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24 April, 2015

Dear Mr. Koufou,

Re: Consultation on Changes to Investment Regulations

The International Corporate Governance Network (ICGN) welcomes the opportunity to comment on the Department for Work & Pensions (DWP) consultation regarding changes to the investment regulations following the Law Commission's Fiduciary Duties of Investment Intermediaries Report. ICGN was founded 20 years ago and is an investor-led membership organisation of more than 600 individuals based in over 50 countries from around the world. Our mission is to inspire and promote effective standards of corporate governance to support the sustainable value creation of companies and to advance efficient markets and economies world-wide. Our members represent institutional investors with global assets under management in excess of US$26 trillion. Accordingly, ICGN's members offer a source of practical knowledge and experience in regard to governance and investment issues. For more information on the ICGN, please visit www.icgn.org.

The membership of ICGN has vetted and adopted a series of guidance principles and best practice documents that bear on the consultation questions. In particular, the *ICGN Global Governance Principles*[1]*,* the *ICGN Statement of Principles for Institutional Investor Responsibilities*[2] and *ICGN Model Contract Terms between Asset Owners and Managers*[3] are particularly relevant. We highlight the most relevant elements of ICGN guidance in this letter, though we also encourage you to review these documents.

[1] See: https://www.icgn.org/images/Global_Governance_Principles_2014.pdf
[2] See: https://www.icgn.org/images/ICGN/files/icgn_main/Publications/best_practice/SHREC/ICGN_Principles_Investor_Responsibilities_Guidance_Sept_2013_print.pdf
[3] See: https://www.icgn.org/images/ICGN/files/icgn_main/Publications/best_practice/SHREC/ICGN_Model_Mandate_2012_re-printApr2013_FULL.pdf

Q-1: How could regulation 2(3) (b) of the Investment Regulations be amended so that it more clearly reflects the distinction between financial and no-financial factors?

The current wording of regulation 2(3) (b) of the Investment Regulations is problematic, and would benefit from greater clarification about how environmental, social governance (ESG) and ethical criteria are used in the investment process.

Forcing categorization of these ESG factors into binary "financial"/"non-financial" groupings is not necessarily helpful and can be a source of confusion. While the often qualitative nature of ESG risks gives rise to their being regarded as "non-financial", the potential for financial impacts on the companies – and on investors—is substantial. Even for investment strategies that are not explicitly ESG- or ethically-themed, ESG factors play an increasingly important role in the assessment of a company's long-term opportunities and risks. This continues to build as part of mainstream investment analysis, in which material ESG factors are taken into consideration as part of a disciplined investment process. [4]

It may be useful for the Investment Regulations to distinguish investment strategies where ESG factors are taken into consideration in ways that do not necessarily focus on financial or investment performance. Examples of these include ethical or ESG-themed funds.

Remaining Fit for Purpose in the Face of Change

The Kay Review, the ensuing UK Law Commission Report on Fiduciary Duties of Investment Intermediaries and the DWP follow-on consultation are all part of an ongoing transition in understanding the role played by institutional investors in response to the corporate governance environment in which we operate. The Kay Review and UK Law Commission discuss many of those dynamics. DWP investment regulations must keep up with these changes to ensure that investment fiduciaries' practices are fit for purpose to serve the financial interests of pension scheme members, both today and long into the future.

We begin with an emphasis on remaining fit for purpose in the face of change, as ICGN guidance reflects our members' understanding that the pension investment industry in in the midst of an ongoing evolution. There is a danger that portraying the primary regulatory concern as merely a distinction between financial and non-financial factors could encourage continued treatment of long-term investment risks and opportunities as merely an effort to "bolt on" consideration of ESG issues to current approaches, rather than an integration of material sustainability factors into fundamental investment analysis.

The direction of change in the industry is toward the latter. ICGN guidance recognises that we are continuing to build our understanding of how management of

[4] In this vein the ICGN has recently announced an executive education partnership with the French business school INSEAD to train investors and corporate on how ESG factors impact long-term value. See: https://www.icgn.org/images/ICGN/ICGN_INSEAD_Press_Release_Final.pdf

environmental, social and financial capital can influence economic results. Regulations should acknowledge this progression and facilitate alignment of investment practices with the growing industry sophistication in recognition of when, how and why ESG factors are integral to mainstream evaluation of investment risks and opportunities.

