PRI Principles for Responsible Investment

DISCUSSION PAPER RESPONSE

FCA AND FRC: BUILDING A REGULATORY FRAMEWORK FOR EFFECTIVE STEWARDSHIP

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INTRODUCTION

ABOUT THE PRI

The Principles for Responsible Investment (PRI) is the world's leading initiative on responsible investment. Originally set up by the UN in 2005, the PRI now has over 2,300 signatories (pension funds, insurers, investment managers and service providers) to the PRI's six principles globally with approximately US $83 trillion in assets under management. 366 of these signatories, representing $9 trillion, are based in the United Kingdom.

The PRI supports its international network of signatories in implementing the Principles. As long-term investors acting in the best interests of their beneficiaries and clients, our signatories work to understand the contribution that ESG factors make to investment performance, the role that investment plays in broader financial markets and the impact that those investments have on the environment and society as a whole.

The PRI works to achieve this sustainable global financial system by encouraging adoption of the Principles and collaboration on their implementation; by fostering good governance, integrity and accountability; and by addressing obstacles to a sustainable financial system that lie within market practices, structures and regulation.

SUMMARY OF THE PRI'S POSITION

The PRI welcomes this discussion paper, which raises a number of important questions on stewardship with which members of the financial community should engage. This is central to the PRI's mission – Principle 2 states: "We will be active owners and incorporate ESG issues into our ownership policies and practices".

Active ownership is one of the most effective strategies available to investors to minimise risks and maximise returns. Recent academic research commissioned by the PRI shows that successful engagement dialogue is not only correlated with positive returns on assets,[1] but it also increases communication, learning and internal relationships for investors and companies.[2]

Active ownership can also enable investors to have a positive impact on society and the environment. By raising corporate awareness of environmental and social issues and by encouraging them to take effective action and to report on these issues, investors can encourage companies to minimise their negative impacts and maximise their positive contribution.

The PRI has actively solicited signatory views on the upcoming changes to the regulatory landscape for stewardship in the UK. The PRI engaged with signatories on the consultations relating to the revised Shareholder Rights Directive (SRD II) and the draft Stewardship Code, and convened a group

[1] https://www.unpri.org/academic-research/local-leads-backed-by-global-scale-the-drivers-of-successful-engagement/537.article
[2] https://www.unpri.org/academic-research/how-esg-engagement-creates-value-for-investors-and-companies/3054.article

of signatories, policymakers and other stakeholders in April 2019 to discuss the future of stewardship, including some of the questions raised in this Discussion Paper. This engagement has informed our response to the Paper.

In addition to the existing recommendations set out below, **the PRI recommends**:

1) **The proposed definition of stewardship is retained –** this definition reflects corresponding duties in the UK and beyond, and reflects many investors' existing stewardship activities.

2) **The key attributes of effective stewardship emphasise outcomes –** the outcomes which investors can achieve from stewardship should be a central focus of the proposed attributes.

3) **Proxy advisors and investors work together on market actors' concerns** – we would welcome further dialogue between investors and proxy advisors to strengthen their contribution to a culture of effective stewardship in the UK and beyond.

EXISTING STEWARDSHIP RECOMMENDATIONS

The PRI has made recommendations in connection with the revised Stewardship Code[3] and the implementation of SRD II[4] as summarised below:

Stewardship Code

1) **A focus on outcomes –** the Stewardship Code should ensure that signatories place outcomes for clients, beneficiaries and society at the heart of their stewardship strategies to deliver long-term value.

2) **The provision of ESG-related services by service providers –** the Code should include ESG provisions for service providers, reflecting their influence on investment processes.

3) **Guidance –** the Guidance should provide regularly updated examples of good stewardship practices, particularly for asset classes other than listed equity.

