UKSIF
UK Sustainable Investment and Finance Association

Catherine Horton
Financial Reporting Council
8th Floor, 125 London Wall
London EC2Y 5AS

28th February 2018

Dear Ms Horton,

I am writing in my capacity as Chief Executive of the UK Sustainable Investment and Finance Association (UKSIF) in response to the Financial Reporting Council's (FRC) recent consultation on proposed revisions to the UK Corporate Governance Code.

About UKSIF

UKSIF is the membership network for sustainable and responsible investors in the UK. We act as the voice of the responsible investment sector and promote long-term investment aimed at sustainable economic development. Our members include many of the UK's largest pension funds, banks, insurance firms and asset managers, all of whom are committed to long-term sustainable economic growth. More information is available at www.uksif.org.

I would like to start by thanking you and your colleagues for meeting UKSIF in late 2017 to discuss the views of our membership relating to the corporate governance regime in the UK and the Stewardship Code. We welcome the inclusion of questions relating to the Stewardship Code in this consultation as a primer ahead of a more comprehensive consultation later this year. We have answered a selection of questions in both the corporate governance and stewardship sections and would welcome any comments or questions you may have via fergus.moffatt@uksif.org.

UK Corporate Governance Code and Guidance on Board Effectiveness Questions

Q3. Do you agree that the proposed methods in Provision 3 are sufficient to achieve meaningful engagement?

Partly. The key aim of this section is to effect meaningful engagement, and this should be the focus, rather than the means by which it may be achieved. We welcome explicit reference to 'a director appointed from the workforce, a formal workforce advisory panel, or a designated non-executive director' as examples from the Government's Corporate Governance Review by which this may be achieved. However, we feel this should be a non-exhaustive list and flexibility should be maintained in how a company can achieve meaningful engagement with its workforce.

We are not specialists in engagement, but feel it is entirely possible that approaches other than those listed may be more suitable for some companies: Where this is the case such companies should be permitted to pursue alternative routes provided they can explain why such an approach was necessary and show how they have achieved meaningful engagement in accordance with the Corporate Governance Code.

Q4. Do you consider that we should include more specific reference to the UN SDGs or other NGO principles, either in the Code or in the Guidance?

Yes, particularly through guidance. The UK has a world leading corporate governance regime. If it wants to retain such status it must recognise and adapt to a changing landscape in which it is essential that national financial regulation and corporate governance regimes are aligned with international agreements and commitments in areas such as sustainable development and climate change. This is essential to the long-term success of the global economy and the UK's continued prosperity.

The proposed revision to the corporate governance code notes the following recommendation in the Corley report:

> *Recommendation 27: FRC – Include social impact aspects in Corporate Governance Code: The FRC should ensure its review of the Corporate Governance Code encourages more companies to be purposeful, engaged with wider stakeholders and committed to assessing and communicating their social impact in the context of the SDGs.*[1]

Given backing from both Her Majesty's Treasury and the Department for Digital, Culture, Media and Sport, it is important that the Corley Report recommendations are acknowledged by regulators and acted upon, and we welcome the FRC's approach in this regard.

The FRC notes that it has incorporated Corley recommendation 27 via principles A and C, '*the need for companies to consider their responsibilities to shareholders and stakeholders, and the contribution made to wider society*.' While this a welcome step, we don't feel the FRC can claim to have adequately addressed the Corley recommendation without explicit mention of the Sustainable Development Goals in the Code itself, with additional information for companies in guidance.

The Code should also make explicit reference to the Taskforce on Climate-related Financial Disclosures (TCFD) recommendations. These are geared towards the disclosure of '*clear, comparable and consistent information about the risks and opportunities presented by climate change and [the recommendations'] adoption will ensure that the effects of climate change become routinely considered in business and investment decisions'*.[2]

The recent final report by the EU Commission's High Level Expert Group on Sustainable Finance (HLEG) made improvements to the European corporate governance and stewardship regimes one of its eight priority recommendations and we would draw the FRC's attention to the report, which makes explicit reference to the SDGs in its proposal to strengthen director duties related to sustainability:

> *Specific duties of non-executive directors and supervisory boards: Require the company management to develop a climate strategy, aligned with climate goals, and to describe the*

[1] Social Investment Advisory Group, *Growing a Culture of Social Impact Investing in the UK*,
[2] Michael Bloomberg, *Recommendations of the Task Force on Climate-related Financial Disclosures,* June 2017 available at https://www.fsb-tcfd.org/wp-content/uploads/2017/06/FINAL-TCFD-Report-062817.pdf

company's approach to the SDGs. Ensure that remuneration policies and individual executive employment contracts are consistent with the long term, including sustainability goals.[3]

Q9. Do you agree that the overall changes proposed in Section 3 of the revised Code will lead to more action to build diversity in the boardroom, in the executive pipeline and in the company as a whole?

