PRI Principles for Responsible Investment

CONSULTATION RESPONSE

FRC: PROPOSED REVISION TO THE UK STEWARDSHIP CODE

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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 the revised version of the Stewardship Code, which presents an improved approach to investor stewardship. In particular, the PRI welcomes:

- Recognising that investors must consider environmental, social and governance (ESG) issues, including climate change. Explicit commitment to ESG issues in investor stewardship is a necessary and welcome step.
- Expanding the definition of stewardship to asset classes beyond listed equity. This reflects how investors can, and should, influence companies to improve outcomes for clients and beneficiaries.
- Introducing an annual reporting requirement, which focuses not only on the processes and policies that signatories have in place, but the outcomes for beneficiaries and clients of stewardship activities.

The PRI recommends:

(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. Specifically:

- Section 3 should clarify that quality engagement and informed voting of shares should be prioritised over high-volume activities and signatories should take actions based on active monitoring of their agents.
- Provision 14 should extend the scope of active monitoring to include issues that may have significant real economy impacts.
- Section 4 should include whether a signatory engages on the real economy impacts of issuers' business activities as an element of their engagement policy.
- Principle I should support two-way communication between signatories and their clients or beneficiaries, rather than unilateral communication.
- The Guidance should better encourage those activities which significantly affect stewardship outcomes.

(2) The provision of ESG-related services by service providers – service providers have a major influence on the incorporation of ESG issues into investment processes, and the Code should reflect this more explicitly.

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

In addition, the PRI makes the following recommendation, which is separate from the questions posed by the consultation:

(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.

RESPONSE TO DETAILED QUESTIONS

PROPOSED REVISIONS TO THE CODE - GENERAL

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.

The proposed Sections cover the core areas of stewardship. In particular, the PRI welcomes the following:

- Signatories should ensure that stewardship is adequately resourced and supported by internal governance and incentive structures (Section 1, Principle C, Provisions 3, 4 and 5)
- Explicit recognition that signatories must take account of material ESG factors (Section 2, Principle E, Provision 11)
- Explicit recognition that signatories should exercise stewardship across asset classes (Section 5, Provision 23)
- Expectation that signatories explain various aspects of their policy on voting shares in listed assets, including asset managers' policy on allowing clients to direct voting in segregated and pooled accounts (Section 5, Principle 25)
- Service Providers Section of the Code.

The PRI makes the following recommendations, set out in greater detail in the responses below:

- Focusing on the outcomes and real economy impact of stewardship activities
- Facilitating client and beneficiary voice in stewardship
- Guidance for stewardship of asset classes other than listed equity
- Provision of ESG-related services by service providers.

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

The Principles represent an improved approach to investor stewardship. The PRI recommends that the Principles:

- **General –** ensure that the role of stewardship in delivering sustainable outcomes for beneficiaries, the economy and society is reflected throughout the Code
- **Section 3 –** clarify that effective active monitoring should prioritise high-quality engagement and informed voting decisions over the high-volume exercise of shareholder rights; and
- **Principle I –** encourage signatories to facilitate bilateral communication with clients or beneficiaries, rather than merely unilateral communication.

(i) General

The revisions should ensure alignment between how the Code defines stewardship and how it encourages positive outcomes for beneficiaries, the economy and society. In particular:

- Provision 14 should encourage signatories to actively monitor issues that may cause significant real economy impacts to deliver long-term value.
- Section 4 should encourage signatories to disclose the extent to which they engage on the impacts of issuers' business activities.

The introduction to the Code states that "[t]he Code focuses on developing stewardship to deliver sustainable value for beneficiaries, the economy and society". The PRI supports this view of stewardship, which reflects the fiduciary duty owed to beneficiaries as well as the broader range of stakeholders affected by stewardship. This also reflects the corresponding duty on corporate boards set out in section 172 of the Companies Act 2006, which requires directors to consider the interests of several stakeholder groups.[1] This definition of stewardship should be reflected throughout the Code Principles and Provisions.