4) **Reporting framework –** the reporting framework under the revised Stewardship Code should avoid duplication with existing reporting frameworks widely used by investors. By aligning reporting requirements under the Code with existing frameworks, particularly the PRI's Reporting Framework which also integrates the Task Force on Climate-Related Financial Disclosures (TCFD) recommendations, compliance costs could be reduced.

[3] See: https://www.unpri.org/Uploads/g/a/k/stewardshipcodeconsultationpriresponse_40740.pdf
[4] See: https://www.unpri.org/Uploads/g/a/k/fcaconsultationonrevisedsrdpriresponse_635150.pdf

Revised Shareholder Rights Directive

1) **Require the disclose of an engagement policy and the exercise of shareholder votes.** The FCA should make the requirements under Article 3g of the Directive mandatory, rather than proceeding on a comply or explain basis.

2) **Define "insignificant" votes.** The FCA should provide guidance on which votes are outside of the scope of the reporting requirements of the Directive. A failure to do so risks this term being interpreted too expansively.

RESPONSE TO DETAILED QUESTIONS

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

The PRI strongly supports the definition of stewardship set out in the Discussion Paper, as "the responsible allocation and management of capital across the institutional investment community, to create sustainable value for beneficiaries, the economy and society."

This is strongly aligned with the preamble to the six Principles for Responsible Investment, which states: "As institutional investors, we have a duty to act in the best long-term interests of our beneficiaries. In this fiduciary role, we believe that environmental, social, and corporate governance (ESG) issues can affect the performance of investment portfolios (to varying degrees across companies, sectors, regions, asset classes and through time). We also recognise that applying these Principles may better align investors with broader objectives of society." As noted above, exercise of ownership rights is one of the six Principles.

This view of stewardship also reflects the fiduciary duty owed to beneficiaries, which requires the integration of material ESG issues into investment processes.[5] Beneficiaries' interest in financial returns relates to the usefulness of their savings in future. If the future is severely resource constrained, inequitable and insecure, beneficiaries are unlikely to receive the intended benefits of their savings.[6] Recent revisions to the Occupational Pension Schemes regulations (2018)[7] have established requirements for pension funds to set out their policy in relation to financially material ESG factors, as well as clarifying that non-material ESG issues may be considered where the Trustees have reason to believe members share their concerns and where there is no harm of significant financial detriment. Regulated pension schemes must also establish a policy on exercise of ownership rights, recognising the importance of stewardship for long-term value creation.

The definition also reflects the broader range of stakeholders affected by stewardship activities, and international regulation which is increasingly sensitive to the role of financial markets in contributing to positive and negative impacts on the real economy. For example, a recent political agreement reached at EU level will require investors to disclose adverse ESG impacts, such as in assets that pollute water or devastate bio-diversity.[8] UK corporate boards face a corresponding duty set out in section 172 of the Companies Act 2006, which requires directors to consider the interests of employees, suppliers, customers, the community and the environment.[9]

The definition also reflects emerging stewardship best practices. The PRI has found that some investors are integrating real economy impact into their investment analysis, including it as a third axis

[5] See: https://www.unpri.org/fiduciary-duty/fiduciary-duty-in-the-21st-century/244.article
[6] See: https://www.unpri.org/sustainable-financial-system/how-the-pri-is-contributing-to-a-sustainable-financial-system/199.article
[7] See: https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/739331/response-clarifying-and-strengthening-trustees-investment-duties.pdf
[8] See: http://europa.eu/rapid/press-release_IP-19-1571_en.htm
[9] See: https://www.legislation.gov.uk/ukpga/2006/46/section/172

alongside risk and return[10], and 10% of PRI's asset owner signatories use "real economy targets" when selecting external managers.[11] Thus the proposed definition incorporates the wide range of activities already being undertaken by some investors.

This definition is an important step towards the goal set out in the Guidance to the draft Stewardship Code of building a sustainable financial system, "which both manages systemic risks and drives capital towards more sustainable investments". This is a core part of the PRI's mission to which over 2,300 investors and service providers have signed on to date.

