Mr Jeroen Hooijer
Head of Unit, Company Law
European Commission, Directorate General Justice and Consumers
By email: JUST-A3@ec.europa.eu

1 April 2016

Dear Jeroen

Thank you for the opportunity to comment on the EU's public consultation on long term and sustainable investment.

The Financial Reporting Council is the UK's independent regulator responsible for promoting high quality corporate governance and reporting to foster investment. We promote high standards of corporate governance through the UK Corporate Governance Code. We set standards for corporate reporting, audit and actuarial practice and monitor and enforce accounting and auditing standards. We also oversee the regulatory activities of the actuarial profession and the professional accountancy bodies and operate independent disciplinary arrangements for public interest cases involving accountants and actuaries.

The UK governance and reporting framework encourages reporting of ESG and non-financial matters through the Guidance on the Strategic Report and Corporate Governance Code requirements for disclosure of principal risks and uncertainties and a viability statement.

The FRC also supports engagement between investors and companies in a number of ways. In relation to reporting, the Financial Reporting Lab provides an environment where investors and companies can come together to develop pragmatic solutions to today's reporting needs. It brings companies and investors together to test new reporting formats and support innovation in reporting.

The issues of non-financial reporting, long termism and ESG investment are being considered in a number of current European initiatives, including the Non-Financial Reporting Directive, Institutions for Occupational Retirement Provision Directive and the Shareholder Rights Directive. We encourage the Commission to align these initiatives and, more specifically, to use investor evidence from this consultation to inform the development of the European guidelines for reporting non-financial information.

If you have any questions about this response please feel free to contact Hannah Armitage (h.armitage@frc.org.uk).

Yours sincerely

M McLaren

Melanie McLaren
Executive Director, Codes and Standards

FRC RESPONSE TO THE EU CONSULTATION ON LONG-TERM AND SUSTAINABLE INVESTMENT

1. Rationale for ESG inclusion into investment decisions

1.a. Do ESG factors pay a role in the investment decisions of investors? If not, why? If yes, please specify which considerations are reflecting in your investment policy and mandates? In what form is this commitment expressed?

Our response reflects the evidence we gather from investors and others in the investment chain regarding environmental, social and governance (ESG) issues, reporting, stewardship and other investment topics.

ESG factors play a role in the investment decisions of many investors and we hear from a range of investors that consideration of such factors is becoming more prevalent. However, the extent to which ESG considerations are incorporated depends on investment style and interpretation of fiduciary duty, amongst other reasons. For those investors which do take into account ESG issues materiality of the information remains a very high priority, as they wish to encourage relevant reporting. Many investors feel that companies would benefit from better consultation with investors about what they consider material and what, therefore, should be disclosed. This aligns with the FRC's Clear & Concise initiative which aims to ensure that annual reports provide relevant information for investors.

The use of ESG information may also differ throughout the life cycle of the investment. Some investors inform us that they consider ESG issues more fully as part of their due diligence before an initial investment, with ongoing consideration likely to focus less on specific disclosures. This may reflect a focus on engagement, as others without the ability to engage directly may rely more heavily on reporting and disclosures.

ESG factors may be incorporated in mandates, but this depends on the approach of the asset owner. Mandates tend to outline a general approach to such issues, but some mandates may more strongly direct the asset manager. Such an approach often depends on size and the beneficiary base of the asset owner.

1.b. What is the main rationale for institutional investors and asset managers to take ESG risks and opportunities into account in their investment decisions? Please indicate all the relevant issues (multiple choice)

- ☑ **a) risk management:**
- ☑ **b) alignment of investment policies with the long-term interests of beneficiaries of the institutional investor,**
- ☑ **c) pressure from clients on whose behalf the institutional investor invests funds,**
- ☑ **d) seeking a positive social or environmental impact of investments,**
- ☑ **e) ethical considerations,**
- ☑ **f) legal or regulatory constraints, please specify,**
- ☑ **g) other, please specify.**

Please provide an explanation :

The reasons for taking ESG risks and opportunities into account will differ depending on the investor. Additional reasons may include a belief in improved returns and the manager's interpretation of fiduciary duty.

2. Information on ESG risks and opportunities

2.a. Which ESG risks do you perceive as material to investors?

Through reporting on principal risks and in their viability statement companies are required to consider materiality of ESG information to their financial position. We encourage companies to disclose how their principal risks affect them, the range of potential outcomes and any mitigating actions. Investors inform us that they increasingly see long-term prospective information on material information as important in their assessments of companies.

Investor feedback on materiality is that it differs widely between companies. Governance is generally seen as a more fundamental underlying factor, with consideration of environmental and social topics heavily dependent on the company and the investment approach. The recent introduction of the FSB's Task Force on Climate-related Financial Disclosures, and recent feedback we have received from investors expressing surprise that cyber risk and climate change-related risks are not more often reported, shows that investors are interested in receiving material information from companies on a range of issues.

2.b. What are the main sources of reliable and relevant information for investors on material medium- to long-term risks and opportunities, particularly on ESG issues?

A company's annual report and accounts are an important source of information for investors supplemented with their own research and engagement with companies.

In the UK, the Strategic Report (management report) is a key source of information and has led to improvements in the quality and relevance of information for investors. The Strategic Report and the FRC's Guidance on the Strategic Report (https://www.frc.org.uk/Our-Work/Publications/Accounting-and-Reporting-Policy/Guidance-on-the-Strategic-Report.pdf) provide a framework for companies to report on material non-financial matters in their annual report. This ensures that the annual report tells a coherent story.