We note several recent developments that illustrate the need for investors, consultants and regulators to stay current in their thinking and practices on integration of ESG considerations into investment practices:

- European Union Directive 2014/95/EU requires disclosure of non-financial and diversity information by large companies. Company management reports will have to include information on policies, risks and outcomes as regards environmental matters, social and employee aspects, respect for human rights, anticorruption and bribery issues, and diversity in their board of directors.[5]

- Recent research from Harvard Business School into those industry-specific sustainability issues that are defined as material by the Sustainability Accounting Standards Board (SASB) found that $1 invested in 1993 in a portfolio of firms with high performance on SASB material sustainability issues grew to $28.36 by 2014, compared to only $14.46 for competitor firms with low performance on SASB material sustainability issues.[6]

- The 2014 National Association of Pension Funds (NAPF) survey reported that 90 percent of respondents agreed that ESG factors can have a material impact on the fund's investments in the long-term.[7]

- In January 2015, the *ICGN Model Contract Terms between Asset Owners and Managers* was adapted and recommended by the Code for Responsible Investment in Southern Africa ('CRISA') Committee for use by institutional investors in South Africa.[8]

Q-2: Do you agree that amending the Investment Regulations to require trustees to comply with the current requirements in the Stewardship Code, or explain why they have not done so, is the most appropriate way to implement the Law Commission's recommendation?

We agree that requiring fund trustees to either comply or explain on their application of the Stewardship Code is likely to be the most effective way to encourage trustees to consider their approach to stewardship. However, before making this public policy

[5] http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32014L0095
[6] *Turning a Profit While Doing Good: Aligning Sustainability with Corporate Performance* (December 2014), George Serafeim, Professor of Business Administration, Harvard Business School.
http://www.brookings.edu/research/papers/2014/12/08-sustainability-corporate-performance-profit-serafeim
[7] http://www.napf.co.uk/PolicyandResearch/DocumentLibrary/~/media/Policy/Documents/0412_NAPF_engagement_survey_2014.pdf
[8] http://www.iodsa.co.za/?CRISAPN

the DWP should anticipate how this will be monitored, particularly for those funds that may choose to submit an explanation of non-compliance.

ICGN guidance notes the growing proliferation of stewardship codes across various markets and views stewardship as central to the modern investment management process. Pension asset owners should consider how to best manage the rights they have as an investor and should report on implementation of proxy voting and any other stewardship activities. Our guidance also stresses that stewardship can be exercised in collaboration with other investors and can be delegated to third party providers, provided they are monitored and held accountable. It includes fundamental institutional investor activities, such as (without limitation), oversight of stocklending practices and proxy voting. See the appendix for greater detail on this point, drawn from the ICGN Model Mandate.

Q-3: What steps would trustees need to take to comply with any amendments to the Investment Regulations as set out in Chapter 2? What, if any, costs would be involved in meeting any new requirements?

In terms of practical steps that trustees might take to comply with changes in the Investment Regulations, we would emphasise the importance of establishing fiduciary and stewardship responsibilities explicitly in investment management agreements—the contracts between asset owners and asset managers that define the scope and deliverables of an investment mandate. The ICGN Model Mandate[9] provides a practical example of contract language that can incorporate aspects of investor monitoring, voting and engaging that are linked to stewardship and fiduciary responsibilities, and we encourage widespread use of the Model Mandate by fund trustees.[10]

We see the question about costs as being stated backwards. Given that ineffective governance, inadequate risk management and misaligned stewardship practices contributed to causing the recent financial crisis, it seems more appropriate to ask what the costs would be of not implementing reforms aimed at improving management of systemic or long-term risks, identification of long-term opportunities and exercise of prudent investor stewardship. We believe that the future risks and costs of not updating regulatory frameworks to reflect changed circumstances and advances in learning would dwarf the costs of reform.

Indeed, the Law Commission Report emphasizes that some risks cannot be definitively quantified.