Q2 Are there any particular areas which you consider that investors' effective stewardship should focus on to help improve outcomes for the benefit of beneficiaries, the economy and society (eg ESG outcomes, innovative R&D, sustainability in operations, executive pay)?

There are a wide range of issues on which investors can engage to improve the ESG performance of their assets. Three are set out below: climate change, an issue of global urgency; and economic inequality and short-termism, which are of particular relevance in the UK.

(i) Climate Change

Climate change is frequently cited by PRI Signatories as the highest priority ESG issue they face.[12] All investors should have a policy on how they are addressing climate change-related risks and opportunities in their portfolio.

The PRI's *The Inevitable Policy Response to Climate Change*[13] project demonstrates that many investors are still underprepared to deal with the transition risks associated with climate change. The PRI and other partners[14] have commenced a scoping of the investment implications of a rapid and forceful policy response to close the gap between current policies and the ambitions set out in the Paris Agreement.

Such a trajectory is not being actively considered by most corporations and investors, many of whom are basing decision-making on current policies rather than potentially more demanding regulations that may be instituted in the future. To help PRI signatories reduce the risks of such a scenario, PRI

[10] See: https://www.unpri.org/listed-equity/a-practical-guide-to-active-ownership-in-listed-equity/2717.article. See also https://app.powerbi.com/view?r=eyJrIjoiZWFhMGFkODItMDMwOC00ODgxLWEwNDYtZmUwZWZhZGJiZDY4IiwidCI6ImZiYzI1NzBkLWE5OGYtNDFmMS1hOGFkLTEyYjEzMWJkOTNlOCIsImMiOjh9, which sets out signatories' publicly available responsible investment policies, some of which integrate real economy impacts.
[11] Based on responses to SAM 02.4 under the 2018 PRI Reporting Framework. Real economy targets are defined as the extent to which an investment positively or negatively impacts the real economy, including ESG impacts, additionally to financial return.
[12] For example, it was the number one ESG issue in the PRI's 2018 Asset Owner Survey. See also the PRI Blueprint for Responsible Investment: https://www.unpri.org/download?ac=5330
[13] See: https://www.unpri.org/climate-change/the-inevitable-policy-response-to-climate-change/3578.article
[14] Energy Transition Advisors and Vivid Economics, with the support of the ClimateWorks Foundation.

has announced that all signatories will be required to report against TCFD governance and strategy based indicator questions in 2020[15].

As with other issues, investors should avoid taking a siloed approach to climate change stewardship. The Paris Agreement recognised that a 'just transition' would be necessary for workers and communities affected by the shift towards a resilient, low-carbon economy.[16] The UK Green Finance Task Force recommended integrated community place-based investing into a national strategy for a pipeline of green and resilient infrastructure projects[17].

The PRI is also a coordinating partner of the Climate Action 100+, an investor initiative to ensure the world's largest corporate greenhouse gas emitters take necessary action on climate change. The CA100+ statement has been signed by 342 global investors.[18]

(ii) Economic Inequality

The UK has one of the highest rates of income inequality in the OECD.[19] As has been widely noted, higher income inequality in countries is associated with higher rates of crime, lower life expectancy and less social cohesion[20]. The PRI's report *Why and how might investors respond to economic inequality*[21] sets out a number of mechanisms by which inequality may inhibit economic growth and long-term returns, such as:

- **Reduced consumer demand**: the wealthy tend to save more than other consumers, so wage stagnation and the resulting inequality may reduce the spending power of the poor and middle classes, in addition to reduced ability to save for retirement.
- **Increased economic instability:** inequality may drive bubbles, as those without economic resources take on debt for consumption.
- **Rent-seeking and political power:** concentration of wealth may lead to increased political power and influence, capturing economic rents at the expense of productive activity.