Yes. We welcome the FRC's acknowledgement that it is '*essential for boards to be made up of competent, high-calibre individuals who, together, offer a broad mix of knowledge, skills, experiences, backgrounds and personal strengths, including women and individuals from different social and ethnic backgrounds*' because '*companies that focus on increasing diversity in the boardroom, in their executive teams and across their workforces as a whole can expect a positive impact on their performance'.* This is why we firmly support measures which are geared towards increasing diversity in these areas.

We note that last year women made up 27.7% on average of FTSE 100 boards, more than double the 12.5% in 2010. We welcome this progress towards the 33% target set by the Hampton-Alexander Review and recognise that increased transparency has been a crucial factor in accelerating progress. We are also pleased to see in the revised guidance on board effectiveness suggested measures to be taken by the nomination committee relating to boosting diversity both at board level and throughout the rest of the company. This is an area where best practice is likely to evolve and the FRC should look to update its guidance to help companies continue to improve.

Q11. What are your views on encouraging companies to report on levels of ethnicity in executive pipelines? Please provide information relating to the practical implications, potential costs and other burdens involved, and to which companies it should apply.

The FRC has already noted the positive impact of transparency in improving gender diversity on boards. We also note comments by Sir John Parker that a lack of available data 'may present an unnecessary hurdle in tracking progress and being fully transparent to all stakeholders'.[4] His report's recommendations fall under three key areas:

- Increase the ethnic diversity of UK Boards by proposing each FTSE 100 Board to have at least one director from an ethnic minority background by 2021 and for each FTSE 250 Board to do the same by 2024;
- Develop a pipeline of candidates and plan for succession through mentoring and sponsoring;
- Enhance transparency and disclosure to record and track progress against the objectives;

Measures taken by the FRC to boost ethnic diversity should align with these overarching goals. Companies should therefore be required to report on levels of ethnicity on boards and in executive pipelines. The Code is applied on a comply or explain basis. Should there be legitimate obstacles relating to practical implications, then the costs or other burdens which prevent a company from reporting on levels of ethnicity in these areas these can be explained.

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[3] HLEG on Sustainable Finance, *Financing a Sustainable European Economy (Final Report)*, January 2018 available at https://ec.europa.eu/info/sites/info/files/180131-sustainable-finance-final-report_en.pdf
[4] Independent review by Sir John Parker into the ethnic diversity of UK boards. Report available at https://www.gov.uk/government/publications/ethnic-diversity-of-uk-boards-the-parker-review

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Q14. Do you agree with the wider remit for the remuneration committee and what are your views on the most effective way to discharge this new responsibility, and how might this operate in practice?

We support the measures being proposed by the FRC and welcome in particular Provision 40, '*executive remuneration should support long-term company performance and value generation*', which we see as a central tenet of a well-functioning remuneration committee. We therefore welcome the remuneration committee's expanded remit to '*engage with employees and oversee pay and incentives across the wider workforce* [to] *encourage greater focus on the strategic rationale for executive pay levels in a broader context.'* A more holistic approach will enable a company's pay levels to be considered by the remuneration committee in the appropriate context.

UK Stewardship Code Questions

Q17. Should the Stewardship Code be more explicit about the expectations of those investing directly or indirectly and those advising them? Would separate codes or enhanced separate guidance for different categories of the investment chain help drive best practice?

We would welcome increased clarity on expectations of those investing directly and for advisers, including via – where the FRC feels it is most needed – enhanced guidance for different signatory types, but at this stage we feel separate codes are unnecessary and would ultimately drive confusion.

We are also concerned by the example you give in paragraph 9:

> *'Some feel that different codes would help organisations focus on expectations specific to them; for example, the requirement for pension funds to decide whether they consider environmental, social and governance (ESG) factors to be material to their investment, and, if so, to act accordingly.'*

Where a factor is financially material trustees are required by law[5] to consider it as are LGPS funds under new rules governing Investment Strategy Statements[6]. Unfortunately the inclusion of the above sentence in a voluntary initiative such as the Stewardship Code could lead to an increase in confusion over a pension scheme's duties in relation to ESG factors. We recognise the intention here is good, but the FRC must ensure that it is absolutely clear when something is a legal requirement and when something is a Stewardship Code expectation.