The Guidance to the draft Code sets out a goal of building a sustainable financial system, "which both manages systemic risks and drives capital towards more sustainable investments". The PRI shares this goal and believes such a system should support sustainable and equitable economic development. 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[2].

The PRI recognises that international regulation is increasingly sensitive to the role of financial markets in contributing to positive and negative impacts on the real economy[3]. The PRI has found that investors are integrating real economy impact into their investment analysis, including it as a third axis alongside risk and return[4].

The draft Code encourages signatories to monitor and engage on issues which are likely to affect asset valuation over the time horizon of beneficiaries. Responsible investment is premised on the belief that the interests of investors and society converge.[5] Thus the negative and positive impacts of long-term investments will eventually be reflected in asset valuation. However, the Code should make clear that signatories face a responsibility to address negative impacts arising from their investments today.

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[1] See: https://www.legislation.gov.uk/ukpga/2006/46/section/172
[2] See: https://www.unpri.org/sustainable-financial-system/how-the-pri-is-contributing-to-a-sustainable-financial-system/199.article
[3] See: http://europa.eu/rapid/press-release_IP-19-1571_en.htm
[4] See: https://www.unpri.org/listed-equity/a-practical-guide-to-active-ownership-in-listed-equity/2717.article
[5] See: https://www.unpri.org/academic-research/why-and-how-might-investors-respond-to-economic-inequality/555.article

This would also reflect the responsibilities of "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, such as income inequality.

(ii) Section 3

The PRI recommends that Section 3 clarify that signatories should focus on areas where they can have the most impact, even if this leads to engagement with a lower proportion of their portfolio. Good active ownership requires taking a holistic approach to engagement and proxy voting activities.

While understanding of stewardship duties has improved since the launch of the Stewardship Code, the PRI recognises that challenges remain in dispelling the view that effective stewardship involves maximising the number of shareholder votes exercised and issuer engagement meetings held.

The voting data tentatively supports this view. Georgeson's review of the 2018 proxy season[6], for example, demonstrated that while the average quorum at blue-chip annual general meetings was higher in the UK than in any of its European peers, opposition to management proposals was among the lowest. While not inherently indicative of a lack of shareholder engagement – lower opposition may be caused by issuer responsiveness to the needs of an engaged shareholder base – it is suggestive of a culture of high deference to management, which has led to, among other things, controversial pay packages receiving the support of a majority of shareholders despite significant investor and public outcry.

Regarding engagement, some investors are accused by issuers of insufficient preparation for engagement meetings. A 2012 report by Tomorrow's Company and six institutional investors found that "Chairmen feel that some investors attend meetings without having given 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."[7] While evidence suggests that matters have improved since then[8], studies show that even the largest passive investors continue to dedicate insufficient resources to engagement, and only a small proportion of their engagements involve more than a single conversation[9].

A particular issue is the divide between portfolio managers and governance managers, where the investor representatives are not those responsible for making voting decisions, and do not provide feedback of the outcomes from engagement meetings to investment decision-makers. The Tomorrow's Company report noted:

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[6] See: https://www.georgeson.com/uk/Documents/Georgeson%202018%20Proxy%20Season%20Review.pdf
[7] See: https://www.icsa.org.uk/assets/files/pdfs/Policy2/2020_Stewardship_Final_L.pdf
[8] For example, PwC's *2017 Annual Corporate Directors Survey* found that, globally, 84% of directors at least somewhat agreed that investors were well-prepared for meetings, up 21 percentage points from 2016. See: https://www.conference-board.org/retrievefile.cfm?filename=Panel-III---PwC---Director-Shareholder-Engagement---Getting-It-Right.pdf&type=subsite
[9] See: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3282794

> "Companies are frustrated by the divide between governance specialists and portfolio managers. For example, one environmental, social and governance (ESG) specialist was critical of the company's governance practice while apparently unaware of the conversations the company had already held with the portfolio manager. In other examples investors had appeared to follow the advice of a third party to vote against a company's resolution without seeking an explanation from the company, or on some occasions, apparently ignoring a conversation that had previously taken place with the company. Sometimes meetings are assumed by investors to be intended for the governance specialist, whereas the chairman is looking to communicate a holistic view of the company and would like the total view of investors to be represented at the meeting."