This is a particular risk for "universal owners" – asset owners with highly-diversified portfolios and long-term investment horizons which face risks that are not particular to any single company or sector but rather the wider economy. While such owners may theoretically see higher profitability at individual companies where wage expenses are minimised, applying this thinking across their entire portfolio would inhibit the consumer demand that fuels economic growth.

[15] See: https://www.unpri.org/news-and-press/tcfd-based-reporting-to-become-mandatory-for-pri-signatories-in-2020/4116.article
[16] See: https://www.unpri.org/academic-research/climate-change-and-the-just-transition-a-guide-for-investor-action/3202.article
[17] See: http://greenfinanceinitiative.org/workstreams/green-finance-taskforce/
[18] See: https://climateaction100.wordpress.com/investors/
[19] See: https://www.unpri.org/academic-research/climate-change-and-the-just-transition-a-guide-for-investor-action/3202.article
[20] See: https://www.equalitytrust.org.uk/resources/the-spirit-level
[21] See: https://www.unpri.org/academic-research/why-and-how-might-investors-respond-to-economic-inequality/555.article

Inequality in the UK has manifested itself in a number of ways, including reduced social mobility[22] and a high disparity between the pay of executives at public companies and the median worker. A recent report by the Business, Energy and Industrial Strategy Committee (BEISC)[23] points out that "[o]ver the last decade chief executives' earnings in the FTSE 100 have increased four times as much as national average earnings. FTSE 100 chief executives earn around £4 million per annum while average pay is under £30,000." Similarly, while executives saw pay rises of 11% in 2017, the median worker salary failed to keep pace with inflation[24].

The BEISC report attributes this issue in part to a failure of investor stewardship, stating "we do not have confidence in remuneration committees, or institutional investors in exercising their stewardship functions, in a way that consistently bears down on executive pay". Investor engagement on executive pay in the UK should include its role in exacerbating income inequality.

(iii) Short-termism

Communicating to investee companies that investors are motivated by these companies' long-term performance, and that they support investments whose benefits may take several years to materialise, should be a core message of investors' active ownership activities.

Short-termism in UK equity markets is a longstanding concern, and was a central pillar of the Kay review in 2012.[25] Issuers frequently cite investor pressure as the primary motivator for engaging in behaviour that will benefit short-term financial performance over the company's long-term health[26], and has been used as a justification for governance structures limiting shareholder rights such as dual-class shares.

These short-term pressures arise in part from a misalignment of incentives along the investment chain. While asset owners and their beneficiaries generally have long-term investment horizons, as noted in the Discussion Paper asset manager selection is often made on the basis of financial performance over a relatively short period.

The structure of executive pay has also contributed to short-termism. Despite investor attention to this issue set out above, a focus on short-term financial metrics in executives' annual bonus plans among other issues has led to short-term profitability being incentivised at the expense of long-term growth.[27] The PRI is currently scoping research to investigate how executive pay can drive and deliver corporate sustainability in the long-term.[28]

[22] See: https://www.gov.uk/government/news/social-mobility-in-great-britain-fifth-state-of-the-nation-report
[23] See: https://publications.parliament.uk/pa/cm201719/cmselect/cmbeis/2018/201802.htm
[24] See: https://www.theguardian.com/business/2018/aug/15/uk-top-bosses-pay-rise-average-earnings-hit-39m-2017-high-pay-centre
[25] See: https://www.gov.uk/government/news/kay-review-publishes-report-on-uk-financial-sector
[26] See: https://www.fcltglobal.org/docs/default-source/default-document-library/fclt-global-rising-to-the-challenge.pdf
[27] See: https://www.sciencedirect.com/science/article/pii/S0167268118300428
[28] See: https://www.unpri.org/pri-blog/whats-the-future-of-executive-pay/4290.article

Q3 To what extent do the proposed key attributes capture what constitutes effective stewardship? Which attributes do you consider to be most important? Are there other attributes that we should consider? If so, please describe.