> *"Trustees must weigh returns against risks, including long-term risks. It is often said that trustees should "optimise the risk return ratio". We think this is*

[9] See: https://www.icgn.org/images/ICGN/files/icgn_main/Publications/best_practice/SHREC/ICGN_Model_Mandate_2012_re-printApr2013_FULL.pdf

[10] For example, the Code for Responsible Investment in Southern Africa (CRISA) announced earlier in 2015 its use of the ICGN Model Mandate to guide implementation of CRISA in South African. This involved the adaptation of Mandate's model contractual provisions for application in a South African legal context.

correct, but it may not be a helpful way of thinking about the problem, as it suggests that the decision is a mathematical one. Only some risks can be reduced to numbers – and the search for numbers may lead investors astray." [UK Law Commission Final Report, paragraph 5.52]

Finally, we would also like to draw your attention to the Focusing Capital for the Long Term Initiative, which has been undertaken separately from ICGN but includes a working group with a number of ICGN members.[11] The Initiative has developed a roadmap to help institutional investors evaluate, adapt, and adopt an organizationally appropriate mix of action areas to enhance the long-term value they create for their beneficiaries.[12]

- ***Investment beliefs** - Clearly articulate investment beliefs, with a focus on their portfolio consequences, to provide a foundation for a sustained long-term investment strategy.*
- ***Risk appetite statement** - Develop a comprehensive statement of key risks, risk appetite, and risk measures, appropriate to the organization and oriented to the long term.*
- ***Benchmarking process** - Select and construct benchmarks focused on long-term value creation; distinguish between assessing the strategy itself and evaluating the asset managers' execution of it.*
- ***Evaluations and incentives** - Evaluate internal and external asset managers with an emphasis on process, behaviors, and consistency with long-term expectations. Formulate incentive compensation with a greater weight on long-term performance.*
- ***Investment mandates** - Use investment-strategy mandates not simply as a legal contract but as a mutual mechanism to align the asset managers' behaviors with the objectives of the asset owner. Focusing Capital on the Long Term: Long-Term Portfolio Guide (March 2015)*[13]

[11] In addition to the Initiative, a number of leading UK pension fund members from ICGN also recently participated in development of *A Guide to Responsible Investment Reporting in Public Equity*, which is intended to be particularly useful for small pension funds in engaging and monitoring stewardship and integration of ESG factors into fund manager practices. See: http://www.uss.co.uk/UssInvestments/Responsibleinvestment/Documents/guidetoRIreportinginpublicequity.pdf
[12] The Focusing Capital for the Long Term website is: http://www.fclt.org/en/home.html.
[13] See the complete Guide at: http://www.fclt.org/content/dam/fclt/en/ourthinking/FCLT_Long-Term%20Portfolio%20Guide.pdf

We hope these comments will be helpful. If you wish to discuss our comments further, please contact Keith Johnson of ICGN's Shareholder Responsibilities Committee or ICGN Policy Director George Dallas, whose contact details are listed below.

Yours Sincerely,

Erik Breen
Chair, ICGN Board of Governors

ICGN contacts:

- Keith Johnson, ICGN Shareholder Responsibilities Committee: kjohnson@reinhartlaw.com
- Carol Nolan Drake, Co-Chair, ICGN Shareholder Responsibilities Committee: drake@opers.org
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Appendix

ICGN Views on Consideration of Financial and Non-Financial Factors

Development of a Fiduciary Culture Focused on the Long Term
As an organisation of investment industry professionals, ICGN is focused on encouraging best practices rather than teaching how to avoid regulatory sanctions. Accordingly, our guidance stresses investor responsibilities, policies, structures, goals, incentives and reporting. We hope that the DWP will use both aspirational and prescriptive tools to influence the practices and behavior of pension fund investors and their advisors.

The UK Law Commission Final Report highlighted some of the ways in which non-financial factors can actually have financial ramifications, especially over the long term.

> *"When investing in equities over the long term, the risks will include risks to the long-term sustainability of a company's performance. These may arise from a wide range of factors, including poor governance or environmental degradation, or the risks to a company's reputation arising from the way it treats its customers, suppliers or employees. A company with a poor safety record, or which makes defective products, or which indulges in sharp practices also faces possible risks of legal or regulatory action. Where poor business ethics raise questions about a company's long-term sustainability, we would classify them as a financial factor which is relevant to risk.*[14]

Systemic and Portfolio-Wide Effects
The *ICGN Model Contract Terms between Asset Owners and Managers* goes beyond identification of risks to emphasize consideration of opportunities and awareness of long-term portfolio-wide and systemic effects.[15]