This problem continues today. 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[10].

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.

(iii) Principle I

The PRI recommends that Principle I be modified to encourage code signatories to engage clients and beneficiaries on their sustainability preferences.

The PRI encourages asset owners to regularly engage beneficiaries about their sustainability preferences and be transparent about their investment and ownership practices. The PRI 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[11]. The PRI recognises that this poses practical challenges for many pension funds, however, it is consistent with the aspirational nature of the draft Code.

Provisions 21 and 22 seek to strengthen the lines of communication between asset managers and asset owners, and asset owners and beneficiaries. The accompanying Guidance makes clear that asset owners which do not engage with their beneficiaries should disclose their rationale for not doing so. Specifying that Principle I encourages two-way communications between signatories and their clients or beneficiaries would support more informed stewardship on the part of signatories and would also be a more accurate reflection of Provisions 21 and 22.

[10] Based on 465 responses to voluntary indicator LEI 03.1.
[11] See note 2.

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

Yes, 'apply and explain' is appropriate for the Principles. The Principles are high-level in nature and permit signatories a great deal of flexibility in how they are applied.

The PRI also supports 'comply or explain' for the Provisions. Investors may engage in stewardship in a range of ways; a 'comply or explain' approach affords signatories flexibility to deviate from the Code's recommended actions where appropriate. Such an approach also enables prospective signatories that are still developing their stewardship capabilities to commit to the Code's Principles while improving their compliance with the Provisions over time.

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

The PRI recommends:

- Indicating which activities may lead to improved stewardship outcomes.
- Providing examples of how compliance with some Principles and Provisions may be achieved.
- Separating the Guidance into a resource which may be updated regularly.

(i) Promoting stewardship outcomes

The PRI recommends that the Code Guidance – particularly Sections 4 and 5 – indicate expectations of how signatories might exercise effective stewardship.

Many of the Provisions are disclosure-based, and do not indicate how signatories' actions might drive greater stewardship outcomes and a more sustainable financial system. For example, the Provisions under Sections 4 and 5 indicate expected disclosure of engagement and voting but do not draw a relationship between these activities and their outcomes. The Guidance elaborates on the information that might be disclosed to comply with the relevant Provision.

This approach blurs the distinction between the Guidance and the Provisions and may lead to boilerplate reporting. Given that the FRC has signalled its intention to engage in "tiering", this implies that signatories will be assessed on the amount and quality of the information they provide, rather than what that information indicates about the quality of the signatory's stewardship. While transparency is of value and should be encouraged, it is no substitute for effective stewardship.

(ii) Providing examples

The PRI recommends that additional examples of good practice be included in the Guidance, particularly under Section 3 regarding using the outputs of monitoring (as set out under Q12); Section 4 regarding engagement policies; and Section 5 regarding stewardship of assets beyond listed equity (as set out under Q15).

Examples of good practice that could be included under Sections 3 and 5 are set out in detail below. Regarding Section 4, the PRI has published *A Practical Guide to Active Ownership in Listed Equity*[12]. This suggests that an engagement policy should include the criteria used to prioritise and select cases for engagement including how the views of beneficiaries, clients and other stakeholders will be taken into account. It also recommends that investors' engagements are proactive to ensure that ESG issues are managed in a preventive manner, rather than reactive to address issues that may have already occurred.

(iii) Separating the Guidance

The PRI recommends that the Guidance be treated as a dynamic resource to be updated on a regular basis. This would be best achieved by separating the Guidance from the remainder of the Code.