The proposed key attributes are a useful framework for capturing effective stewardship. The PRI's view is that the first two attributes, relating to a clear purpose and constructive oversight and engagement, are of particular importance, and recommends strengthening the second attribute by emphasising a holistic and outcomes-based approach to stewardship.

(i) A clear purpose

The first attribute refers to "[a] clear understanding of the scope, role and purpose of stewardship and good communication to align stewardship objectives", between investors and clients/beneficiaries. This attribute should be more strongly reflected in the regulatory framework for stewardship.

The PRI supports this view and has previously identified greater attention to beneficiary interests as one of nine key conditions that must be addressed to achieve a more sustainable financial system.[29] The revised Shareholder Rights Directive and draft Stewardship Code both seek to improve downward information flow – from asset managers to asset owners, and asset owners to beneficiaries. If alignment of stewardship objectives and attention to beneficiary interests is to be achieved, this framework will need to incentivise information flow in the opposite direction. The PRI has recommended expanding Principle I of the Code to engage clients and beneficiaries on their sustainability preferences.

The FCA has also proposed introducing a requirement for the Independent Governance Committees (IGCs) of contract-based pension schemes to report on the extent to which (if at all) the ethical and other concerns of consumers are taken into account in investment strategies and decision-making.[30] This has the potential to significantly improve awareness of beneficiary interests throughout the investment chain.

The PRI encourages asset owners to regularly engage beneficiaries about their sustainability preferences and be transparent about their investment and ownership practices. The PRI recognises that this poses practical challenges for many pension funds, however, it is consistent with the aspirational nature of the draft Code.

[29] See: https://www.unpri.org/sustainable-financial-system/how-the-pri-is-contributing-to-a-sustainable-financial-system/199.article
[30] See: https://www.fca.org.uk/publications/consultation-papers/cp19-15-independent-governance-committees-extension-remit

(ii) Constructive oversight, engagement and challenge

This attribute should place a greater emphasis on the outcomes of stewardship activities. The holistic approach to stewardship which this attribute recommends should also be more strongly reflected in the Stewardship Code.

Both this attribute and the Stewardship Code should focus more on the outcomes investors may achieve through stewardship, rather than the quantity of their active monitoring activities. As set out in response to Q4 below, investors should be encouraged to dedicate stewardship resources to those assets and issues where they have the greatest potential to effect change and positive outcomes. The PRI's response to the Code consultation sets out more detailed recommendations for how the Code could be amended in this regard.[31] This focus on outcomes should be long-term, and as such investors should be prepared to trade short-term performance for long-term gains.

The attribute's focus on the integration of stewardship and investment decisions is also welcome and should be more strongly reflected in the Stewardship Code. It underscores the need for investors to take a holistic approach to stewardship and to ensure that information is being effectively shared across the organisation.

The internal divide between portfolio managers and ESG specialists is an oft-cited concern, where the investor representatives are not those responsible for making voting decisions, and do not provide feedback of the outcomes from engagement meetings to relevant decision-makers. According to responses to the PRI's reporting framework, 24% of responding signatories lack a systemic process whereby information derived from ESG engagement is made available for use in investment decision-making.[32]

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

There should be no limit to the geographic or asset class scope of stewardship. Rather, signatories should focus on areas within this broad scope where they can have the most impact. The reporting requirement under the revised Stewardship Code and the assessment of responses should reflect this focus on outcomes and prioritisation.

Good active ownership requires research, prioritisation, setting objectives, tracking results, integration with investment decision-making, persistence and consistency. The PRI recognises that challenges remain in dispelling the view that effective stewardship involves maximising the number of shareholder votes exercised and engagement meetings held. For example, a 2012 Tomorrow's Company report found that "Chairmen feel that some investors attend meetings without having given

[31] See note 3.
[32] Based on 465 responses to voluntary indicator LEI 03.1.

sufficient thought to why they are having the meeting – the meetings often lack a clear agenda and purpose. Chairmen were not always impressed by the credibility of some investors' representatives."[33]

Engagement and proxy voting activities should not be standalone objectives. Dialogue without clear purpose, preparation and consistency of messaging can be more detrimental than no action at all. A 'quantity over quality' approach fails to generate value for clients and beneficiaries and dilutes the influence of more informed investors.