Q20. Are there elements of the revised UK Corporate Governance Code that we should mirror in the Stewardship Code?

Yes. We think the following priorities should be reflected in both the Corporate Governance Code and the Stewardship Code:

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[5] TPR – '*What you need to do: Take ESG factors into account if you believe they're financially significant.*', DB Investment Guidance, available at http://www.thepensionsregulator.gov.uk/guidance/db-investment-two-strategy.aspx#s24352

[6] UKSIF brief on new rules for LGPS funds available at http://uksif.org/wp-content/uploads/2016/11/Policy-update-LGPS-Investment-Strategy-Statement-Guidance.pdf

1. A continued emphasis on long-term value creation and investment;
2. Alignment with s.172 on Directors' Duties in the Companies Act;
3. Explicit reference to environmental, social and governance factors throughout the document, in addition to explicit referencing of the SDGs and the TCFD recommendations.
4. The FRC to strengthen the link between the Stewardship Code and the Corporate Governance Code to better align boards and shareholders.
5. Simplification of both codes, and the continuation of the 'comply or explain' approach.
6. Continued alignment in both codes with the thinking in the Kay Review to deliver 'the improvements to equity markets necessary to support sustainable long-term value creation by British companies'.[7]

Q21. How could an investor's role in building a company's long-term success be further encouraged through the Stewardship Code?

Q22. Would it be appropriate to incorporate 'wider stakeholders' into the areas of suggested focus for monitoring and engagement by investors? Should the Stewardship Code more explicitly refer to ESG factors and broader social impact? If so, how should these be integrated and are there any specific areas of focus that should be addressed?

There is an increasing wealth of evidence to show the financial materiality of ESG factors. This includes

- Arabesque and Oxford University meta study, From the Stockholder to the Stakeholder;[8]
- MSCI, Can ESG add alpha?;[9]
- ILG, The value of responsible investment;[10]
- MSCI, How ESG affects equity valuation, risk and performance.[11]

Given this is the case we would welcome a greater focus on the value of ESG considerations throughout the document, both in terms of risk mitigation but also as a driver of long-term value.

Currently social and environmental issues appear to be hidden away in the text. Various initiatives and policy developments including the Paris Agreements, the SDGs, the Taskforce on Climate-related Financial Disclosures, the Corley report and the Government's wider work around social investment all point towards environmental and social issues becoming increasingly important areas for institutional investors and their stewardship and engagement activities.

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[7] The Kay Review of UK Equity Markets and long-term decision making, 2012 available at http://www.ecgi.org/conferences/eu_actionplan2013/documents/kay_review_final_report.pdf
[8] Arabesque and Oxford University, *From the Stockholder to the Stakeholder,* 2015, available at https://arabesque.com/research/From_the_stockholder_to_the_stakeholder_web.pdf
[9] MSCI, Can ESG Add Alpha?, 2015 available at https://www.msci.com/documents/10199/4a05d4d3-b424-40e5-ab01-adf68e99a169
[10] University of Cambridge Institute for Sustainability Leadership, *The value of responsible investment*, 2014 available at https://www.cisl.cam.ac.uk/publications/publication-pdfs/ilg-the-value-of-responsible-investment.pdf
[11] MSCI, *The foundations of ESG investing – Part 1: How ESG affects equity valuation, risk and performance,* 2017 available at https://www.msci.com/www/research-paper/foundations-of-esg-investing/0795306949

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As such these are key areas which should be emphasised throughout the document far more frequently and explicitly that at present.

Q25. Are there elements of international stewardship codes that should be included in the Stewardship Code?

International stewardship codes including the South African King's Code, the Japanese Stewardship Code, the Australian Stewardship Code, and the International Corporate Governance Network Global Stewardship Principles all explicitly reference ESG factors emphasising, the importance of their consideration to institutional investors. This should be reflected in the UK Stewardship Code.

Q29. Should the Stewardship Code explicitly request that investors give consideration to company performance and reporting on adapting to climate change?

Yes.

I hope our answers are clear. If you have any comments or if we can provide clarification on any of the points we have made please do not hesitate to contact me via fergus.moffatt@uksif.org.

Yours sincerely,

Simon Howard
Chief Executive
UK Sustainable Investment and Finance Association (UKSIF)