The Guidance should encourage positive outcomes and give examples of how they might be achieved. What constitutes good practice and a wider range of examples of this will emerge over time. The Guidance may be of greater value to signatories if it is updated separately and on a more regular basis than the Code's Principles and Provisions.

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?

Yes, the PRI supports the introduction of a regular reporting requirement. While the stewardship activities in which a signatory has engaged will be relevant and should be included in the proposed report, outcomes achieved will be the most pertinent information for reporting purposes, such as:

- Changes to corporate practice or shareholder meeting agenda items achieved following engagement.
- Support for relevant shareholder proposals.
- Any investments made on the basis of ESG disclosures.

The inclusion of outcomes is welcome. Stewardship value is best assessed not by the number of engagement meetings or shares voted but by changes in corporate behaviour through high-quality relationships, and more broadly the benefits stewardship brings to savers and the real economy.

A gap has opened between the public positions and policy statements of several market actors on the one hand, and their efforts in following through on these statements on the other. This was an issue which the Kingman Review drew attention to, as set out in further detail below. An outcomes-focused approach could be helpful to signatories in framing their stewardship activities and could ensure resources are committed to make a sustainable financial system a reality.

[12] https://www.unpri.org/listed-equity/a-practical-guide-to-active-ownership-in-listed-equity/2717.article.

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?

The Stewardship Code should fully address the Kingman Review recommendations. As such, the PRI recommends an increased focus on the outcomes of stewardship activities.

The principal recommendation of the Review regarding the Stewardship Code was as follows:

> *"The Review recommends that a fundamental shift in approach is needed to ensure that the revised Stewardship Code more clearly differentiates excellence in stewardship.* ***It should focus on outcomes and effectiveness, not on policy statements.*** *The Government should also consider whether any further powers are needed to assess and promote compliance with the Code.* ***If the Code remains simply a driver of boilerplate reporting, serious consideration should be given to its abolition****."*

As set out above, the introduction of an annual Activities and Outcomes Report will improve the Code's effectiveness and lead to a shift in focus towards outcomes on an ongoing basis rather than a policy statement at a fixed point in time.

Care must be taken to ensure that the Activities and Outcomes Report does not become another medium for boilerplate reporting. A focus on outcomes would ensure that annual reporting sets out where a signatory has generated value or positive impacts and would prevent a reliance on standard language which can be replicated year-on-year and by multiple signatories.

PROPOSED REVISIONS TO THE CODE – PRINCIPLES AND PROVISIONS

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

Yes. Defining organisational purpose and strategy can encourage an internal commitment to stewardship activities throughout an organisation. Setting out these elements provides employees with principles to guide their decision-making on stewardship and investment practices. It assists external stakeholders in choosing between providers and gives them a tool to hold organisations to account when they deviate from their stated purpose and strategies.

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?

The Provisions and Guidance sufficiently reflect other asset classes. As set out in response to Q15 below, the PRI recommends that the Guidance for Section 5 be amended to give examples of how signatories may exercise stewardship of other asset classes.

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?

Yes. It is reasonable for clients and beneficiaries, as the ultimate owners of capital, to understand the beliefs that underpin how their assets are invested.

In particular, the PRI has found that a lack of disclosure of investment beliefs regarding ESG issues by some asset owners, asset managers and investment consultants creates a multiplier effect throughout the investment market. A perception that responsible investment is not a priority for asset owners limits the limits the willingness of investment consultants and investment managers to focus on responsible investment and ESG issues in their products and in their advice.[13] Provision 12, taken with Principle E, has the potential to address this barrier.

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

The PRI recommends:

- Including an explicit expectation that signatories will take remedial action where active monitoring has exposed a gap between the stewardship policies of an asset owner/asset manager and an asset manager/service provider.
- Amending the guidance to include examples of how signatories may effectively monitor their agents and use the outputs from this monitoring.