(i) Asset class scope

The PRI's view is that stewardship responsibilities extend to all asset classes. While different ownership rights attach to different asset classes, all provide opportunities for investor engagement and 'pressure points' where investors can influence outcomes and mitigate risks. The PRI requires signatories to report on various aspects of their responsible investment policies and activities for listed equity, fixed income, private equity, hedge funds forestry, farmland, infrastructure, property, commodities, cash and inclusive finance products, and provides a range of guides setting out how investors can incorporate ESG and be active owners.[34] The PRI has recommended that the Guidance to the Stewardship Code include more examples of recommended practices for stewardship of other asset classes, given that investors tend to have less experience of stewardship beyond listed equity.[35]

(ii) Geographical scope

The geographical scope of stewardship should be similarly broad, given evidence that performance on corporate social responsibility tends to be poorer the further investors are located from investee companies.[36] Collaborative engagement is one effective method for overcoming challenges in exercising stewardship across borders.

As noted in the Discussion Paper, a "home bias" exists in stewardship insofar that investors are more likely to engage with companies within their jurisdiction. The PRI has found that language barriers as well as "[c]ultural distance that can lead to the avoidance of direct discussion or straightforward style of questioning that can undermine the dialogue"[37] have tended to inhibit cross-border engagements.

Collaborative engagement is particularly suited to improving such engagements. Geographic and cultural diversity within a group can enable investors to share local knowledge and contacts, and to take a more nuanced approach to engagement that is sensitive to the economic, regulatory and cultural context of different markets.

[33] See: https://www.tomorrowscompany.com/publication/2020-stewardship-improving-the-quality-of-investor-stewardship/
[34] See: https://www.unpri.org/investor-tools
[35] See: https://www.unpri.org/asset-owners/asset-allocation
[36] See: https://www.researchgate.net/publication/303197029_Institutional_Ownership_and_Corporate_Social_Responsibility_The_Moderating_Effect_of_Geographic_Proximity
[37] See note 10.

Research[38] backed by the PRI has also found that success rates in collaborative engagements are elevated by about one-third when there is a lead investor who heads the dialogue. Success rates are enhanced when that investor is located in the same geographic region as the targeted firm.

Q5 We welcome examples of how firms with different objectives and investment strategies approach stewardship. In particular, we welcome input on how stewardship practices differ across active and index-tracker funds, in the following areas:

i: how firms prioritise and conduct stewardship engagements

ii: what investments firms have made in stewardship resources

iii: how stewardship activity is integrated with investment decisions.

(i) Prioritising and conducting stewardship engagements

Many passive investors and index-tracker funds hold stakes in thousands of companies. As such, effective prioritisation is key to ensuring that these investors can fulfil their stewardship responsibilities.

The PRI's Passive Investments Working Group (PIWG) is tasked with promoting ESG integration in passive investments across asset classes, and provides opportunities for signatories to share knowledge and collaborate for change and impact.[39] Engagement by this group has shown that some investors have focused their attention on market laggards, often identified through ESG scores supplied by data providers with a percentage of investee companies with the lowest scores targeted for engagement and potentially further escalation strategies.

As universal owners, many passive investors attempt to address systemic risk in their investment strategy by 'engaging the market' rather than engaging individual companies. For example, several Nordic investors have moved from traditional passive portfolios to decarbonised passive portfolios with the development of low-carbon equity indices.[40]

(ii) Investments in stewardship resources

Research indicates that passive investors tend to spend less on stewardship compared to other investors.[41] Given the inability of such investors to reduce their exposure or divest from an investee company unless they exit the index or adjust the weightings of a tailored index, these investors should be incentivised to dedicate more resources to stewardship.

