidance produced by, among others, UN PRI (most major asset classes), BVCA (private equity), and GRESB (infrastructure and real estate). We are happy to share work we are developing in this area over time and hope other signatories can do likewise to facilitate sharing of best practice.

In some cases, the guidance offers little more to the reader than is already in the provision text. e.g. Provision 5, Provision 8, Provision 10, Provision 11, etc. More signposts to existing initiatives that drive best practice stewardship disclosure would be beneficial.

Notably absent is a reference to the TCFD recommendations in the guidance itself. For code signatories looking to disclose against Provision 3 (governance) or Provision 11 (ESG integration), a link to the TCFD recommendations in the guidance would be beneficial. While the TCFD recommendations might be replaced or developed in time, the Code’s guidance is flexible and can be updated by the FRC without consultation.

Whilst generally not prescriptive in of itself, there are provisions on asset owners where the language feels quite daunting. For example, code (Annex A), p7: Provision 13 As currently drafted, would place a great burden on asset owners to set criteria that we believe is

unrealistic. We would recommend that this should have emphasis on communicating priorities linked to investment beliefs rather than specific criteria.

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

A5. We are supportive of the proposal to an annual Activities and Outcomes Report. We believe the overriding principal that guides the content of the report should be that it is useful and engaging and meets the needs of its stakeholders.

We strongly recommend that the FRC does not get drawn into providing templates as we believe this will lead to ‘filling in the blanks’ as this will fail to deliver on our recommendation above that each report should think about its readers – clients, beneficiaries and other stakeholders - focusing on what they want first and foremost. This would necessitate signatories exploring what those needs are.

Another guiding principle is that the report should provide assurance that the signatory has delivered across all its stewardship obligations – so needs to be comprehensive in coverage but need not contain lots of unnecessary detail. We would recommend such detail can be signposted in other available documents e.g. individual voting decisions, detailed technical guidelines and other supporting policies. We would also recommend the FRC are clearer that matters need only be reported once, even if the evidence supports several principles or provisions. One example is securities lending, which is referred to in number of areas.

Furthermore, we would encourage an approach that is inclusive and flexible. For example, it would be appropriate in our view for those operating within a ‘collective model’ to use a report produced on behalf of several signatories, for example an LGPS Asset Pool.

Whilst strongly supporting transparency, there are several places in the guidance which imposes a significant burden on some investors that in our view exceeds the benefit. For example, Code (Annex A), p18: Guidance under Provision 26 – explaining rationale for every vote against. What this means in practice must be contextualised by the quantum of voting undertaken, for large diversified holdings such as passive

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

A6. Yes, but with regards to assessment and enforcement for resource-constrained asset owners, we encourage a phased approach. Please see our comments above.

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

A7. We believe enforcement of the new version of the Code needs to improve considerably compared with enforcement against the current version. This will necessitate the FRC recruiting more stewardship professionals. We do not have a comprehensive set of recommendations for enforcement, but suggest that the threat of de-listing signatories could be an option. We believe it would be worthwhile engaging the FCA to discuss appropriate enforcement actions. We reiterate our points made above about the implications the new Code has on resource-constrained asset owners and we would encourage a tailored approach to enforcement in recognition of these features.

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

A8. Yes. Signatories should make clear their role in the investment chain, and explain why they have resolved to design and resource their approach to stewardship in the way they have.

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

A9. Yes.

One of the core strengths of the new code is the expansion beyond listed equities. We strongly urge the FRC to ensure the Code encourages application of stewardship across all major asset classes.

We believe the guidance could be improved by suggesting reference materials to signatories, particularly asset classes and issues newly covered by the Code. In particular we recommend that the guidance refers to the recommendations of the Taskforce on Climate-related Financial Disclosures (TCFD) as (currently) the best-practice framework for disclosing on climate change issues. In addition, guidance for newly covered asset classes could signpost to the good work done by the UN PRI (most major asset classes), BVCA (private equity), and GRESB (infrastructure and real estate), among others.

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

A10. Yes, subject to the comment below.

As investors in funds managed by external fund managers, we are less interested in how stewardship is done at a firm-level: what we really care about is the quality of stewardship in the strategy we are consider allocating to. Provision 1, and/or the associated guidance, should make it clear that signatories should disclose the coverage of the stewardship approach, and highlight by exception the funds/ strategies/ asset classes not covered by the disclosed stewardship approach (or covered by other stewardship policies and processes).

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

A11. Yes. Investment beliefs should be the foundation upon which one's stewardship approach is built. This guarantees an intentional rationale for the stewardship approach.

In the case of service providers advising on investment beliefs to asset owners, we think there should be a process for managing conflicts of interest which could arise. For example, the recommendations with respect to beliefs should be clearly designed with client interest at heart; beliefs should not be geared towards product specialisms offered by the service providers for an additional fee.

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

A12. Yes.

