RESPONSE TO INDEPENDENT REVIEW OF THE FINANCIAL REPORTING COUNCIL: CALL FOR EVIDENCE

INTRODUCTION

The United Nations-supported Principles for Responsible Investment (PRI) is the world's leading initiative on responsible investment. The PRI has over 2000 signatories (pension funds, insurers, investment managers and service providers) globally with approximately US $82 trillion in assets under management. Over 250 of these signatories are based in the UK.[1]

Responsible investment explicitly acknowledges the relevance to investors of environmental, social and governance (ESG) factors in investment decision making for the long-term health and stability of financial markets. The PRI welcomes the opportunity to contribute evidence to the FRC consultation on revisions to the UK Corporate Governance Code.

ABOUT THE CONSULTATION

In June 2018 the UK government Department for Business, Energy and Industrial Strategy (BEIS) launched a call for evidence on the role of the UK regulator, the Financial Reporting Council (FRC) with respect to the purpose and function of the FRC as well as its: impact and effectiveness; powers, legal status and relationship with government, governance and leadership, funding, resources and staffing and role in reducing the risk of major corporate failure. The Review will seek to establish whether the FRC and the current regulatory structure are effective currently and for the future, and it will put forward proposals to ensure that the regulatory system as effective and credible as possible.

SUMMARY OF THE PRI'S POSITION

The PRI welcomes the opportunity to respond to the Review. Recommendations made by PRI to the FRC consultation in the future direction of the UK Stewardship Code should form part of the Review.[2] The PRI believes that the FRC should:

1) explicitly reference the Task Force for Climate-related Financial Disclosures (TCFD) in the UK Stewardship Code as a framework for best practice climate-related financial disclosures;

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[1] See https://www.unpri.org/signatory-directory/

[2] PRI's full response to the consultation can be seen here.

2) explicitly reference ESG issues in a new Principle of the Stewardship Code[3]; and
3) implement a strategy to increase the number of UK asset owners to sign the UK Stewardship Code, including corporate pension funds.

CONSULTATION QUESTION RESPONSES

Q20: Are there wider issues of financial and other reporting on which a stronger regulatory role would be desirable to better meet the information needs of investors and other stakeholders?

1) **We recommend that the FRC should explicitly reference the Task Force for Climate-related Financial Disclosures (TCFD) in the UK Stewardship Code as a framework for best practice climate-related financial disclosures.**

Over 480 institutional investors, representing $42.2 trillion of assets, responded to PRI's voluntary climate risk indicators at the end of March this year.[4]

These indicators were introduced for the first time in January 2018 and are based on the TCFD recommendations. 180 investors opted to make their responses public, which are now available on the PRI data portal. In the UK there were responses from 84 investors, which in absolute numbers was more than any of the other of the 50 countries that the PRI operates in.

The volume of responses provides evidence that UK (and international) investors are starting to think systematically about climate-related risks and they are prepared to report to industry bodies like the PRI. In addition, the 'Progress in Preparing for Climate Change'[5] report from the UK Committee on Climate Change also recommends that the UK Stewardship Code should be amended to ask investors to consider company performance and reporting on adapting to climate change. Explicit reference to the TCFD framework in the UK Stewardship Code would:

- clarify that institutional investors and companies are aware of this issue and establishing management systems to reduce exposure from related financial risks;
- minimise the risk of future litigation against UK investors and company directors. Financial institutions and companies' directors may face legal liability exposure by failing to assess and manage climate risk. The TCFD framework outlines information that is required for disclosure, and thereby will help UK directors reduce the likelihood of future climate-related litigation
- align institutional investors and companies with the Paris Climate Agreement and the UK government's Clean Growth Strategy;
- contribute towards longer term financial stability. Climate-related disclosure will facilitate an orderly transition to a low-carbon economy and support an efficient market response to climate change.[6]

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[3] Currently the UK Stewardship Code only references "social and environmental matters" as examples of issues that may warrant escalation of stewardship activities. See the UK Stewardship Code (issued in September 2012).

[4] This data is available in the PRI's data portal.

[5] UK Committee on Climate Change, Progress in Preparing for Climate Change. Recommendation 22 of the report also recommended that "The Financial Reporting Council's UK Stewardship Code should ask investors to consider company performance and reporting on adapting to climate change."

[6] The Bank's response to climate change, quarterly bulletin, 2017, Q2.

Q23: How effective has the Stewardship Code been in driving more and higher quality engagement by institutional investors? If not, why? How might quality of engagement be further strengthened?