Provisions 15 and 16 should recommend that signatories take action where agents' stewardship policies fail to align with those of the principal.

Section 3 is clear that signatories should monitor the agents that operate on their behalf. The Consultation Paper also makes clear that institutional investors cannot delegate their responsibility for stewardship. A stronger assertion in the Code of how signatories may act on the basis of their monitoring of agents would support a greater emphasis on outcomes.

The Guidance should also provide examples of monitoring and actions that may be taken, including:

- Monitoring agents' achievements of results and milestones.
- Ensuring that portfolio managers and analysts responsible for making investment decisions receive the information collected through outsourced engagement activities.
- Engaging with proxy advisors and providing them with periodic feedback on their analysis and recommendations through surveys, questionnaires or one-to-one meetings.

[13] See: https://www.unpri.org/asset-owners/how-asset-owners-can-drive-responsible-investment-beliefs-strategies-and-mandates/277.article

- When engagement and voting activities are outsourced to more than one entity, developing an active ownership policy which defines expectations and frameworks of reference for third parties to use to ensure consistency of messages to investee companies.

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

Yes. The term "collaborative engagement" is more commonly used internationally and is the term the PRI uses for its programme of bringing investors together to engage with issuers on a range of environmental, social and governance issues.

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

Yes. The PRI recommends that the Guidance to Section 5 give examples of how signatories may exercise effective stewardship over other asset classes. Such guidance should avoid being overly prescriptive, noting the wide range of effective stewardship practices that signatories may engage in.

Stewardship has value across all asset classes. The PRI's Principle 2 – "*We will be active owners and incorporate ESG issues into our ownership policies and practices*" – does not restrict the concept of active ownership to any particular asset class.

However, investors tend to have less experience of stewardship beyond listed equity[14]. The PRI suggests that some examples of recommended practice in the Guidance to Section 5 would be helpful for signatories seeking to expand their stewardship activities into other asset classes for the first time. The PRI reporting framework recognises the importance of active ownership of assets other than listed equity and has published guidance on how investors may do this:

(i) Private equity

ESG monitoring, reporting and dialogue in private equity[15] gives an overview of how Limited Partners (LPs) may monitor General Partners (GPs) on ESG integration in private equity, as well as current GP good practices.

The report identifies seven key monitoring practices for LPs:

1) Exception-based reporting – for information unlikely to change on an annual basis, some LPs would prefer that the GP reports any changes on a by-exception basis rather than regularly reiterating previously reported information

[14] See: https://www.unpri.org/asset-owners/asset-allocation
[15] See: https://www.unpri.org/private-equity/esg-monitoring-reporting-and-dialogue-in-private-equity/3295.article.

2) Using the Limited Partner Advisory Committee (LPAC) and the Annual Investor Meeting (AIM) – including ESG as a regular agenda item at LPAC meetings and/or the AIM, or even stipulating that changes to the GP's responsible investment policy should be agreed with the LPAC, takes advantage of existing governance structures while also engaging other investors in the fund on ESG integration
3) Using monitoring templates – some LPs send proprietary or annualised reporting templates annually to their GPs, which allows them to collect information homogenously and track progress
4) Assessment and scoring of GPs – many GPs welcome feedback on the usefulness of the ESG information they report. Some LPs also use the information disclosed to them to rate or rank GPs annually on their ESG practices.
5) Using the PRI reporting framework – LPs can request a GP's private Transparency Report and Assessment Report (which scores GPs on their individual processes and benchmarks their responses) through the PRI's online Data Portal and use this as an annual monitoring mechanism.
6) ESG incident monitoring – some LPs will seek an understanding of how serious incidents are dealt with as a demonstration of the GPs capabilities. LPs may conduct their own incident monitoring through automated tools to proactively flag potentially material risks and will then follow up with the GP to get assurance that the incident is being managed.
7) Review GPs' internal ESG/CSR management and initiatives – LPs may monitor GPs' internal commitment to good management of ESG issues, such as their approach to carbon footprinting, recycling and efficiency, commitments to community engagement, diversity and inclusion.