> *"As long-term owners which are exposed across asset classes, major institutional investors need to be aware of systemic risks to the value of their overall portfolio. Their perspective reaches beyond the risks in any one investment portfolio, either in terms of lifetime or scope, and they need their fund managers to consider not only risks which affect the immediate volatility of their portfolio, but also those which can affect investment value over a longer period or a broader spread of investments. This goes to the core of alignment of interests.*
>
> *There are three aspects to these risks which matter to the long-term owner: singular long-term risks within individual assets; risks with a combined impact across an asset owner's portfolio; and economic impacts which come to bear*

[14] http://lawcommission.justice.gov.uk/docs/lc350_fiduciary_duties_guidance.pdf
[15] The Law Commission Report does recognize legitimacy of taking a broader view when it states, in paragraph 6.53: *"In the Consultation Paper we said that the aim of a pension fund is to secure returns across the whole portfolio. Therefore there can be no legal objection to making a decision which, after due consideration, is designed to provide financial benefits to the portfolio as a whole."*

across the financial system as a whole or over a long time horizon. Similarly, portfolios with longer-term investment horizons might have opportunities not available to short-term investors, where long-term factors have positive impacts.

The term ESG factor is used here to mean material and relevant investment risks and opportunities for asset owners with long-term investment horizons. They may have a significant (albeit often difficult to quantify) financial impact over the investment life of the asset owner – though often requiring an intervention to internalise external costs or some other regulatory change before those costs are triggered – and clients are increasingly seeking to build them into the risk management processes and investment decision-making of their managers.

Just as portfolio performance is now generally adjusted for the risk taken to achieve returns, it is likely that its calculation will also need to take account of the risks which are assumed in these ESG areas, to the extent that these can be identified. That analysis will need to be integrated into the monitoring, evaluation and remuneration." [ICGN Model Mandate, section 1.0]

Intergenerational Impartiality

ICGN guidance stresses the need to impartially balance the current and future interests of different generations included in the pension scheme.[16] It also recognizes that ESG factors can be material across all asset classes.

"Most collective investment vehicles will aggregate the interests of underlying beneficiaries investing over a range of time horizons; in many cases, these differences will not be just a matter of a few years but whole generations. Such generational differences create real challenges for the governing bodies charged with acting in the interests of all beneficiaries. Such challenges cannot simply be ignored but rather need to be managed such that actions now do not damage the long-term interests of those who will only begin to drawdown benefits from the collective vehicle many years later. There may in some cases be a tendency to focus more on the interests of those drawing benefits already or those who will shortly begin to do so; this tendency must be countered by a consciousness of the need to be fair between the range of generations among the collective vehicle's beneficiaries." [ICGN Statement of Principles for Institutional Investor Responsibilities, section 6.2.3]

Selection of Asset Managers/Service Providers and Alignment of Incentive Structures

Attention to selection of asset managers and other service providers with the skills to integrate long-term issues, along with alignment of incentives (including fee

[16] The Law Commission Report also recognizes intergenerational fairness in paragraph 5.38: *"However, younger members will judge the investment strategy in the long-term, which requires a long-term approach. Members will have little interest in immediate high returns if the result is an accumulation of risks, leading to a lower pension in forty years' time.* "

structures), with fiduciary goals throughout the service provider chain, are also an important components of ICGN guidance.

> *"The time horizon of most asset owners is considerably longer than that of fund managers. Thus for long-term portfolios, the factors and risks which matter to the asset owner are somewhat different from those typically considered within fund management processes. But as these factors and risks will impact their long-term returns, many asset owners are keen to see more effective integration of these longer-term factors into investment processes.*
>
> *Proposed subject matters for model terms [of investment contracts] include*
>
> > *• monitoring ESG factors: requiring appropriate measurement monitoring and reporting as a necessary first step to integration, whether using internal staff and systems or by employing external providers*
> >
> > *• due diligence: permitting due diligence by the client into the processes to deliver on the fund manager's integration and risk management commitments and its approach to them, on an initial and ongoing basis, to ensure these continue to be carried forward properly in practice*
> >
> > *• effective ESG integration: ensuring that the fund manager establishes and adheres to relevant internal guidelines on how ESG factors are effectively integrated into investment decision-making; setting standards against which the fund manager will report on the effectiveness of this integration." [ICGN Model Mandate, section 1.3]*
>
> *"Institutional investors should reinforce their obligations to act fully in the interests of beneficiaries or clients by setting fee and remuneration structures that provide appropriate alignment over relevant time horizons. In large part this will require the structure for fees paid to parties in the investment chain to be more associated with the long-term perspectives which will generate returns over the time-horizon that beneficiaries and clients are seeking.*
>
> *Collective investment vehicles may also seek transparency of the remuneration structures for individuals within the agents that they hire, in particular to gain reassurance that these provide appropriate incentives to those individuals. In particular, they may wish to assure themselves that pay structures for individuals do not inappropriately incentivise risk-taking behaviours. Consideration should be given to including a long-term performance incentive that reflects long-term investment results or is in the form of an interest in the fund that extends through the period of responsibility for the investments. "[ICGN Statement of Principles for Institutional Investor Responsibilities, section 3.5]*