2) **Add explicit reference to ESG issues in a new Principle of the Stewardship Code.**

The Code[7] should state that it requires investors to:

> *"demonstrate how they promote the long-term performance and sustainability of companies, including their integration of material environmental, social and governance (ESG) factors in stewardship activities"*

Explicit reference to ESG issues in the UK Stewardship Code provides clear direction to investors on fulfilling their fiduciary duties. It will also align the Code with a strong and clear trajectory taking place both in the UK and internationally, as evidenced by a series of developments since the Code's last review which should be reflected in any updated Code.

- The PRI identifies over 300 policy instruments, including stewardship codes, which require or encourage consideration of ESG issues.[8] Half of these were introduced in the last three years. Explicit reference to ESG issues are now being included as Stewardship Codes are developed across the world.[9]
- A new Principle on ESG issues would be consistent with international best practice, in particular the EU Shareholder Rights Directive. The EU Shareholder Rights Directive specifically references ESG issues throughout,[10] and places a positive duty on all investors to consider stewardship and long-term factors. The directive will address many of the weaknesses identified by the PRI's 'Global Guide to Responsible Investment Regulation',[11] which should also be supported by the UK Stewardship Code.

The UK Stewardship Code will be incomplete without explicit reference to ESG issues and clarification on stewardship duties, trailing behind these international developments to recognise ESG factors as core to investors' legal obligations as fiduciaries.

3) **The FRC should implement a strategy to increase the number of UK asset owners to sign the UK Stewardship Code, including corporate pension funds.**

Signing UK asset owners to the Stewardship Code creates a multiplier effect throughout the investment market. Weak implementation of the Stewardship Code by individual asset owners sends signals to the investment market as a whole that stewardship is not a priority for asset owners. In turn, this limits the willingness of investment consultants and investment managers to focus on stewardship duties and ESG issues. By implementing their commitments to the Stewardship Code with sufficient scale and depth, asset owners can accelerate the development of effective stewardship through the investment chain.

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[7] Currently the UK Stewardship Code only references "social and environmental matters" as examples of issues that may warrant escalation of stewardship activities. See the UK Stewardship Code (issued in September 2012).

[8] PRI's Global Guide to Responsible Investment Regulation

[9] There has been notable growth in stewardship codes in recent years, particularly in Asia, with Japan, Hong Kong, Malaysia, Singapore and South Korea implementing codes since 2014. While all stewardship codes are voluntary, some governments promote ESG issues in the Code more explicitly than others. In particular, the Australian, Brazilian and South African codes include explicit reference to ESG issues within their principles, and we recommend that the FRC amend the UK Stewardship Code similarly. See Appendix B for excerpts.

[10] EU Shareholder Rights directive, sections 14, 22, 29, article 3g. 1(a)

[11] See the PRI Global Guide to Responsible Investment Regulation. An online map of responsible investment regulation can be found here also.

APPENDIX A

Full list of consultation questions

Q1: What should the FRC's objective(s) be? Is its present mission statement the right one?

Q2: Does the FRC's name remain right?

Q3: Are the functions and structure of the FRC still relevant and appropriate, or is there a case for any structural change? Should any of the FRC's functions move to other regulators?

Q4: What lessons can be learned from other countries' regulatory systems? Which ones?

Q5: How effective has the FRC been in influencing wider debates that affect its ability to deliver its objectives – for example, around audit competition, or its legal powers?

Q6: Is the current balance between cross-cutting reviews and firm-specific investigations most effective?

Q7: What are the FRC's strengths and weaknesses?

Q8: The recent joint report on Carillion from the Business, Energy and Industrial Strategy and the Work and Pensions Select Committees4 considered the FRC to be characterised by "feebleness and timidity" and recommended that a change of culture and outlook is needed. Do you agree? If so, please cite relevant evidence which informs your view.

Q9: Are there changes respondents would like to see to achieve the vision set out in the Review's terms of reference?

Q10: Are arrangements for financial reporting, audit and corporate governance the critical elements for effective delivery of FRC's mission, or are elements missing?

Q11: How effective is the FRC at driving quality improvements in audit? What further improvements would respondents like to see?

Q12: Where quality does fall short, do the FRC's interventions have sufficient impact and deterrent effect?

Q13: What force is there in the concern of some that the FRC may be too close to the "big 4"? Or that the FRC is too concerned with the risk of failure of one of the "big 4"?

Q14: Are investigations of audit work effective, transparent, satisfactorily concluded and unfettered?

Q15: Could a different regulatory strategy or tactics result in greater avoidance of harm?

Q16: Could or should the FRC's work promote competition and a well-functioning audit market? Does the FRC's work undermine competition or a well-functioning audit market in any way?