In addition to the above, the PRI data portal provides a number of approaches PRI signatories are taking at various stages of the investment process with private equity[16].

(ii) Fixed income

Last year, the PRI and the CFA Institute jointly published *Guidance and Case Studies for ESG Integration: Equities and Fixed Income*[17]. This divides ESG integration in fixed-income analysis into four categories.

- Corporate bonds – one case study looks at how an asset manager generates ESG ratings for companies not covered by market data providers, using a self-assessment tool that reflects the sector-specific risk issues relevant to the issuer.
- Sovereign bonds – one asset manager specialising in sovereign bonds and currency assigns a Financial Stability Score to a country based on the overall balance sheet strength and ESG factors, and this score is then used in the portfolio construction process.

[16] See, for example, p. 19, 20, 22: https://app.powerbi.com/view?r=eyJrIjoiYWIxMmE2ZTgtYjM4My00Y2FkLWE2MGQtMjYxMzZmYTZlZmQ5IiwidCI6ImZiYzI1NzBkLWE5OGYtNDFmMS1hOGFkLTEyYjEzMWJkOTNlOCIsImMiOjh9
[17] See: https://www.unpri.org/investor-tools/guidance-and-case-studies-for-esg-integration-equities-and-fixed-income/3622.article.

- Municipal bonds – a sustainable data research firm and an asset manager developed a framework that allows for the evaluation and scoring of municipal debt through the lens of ESG. Projects are further categorised according to impact, allowing low-impact projects to be automatically excluded when searching for investment opportunities.
- Structured credit – an investment manager has begun to collect potential ESG assessment factors as part of its due diligence process when investing in community-bank subordinated debt.

(iii) Infrastructure

The PRI has published a number of tools[18] to facilitate responsible investment in infrastructure which may be of particular relevance given recent government efforts to boost investment in infrastructure and other patient capital projects[19].

The *Primer on responsible investment in infrastructure*[20] sets out key ESG considerations in infrastructure investing and case studies of responsible infrastructure investments. It also provides examples of how investors can be active owners with infrastructure, including:

- Engagement strategy – use ESG assessments undertaken during due diligence to prioritise attention to ESG considerations and potential for improving profitability and risk management.
- Post-acquisition plan – include material ESG risks and opportunities identified during due diligence into the post-acquisition plan of each asset/project company and integrate this into asset management activities.
- Communicating expectations – define and communicate expectations of ESG operations and maintenance performance to the infrastructure business managers. Refer to international standards and guidelines where relevant, such as the International Finance Corporation (IFC) Performance Standards and the Equator Principles.
- Responsibility for sustainability and asset management – advocate a governance framework that clearly articulates who has responsibility for ESG and sustainability, the company board's accountability and oversight of ESG considerations.
- Building asset or project company capacity on ESG – make ESG information and expertise available to the asset/company to help it develop capacity and management skills in this area.

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?

The PRI welcomes the introduction of the Service Providers Code, which recognises the important influence that service providers such as investment consultants and proxy advisors may have on outcomes for clients and beneficiaries, and their duty to improve stewardship in the UK.

[18] See: https://www.unpri.org/investor-tools/infrastructure
[19] See, for example, the 2019 Spring Statement, which sets out ambitions for boosting private investment in infrastructure: https://www.gov.uk/government/news/spring-statement-2019-what-you-need-to-know . The Statement notes that as part of its Clean Growth Strategy, net gains in biodiversity will be mandated for new developments.
[20] See: https://www.unpri.org/download?ac=4141

The PRI recommends:

- Amending Provision 1 to make explicit reference to how signatories are meeting the needs of clients with regards to ESG issues.
- Amending the Guidance to Provision 2 to encourage signatories to publish details and statistics of errors made in their service provision.