As we have discussed above, we recommend that the language in the Code be made clear that it is appropriate for asset owners, particularly smaller resource-constrained asset owners, to have a model of stewardship whereby ownership and responsibility remains with the signatory, but where it is permissible to have high quality implementation of stewardship via appointed contractors, with oversight by the signatory.

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

A13. Yes.

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

A14. Yes.

We have been involved in engagements where Boards and/ or management have refused to countenance perfectly ordinary shareholder requests. Such engagements tend to grind to halt, unless one considers legal action or a lengthy, activist-style public battle. We would support a mechanism as described in the question and we have recently joined the Investor Forum to try and overcome these issues. Were such a mechanism to be introduced, one would have to take the utmost care to avoid conflicts of interest, regulatory issues (e.g. takeover code and concert party issues), or risks of the escalation becoming public (which could affect a company's market value). We recommended leveraging the Investor Forum's experience to set up the mechanism.

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

A15. Yes, primarily through inclusions in the guidance. We refer back to our comments under A4.

We observe that provision 27 might more properly be included in Section 4.

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

A16. No.

We have viewed a suggested version of the *Service Providers Stewardship Code* drafted by the Purposeful Company. We endorse this version and believe that it would hold service providers to a higher and more appropriate standard of stewardship service than the version proposed by the FRC. We recommend the FRC engage the Purposeful Company to further develop the *Service Providers Stewardship Code*. We think service providers that are Code signatories should report annually.

We recommend the work of the AMNT <https://amnt.org/wp-content/uploads/2018/12/FINAL-investment-consultant-December-2018-report.pdf> and imminent work by the PRI to assist in the development of the minimum stewardship requirements for investment consultants.

Particularities

We provide some specific comments on the consultation documentation:

Consultation document, p12: The definition of service providers should be clear that it includes fiduciary managers or investment consultants that take part in fund manager selection.

Consultation document, p13: paragraph 60 could be edited and inserted into the Code p5

Consultation document, p14: paragraph 72 – if the FRC intends to ‘name and shame’ as part of Code enforcement, the criteria against which signatories are scored should be made clear. We re-iterate points made above about resource-constrained asset owners.

Consultation document, p17: question 9 – could add in the Guidance links to good practice developed by other organisations, e.g. BVCA RI Advisory Group and PRI PE monitoring guidelines.

Code (Annex A), p1: reference to ESG factors should say “including climate change”.

Code (Annex A), p3: reference to annual reports – the signposts to other reports may include quarterly disclosures.

Code (Annex A), p3: we like this definition of asset owners. It is not the same as the definition on p20, which is less suitable. It would be good to have the p3 definition in both cases.

Code (Annex A), p4-5: we think it would be useful to include here some details explaining that the FRC will check your Policy and Practices Statement and of the assessment of the Outcomes Reports.

Principle 1:

Code (Annex A), p6: Provision 2, there should be guidance on what ‘stakeholder’ means.

Code (Annex A), p6: Provision 3 – we are not sure how this is different to Principle C. This should explicitly link to the risk framework. This helps to interweave stewardship and the TPR governance framework.

Code (Annex A) p6: Provision 4 – requirement is potentially very off-putting to resource-constrained asset owners. Propose change to

“signatories should explain that those to have stewardship responsibilities within the governance structure have the appropriate experience,.....”. This allows for an asset owner to delegate operational implementation of stewardship to an appropriate organisation with expertise and resources e.g. an LGPS asset pool.

The same point can be made but with lesser concern on other provisions for various implementation models, whilst accepting the principles that stewardship ‘responsibility cannot be delegated’.

Principle 2:

Code (Annex A), p7: Provision 10 - This needs to note that there could be a variety of timeframes relating to different aspects of investment beliefs and stewardship.

Code (Annex A), p7: Provision 11 should say “ESG factors including climate change” for consistency with Principle E.

Code (Annex A), p7: Provision 12 for asset owners could have guidance that links to the TPR guidance, which includes guidance on investment beliefs and example beliefs relating specifically to climate change.

Code (Annex A), p7: Provision 13 As currently drafted this places a great burden on asset owners to set criteria that may not be unrealistic. We recommend that this should have an emphasis on communicating priorities linked to investment beliefs rather than specific criteria.

Principle 3:

Code (Annex A), p8: Provision 14 - This needs to note that there could be a variety of timeframes relating to different aspects of investment beliefs and stewardship.

Code (Annex A), p8: Provision 15 - This needs allow for various implementation models, whilst accepting the principles that stewardship 'responsibility cannot be delegated'.

Principle 4:

Code (Annex A), p9: Provision 21 (Asset managers) – would include a requirement to report back to clients on how/ what they have done.

Principle 5:

Code (Annex A), p10: Provision 27 – this feels like it should belong in Section 4.

Guidance

Code (Annex A), p18: Guidance under Provision 26 – explaining rationale for every vote against is burdensome for passive equity investors. There could be a guideline for explaining contentious votes or votes where equity ownership exceeds a certain threshold.