Q17: Can questions regarding the effectiveness of the FRC be separated from the wider question on whether change is needed to audit arrangements to take account of shifting expectations?

Q18: Has the FRC been effective in influencing the development of accounting standards internationally as well as accountable and effective in setting UK GAAP?

Q19: How else could the FRC improve the quality of financial reporting with a view to ensuring investor confidence?

Q20: Are there wider issues of financial and other reporting on which a stronger regulatory role would be desirable to better meet the information needs of investors and other stakeholders?

Q21: Is the current combination of statutory and voluntary methods of oversight for professional bodies effective, and do they remain fit for the future?

Q22: In relation to the UK Corporate Governance Code, are there issues relevant to the Review's terms of reference that respondents believe the Review should consider?

Q23: How effective has the Stewardship Code been in driving more and higher quality engagement by institutional investors? If not, why? How might quality of engagement be further strengthened?

Q24: Do respondents view the FRC as reluctant to undertake investigations or enforcement, or able to do so at speed?

Q25: How could the FRC better ensure it is able to take swift, effective and appropriate enforcement action? What practical or legal changes would be needed to achieve this?

Q26: Have the arrangements put in place following the 2005 Morris Review stood the test of time, or is there a need for change? Should actuarial regulation be a focus for the Review's work?

Q27: Is there more the FRC could or should do to help reduce the risk of major corporate failure?

Q28: Is the FRC quick and effective enough to act on warning signs arising from its work on accounts and financial reporting, or on evidence of concerns over poor corporate governance?

Q29: Is there a case for a more "prudential approach"? If so, how could this operate in practice, and to which category of company might such an approach apply?

Q30: Introduction of the viability statement was an important development, but could it be made more effective?

Q31: Are there gaps in the FRC's powers? Would its effectiveness be improved with further (or different) powers?

Q32: Are the FRC's powers coherent in relation to those of other regulators?

Q33: Taking account of Sir Christopher Clarke's review of sanctions, and subsequent changes, does the sanctions regime now have the right deterrent effect? Does the FRC make best use of the sanctions at its disposal?

Q34: Should the Government legislate to put the FRC on a more conventional consolidated statutory footing?

Q35: What is the optimal structure for the relationship between the FRC and the Government, best balancing proper accountability with enabling the FRC's effectiveness?

Q36: In terms of the FRC's broader accountability, is there a case for further transparency in its actions or functions?

Q37: How effective is the current leadership and Board of the FRC? Please cite relevant evidence which informs your view.

Q38: Is the Board's composition appropriate? Is it the right size? Does it have appropriate membership?

Q39: Is the balance of decision-making between the Board, its Committees and the Executive described in paragraphs 34-36 above right, given relevant legal constraints?

Q40: Is the Board's structure appropriate, including given the FRC's roles on standard setting, assessment and enforcement? Does the Board's accountability appropriately reflect its role and functions? Are its decisions appropriately transparent, bearing in mind the need to balance public interest and confidentiality?

Q41: How should the Executive's effectiveness be assessed and ensured?

Q42: Who should fund the FRC, and how? What are the impacts of current funding arrangements, including of having a partially voluntary funded regime?

Q43: What skills are needed for the FRC to be most effective? Does the FRC have the people, skills and resources it needs, of the quality it needs?

Q44: Are there conflicts of interest in the FRC's structure, processes, or culture? Are there deficiencies in the FRC's approach to managing conflicts of interests?

Q45: Are there any other issues relevant to the terms of reference that respondents would like to raise?

APPENDIX B

Excerpts from global stewardship codes that explicitly refence ESG issues.

Australia

FSC Standard 23: Principles of Internal Governance and Asset Stewardship July 2017[12]

> *'Disclosure should include the Asset Manager's approach where relevant to the following stewardship activities and the governance and oversight associated with each one… approach to considering Environmental, Social and Governance factors (risks and opportunities) and whether these considerations influence investment decision-making and company engagement.'*

Brazil

AMEC Stewardship Code[13]

> *'Principle 3: Take ESG factors into account in their investment processes and stewardship activities Institutional investors should integrate environmental, social and governance factors into their investment process, evaluating both their impact on risks and returns and their contribution to the sustainable development of the issuers of securities.'*

South Africa

CRISA Code[14]

An institutional investor should incorporate sustainability considerations, including environmental, social and governance, into its investment analysis and investment activities as part of the delivery of superior risk-adjusted returns to the ultimate beneficiaries

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[12] https://www.fsc.org.au/_entity/annotation/82bbc3f8-316c-e711-8103-c4346bc5977c

[13] https://www.amecbrasil.org.br/stewardship/codigo/

[14] http://www.iodsa.co.za/?page=CRISACode