(i) Meeting client ESG needs

The PRI recommends that Provision 1 of the Service Providers Code includes an explicit expectation that serving the interests of clients and enabling them to deliver effective stewardship requires the provision of ESG-related advice.

Analysis from the Competition Markets Authority and others has identified competition issues in the markets for both investment consultants[21] and proxy advisors[22]. Combined with the fragmentation of asset owners in the UK, this implies that market forces will not necessarily be a sufficient check on service quality and thus special care must be taken to ensure that service providers support rather than impede the development of a culture of stewardship in the UK.

Regarding investment consultants, both the Myners[23] and Kay[24] reviews found that there was an over-reliance on short-term strategies and herding around a limited range of investment models within the industry. The PRI's Fiduciary Duty in the 21st Century project highlighted that pension fund trustees lean heavily on their investment consultants' advice, often seeming to interpret advice as instruction[25].

This poses a potential barrier to the successful implementation of the amended Investment Regulations, which require trustees to state how they take ESG issues into account, as well as Section 2 of the Code. The PRI's Investment Consultants Services Review[26] found that most consultants (and their asset owner clients) were failing to consider ESG issues in investment practice.

Similarly, proxy 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 Provision 1 as set out above would support effective ESG integration in their research.

(ii) Guidance to Provision 2

The PRI recommends that the Guidance to Provision 2 be amended to include material errors as a metric against which relevant service providers should report.

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[21] See CMA investigation: https://www.gov.uk/government/news/cma-sets-out-investment-consultants-reforms.
[22] One study identified the two largest advisors to control 97% of the market in the US, though this figure is likely to be lower for the UK: https://www.mercatus.org/publication/how-proxy-advisory-services-became-so-powerful.
[23] See: https://www.icaew.com/technical/corporate-governance/codes-and-reports/myners-report.
[24] See: https://www.gov.uk/government/news/kay-review-publishes-report-on-uk-financial-sector.
[25] See: https://www.unpri.org/fiduciary-duty/fiduciary-duty-in-the-21st-century-uk-roadmap/264.article.
[26] See: https://www.unpri.org/asset-owners/investment-consultants.

Proxy advisors have been the subject of increasing scrutiny in various markets, both from regulators and campaigners. Any attempts to regulate proxy advisors should balance their influential role in governance practices and voting outcomes against the value they provide to shareholders in enabling them to fulfil their stewardship responsibilities, and shareholders' right to impartial third-party advice. The PRI opposes efforts to impose regulations on proxy advisors that would undermine the critical role they play in providing independent analysis to investors.

Provision 2 states that "Signatories must inform clients about the accuracy of their services", while the guidance refers to the requirements of chapter 1b, article 3j, 2 of the Shareholder Rights Directive II (SRD II), which requires proxy advisors to disclose on an annual basis:

a) *the essential features of the methodologies and models they apply;*
b) *the main information sources they use;*
c) *the procedures put in place to ensure quality of the research, advice and voting recommendations and qualifications of the staff involved;*
d) *whether and, if so, how they take national market, legal, regulatory and company-specific conditions into account;*
e) *the essential features of the voting policies they apply for each market;*
f) *whether they have dialogues with the companies which are the object of their research, advice or voting recommendations and with the stakeholders of the company, and, if so, the extent and nature thereof;*
g) *the policy regarding the prevention and management of potential conflicts of interests.*

The Principles and Provisions do not recommend that service providers, which include proxy advisors, disclose statistics on errors which may have been made, despite this being the most decisive indicator of service "accuracy". Alongside conflicts of interest, this is one of the most frequent criticisms of proxy advisors and a barrier to effective stewardship[27].

While ultimately it is the responsibility of investors to ensure that the information on which they rely is accurate and reliable, the public disclosure of material errors in proxy research reports, particularly where this has impacted voting recommendations, could be an effective way to increase accountability, improve service output and, ultimately, stewardship outcomes.

[27] 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 .