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[38] See note 1.
[39] See: https://www.unpri.org/signatories/advisory-committees#Passive_Investment_Working_Group
[40] See: https://www.ipe.com/pensions/pensions-in/nordic-region/pensions-in-nordic-region-time-for-action-on-carbon/10004145.fullarticle
[41] See: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2982617 .

While the rise of index-tracker funds has enabled pension savers to access broad listed equity portfolios with market-matching returns at lower cost than actively-managed funds, evidence suggests that this has been associated with a reduction in active ownership.[42]

The concentration of corporate ownership in fewer hands – for example, 88% of the S&P 500 have one of the three largest institutional investors (BlackRock, Vanguard, State Street) as their largest shareholder – should theoretically reduce the collective action problems of institutional investors. Yet research suggests that the providers of index-tracker funds are more likely to dedicate fewer resources to stewardship and less frequently engage in active ownership activities such as the nomination of directors or submission of shareholder proposals.[43] The investments such firms have made in stewardship resources has been particularly scrutinised. The largest investors were shown collectively to have 65 stewardship personnel at a cumulative 53,000 companies, and only a small proportion of their engagements involved more than a single conversation.[44]

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

The PRI agrees that short-termism and free-rider problems are key barriers to achieving effective stewardship in the UK, as set out in our responses to Q2 and Q5 respectively.

The PRI has identified the provision of ESG-related services by investment consultants as another barrier. The PRI's *Investment Consultants Services Review*[45] found that most consultants (and their asset owner clients) were failing to consider ESG issues as a core part of service provision to clients. ESG-related analysis was generally not a standard part of investment advice, but an optional add-on supplied at an extra cost if explicitly requested by the client. In part because the Pensions Act 1995 requires that investment decisions are taken upon receipt of "proper advice", in practice, trustees have leaned heavily on the advice of their investment consultants, often seeming to interpret advice as instruction. The omission of ESG issues from consultants' advice strongly influences the asset allocation decisions and investment strategies of UK pension schemes.

The PRI has recommended that the Service Provider Section of the revised Stewardship Code includes an explicit expectation that serving the interests of clients and enabling them to deliver effective stewardship requires the provision of ESG-related services. In the event that the FCA's regulatory perimeter is extended to capture all the activities of consultants, as proposed by the CMA[46], the PRI recommends that the FCA clarifies the ESG requirements for investment consultants and fiduciary managers.

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[42] See: https://www.wsj.com/articles/index-funds-are-great-for-investors-risky-for-corporate-governance-1498170623
[43] See note 41. This paper also notes the limitations of aspirational stewardship codes in the absence of appropriate incentives for investment managers.
[44] See: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3282794
[45] See: https://www.unpri.org/sustainable-financial-system/investment-consultants-services-review/571.article
[46] See: https://www.gov.uk/government/news/cma-sets-out-investment-consultants-reforms

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

The PRI supports the proposed balance between rules and aspirational standards.

The proposed framework should take account of the reduced ability of smaller asset owners to engage in stewardship activities, and asset owners which consider their scale to be a barrier should be encouraged to consolidate.

Some smaller asset owners have expressed concerns with their ability to comply with the new framework. One concern raised has been that any reliance on quantitative measurements of stewardship under the annual Activities and Outcomes Report will disadvantage smaller investors vis-à-vis large investment managers. The PRI's research has shown that smaller pension funds generally have lower levels of responsible investment implementation compared with their larger peers.[47] Assessments and tiering exercises under the revised Stewardship Code should take account of the capacity differences between investors. Small, medium and even larger pension funds should also be encouraged to build that capacity through consolidation, as the PRI proposed in a recent consultation by the Department for Work and Pensions.[48] However, the PRI shares the government's view that:

> "Whilst we recognise that smaller schemes will have less direct influence over firms in whom they invest or to whom they lend, we re-iterate here that a stewardship policy is still viable, even if it is limited to the recruitment, monitoring and where necessary switching of investment managers."[49]

Q8 To what extent are there issues with proxy advisers that are not adequately addressed by SRD II? What measures would be an effective and proportionate response to any remaining issues?