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Accountability and Reporting

Transparent reporting is critical for accountability, both from investment managers to scheme trustees and of trustees to their scheme participants. Accountability also contemplates increased two-way dialogue between the scheme trustee and members regarding application of member views on ethical beliefs and best interests to investment practices. ICGN guidance highlights a number of key reporting topics.

> *"Manager accountability requires that both the fund manager and any relevant custodian provide relevant and regular information flows to enable client insight into delivery of the overall long-term investment aims, including among other things:*
>
> - *performance on a risk-adjusted basis relative to any benchmark;*
> - *portfolio composition and explanations of significant changes over the period since the last report;*
> - *risk exposures and management;*
> - *the approach to responsible investment and how this is effectively delivered for the portfolio;*
> - *success in achieving overall goals for the client's investors/beneficiaries in a sustainable and impartial manner;*
> - *delivery of voting and stewardship responsibilities according to the mandate;*
> - *level of turnover and explanation if this exceeds expected levels;*
> - *commission payments and counterparty relationships; and*
> - *securities lending positions and activity.*
>
> *Asset owners will also expect to be kept regularly informed as to the governance structures which ensure independence, alignment and culture at the fund manager, and particularly to be kept informed of any key developments in the governance approach.*
>
> *By seeking greater transparency and disclosure from their fund managers, clients will increasingly need to consider the interests of their various investor/ beneficiary groups and which factors are most crucial to their relationships with managers, as well as what the consequences might be of any failure to deliver against the expectations set in the contract and any associated standards, including the investment policy statement or relevant parts thereof. In order for the asset owners also to be accountable to their investors/beneficiaries, they will need to consider disclosing their policy in relation to best practice contract terms (such as those offered in this document) and the extent to which such clauses are reflected in their contracts with their fund managers." [ICGN Model Mandate, section 2.0]*

Stewardship should be Considered and Reported

ICGN guidance treats stewardship as an integral part of pension scheme management responsibilities.

> *"In essence, stewardship is working with the underlying assets to ensure that*

they focus on delivery of risk-adjusted value over the time horizons that matter to long-term owners and taking into account risks and other issues that matter to long-term owners. Some asset owners hire specialist firms to do this work, but many expect this to be part of the process of fund management. The proposed clauses [in the ICGN Model Mandate] require managers to put such stewardship responsibilities into effect. Managers will also require clarity of which ownership rights and powers are placed in their hands by clients to be exercised as they choose, and which are only available to be used pursuant to client directions or approval.

In addition, there is a need for clients to have effective oversight of the voting activities carried out by fund managers in their names. Some clients will prefer directly to control the votes attached to their investments, while others would rather require managers to vote according to established guidelines. The latter will need a basis to hold managers to account for delivery in respect of those guidelines. Still others will simply seek to hold their managers to account for the decisions that they take: this will require high levels of relevant transparency.

A further issue which can cause controversy in the area of stewardship is stocklending, under which clients' shares are in effect sold, subject to a buyback right. Often this activity is more under the client's control than the fund manager's, but on occasion the stocklending programme is in the hands of the fund manager. Whichever approach applies, it will be important to ensure that both sides have access to relevant information, which includes current positions and transparency on fees earned. Particularly in order to deliver stewardship responsibilities, both parties will be keen to have insight into which stocks are subject to lending at given times and they may need to agree a basis on which one or either party can trigger a recall of lent stock, either so that it is not potentially in the hands of a party whose interests diverge from those of the client or so that the parties can exercise stewardship rights in full. [ICGN Model Mandate, section 1.4]