The Stewardship Code should clarify proxy advisors' responsibilities with regards to the provision of ESG-related research.

The concern raised in response to Q6 regarding investment consultants' consideration of ESG issues also applies to proxy advisors. These advisors have historically been positioned as governance experts, the "G" of ESG, yet have not afforded the same attention to environmental and social issues. Amending the Service Provider Section of the Stewardship Code as set out above would support effective ESG integration in their research.

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[47] See: https://www.unpri.org/Uploads/g/a/k/investmentinnovationandfutureconsolidationconsultationpriresponse_645347.pdf
[48] See note 47.
[49] See: https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/739331/response-clarifying-and-strengthening-trustees-investment-duties.pdf

In addition to the annual disclosure requirements set out in SRDII, the PRI recommends that factual errors detected in proxy advisors' research reports be included as an additional reporting metric under the Stewardship Code. Alongside conflicts of interest, the prevalence of errors is one of the most frequent faults found with proxy advisors and a barrier to effective stewardship[50].

At this stage, the PRI does not recommend regulation of proxy advisors, but would welcome greater dialogue between proxy advisors and investors to discuss and address the concerns raised by issuers. The responsibility for resolving these issues does not rest with the advisory firms alone; as a recent PwC report argued, "[i]nvestors need to take responsibility for creating demand for a diverse market of advisory services that support strong stewardship, rather than just seeking the lowest cost solution. As buyers of the service, investors will ultimately determine whether the focus is on stewardship quality or cost."[51]

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

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

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

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

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

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

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

(ii)-(iii) Expanding stewardship regulation

As set out in response to Q4, there is no limit to the asset class or geographical scope of stewardship, therefore rules which encourage and incentivise this expanded stewardship may be desirable. The broadening of the asset class scope of the draft Stewardship Code was a welcome development in this regard. Any regulatory rules should seek to address investors' incentives to exercise stewardship so as to avoid becoming a medium for boilerplate reporting.

[50] See for example, NASDAQ's 2017 Proxy Season Survey, which cites "[r]epeated errors in analysis, data relied upon to make recommendations, and a lack of due diligence" as one of the chief criticisms of proxy advisors globally: https://business.nasdaq.com/marketinsite/2017/Results-Proxy-Season-Survey.html .

[51] See: https://www.pwc.co.uk/services/human-resource-services/insights/demystifying-executive-pay/iss-friend-or-foe-to-stewardship.html

(vi) SRD II

The PRI recommends that the minimum requirements set out in article 3g of the Directive for life insurers and asset managers - to develop and disclose a policy on shareholder engagement and to explain how they have cast votes at general meetings - should be mandatory, rather than "comply or explain".

As set out in the Discussion Paper, the FCA and FRC intend that the implemented Directive will serve as a minimum regulatory baseline whereas the revised Stewardship Code will promote higher standards beyond this. A mandatory disclosure requirement is more consistent with this framework, and will support asset owners in ensuring that firms' engagement with investee companies and voting practices are in line with the interests of their beneficiaries.

The requirements under the revised Directive are also unlikely to represent a significant additional reporting requirement, as many asset managers are already meeting or exceeding the Directive's requirements. For example, 77% of PRI's asset manager signatories headquartered in the UK disclosed that they had a formal engagement policy during the 2017/18 reporting year[52].

Q10 We welcome feedback on whether, to support effective stewardship, we should consider amendments to other aspects of the regulatory framework that affect how investors and issuers interact (such as the LRs, PRs and DTRs)?

No answer.

[52] Data from responses to the 2018 PRI Reporting Framework.