Where there is a need for a greater level of detail on ESG matters, we encourage companies to include this on a company's website so that it does not detract from the key messages and a number of companies already produce separate Corporate Social Responsibility or sustainability reports.

Specialist research by external providers may also be used if there are particular ESG factors of interest to the investor.

2.c. Is it difficult for investors to access such information? If so, please specify:

Accessibility will differ depending on the type of information being used, however, much of the analysis is based on publicly available information, so is widely available.

2e. What factors may prevent or discourage companies from disclosing such data?

Companies may not appreciate the relevance of data to investors' decision-making or engagement processes. Companies may also feel that, on certain issues, they do not have sufficiently robust data and so avoid making disclosures for that reason. Commercial sensitivity or confidentiality concerns may also factor into considerations of disclosure. In addition, if the company feels that it is 'required' to report particular metrics, but the company does not see these as material, this may discourage them from reporting more fully.

2.f. What is the main rationale for companies to publish such information? Please indicate all the relevant issues. (multiple choice)

- [x] **a) relevance of ESG issues to company performance**
- [ ] **b) attracting financing for specific projects, for example green bonds**
- [ ] **c) legal or regulatory constraints**
- [ ] **d) demand from investors**
- [ ] **e) pressure from stakeholders**
- [x] **f) other**

regulatory requirements

2.h. What are the best practices as regards internal corporate governance processes to ensure proper reliability of the disclosed information?

The FRC's UK Corporate Governance Code encourages companies to report fully to investors on their risk management and internal controls systems. It provides that companies should robustly assess their principal risks and explain how they are being managed or mitigated; and monitor their risk management and internal control systems and, at least annually, carry out a review of their effectiveness.

The European principle of 'comply or explain' gives companies flexibility and makes it possible to set more demanding standards than can be done through hard rules. Experience has shown that the vast majority of companies attain these standards and by requiring companies to report to shareholders rather than regulators the decision on whether a company's governance is adequate is taken by those in whose interest the board is meant to act.

3. Integrating ESG information into risk assessment models of institutional investors and asset managers

3.b. Are there specific barriers, other than those of a regulatory nature (see question 9) for investors to integrate medium-to long-term risk indicators, including ESG matters in their risk assessment? If so, please indicate what you consider to be the main barriers.

Among the barriers may be lack of conviction on the part of the fund manager or fund management firm that such factors have an impact on company performance and / or lack of relevant tools or techniques to integrate these factors into standard investment models.

4. Integration of ESG aspects in financial incentives

4.a. When selecting and remunerating asset managers, how do institutional investors take into account asset managers' integration of ESG issues into investment strategies?

What are the best practices in this area?

Some investors will take into account ESG integration and/or active ownership strategies when selecting asset managers. Expectations around the approach to ESG integration are likely to be discussed and set at the mandate-letting stage. Some asset managers have begun to consider the alignment of remuneration with longer-term factors, but this is relatively rare.

5. Capacity of institutional investors

5.a. Do you think that the lack of scale or the lack of skills and resources of some institutional investors may affect their ability to integrate ESG factors in investment decision-making and engage on such issues? If so, how? Please provide evidence if possible.

Investors assess the investment case before investing in a company and as some ESG factors are material to investment outcomes, they should be taking these into account in longer term assessments. Investors may, however, encounter problems engaging on such issues if they lack the resources, as engagement is a labour-intensive activity.

5.b. Please indicate measures/practices that have contributed to enhance institutional investors' capacity and ability to integrate ESG factors in investment decision-making and engage on such issues.

There is a far greater acknowledgement today compared with five years ago that ESG factors can have an impact on long-term performance. As a result, companies have made significant improvements to their reporting to improve the accessibility of such information to investors and are also more able to talk about the impact of such issues on performance. The introduction of the strategic report in the UK has also significantly enhanced the quality of reporting in this area. Data providers also now include more ESG-related information on their standards screens, thus increasing ease of access for investors. Many companies have introduced board level sustainability committees, or have designated a particular non-executive with responsibility for sustainability issues which improves investors' visibility as to ultimate responsibility for these issues.

6. Internal governance and accountability of the institutional investor

6.b. Do beneficiaries of pension funds and other institutional investors with long-term liabilities obtain sufficient and clear information about how the fund or investor is managing ESG risks? Can they give their opinion/be consulted on these aspects? Please provide examples of good practice.

The UK Stewardship Code attempts to increase transparency in the market so that clients and beneficiaries are more aware of the actions being undertaken in their names. The Code has normalised discussions about stewardship in the investment chain and has led to some improvements in reporting. Asset owners, however, tend to feel that improvement could still improve, as evidenced by the introduction in 2015 of 'A Guide to Responsible Investment Reporting in Public Equity' and the Pensions and Lifetime Savings Associations' 2016 Stewardship survey, which found that "While there was general satisfaction with asset managers' approach to stewardship, few respondents declared themselves 'very satisfied' with reporting, or able to 'strongly agree' that institutional investors were active enough stewards."

Asset owners continue to consider the way in which they can best consult with their members. Some funds have undertaken surveys of groups with similar demographics to that of their membership, and increasingly others are discussing undertaking surveys of their members to gather views on the approach to ESG, among other topics.

6.c. Are beneficiaries interested in matters referred to above? Please provide evidence if possible.

The appetite for responsible investment varies. A number of surveys have encountered confusion with the language, but when questions are posed in relation to the environment, corporate responsibility etc, responses are generally more positive. One recent source is the 'Make our money count' survey carried out for Good Money Week. The survey, undertaken by Yougov of the UK public, found that 42 per cent of the public believe that if an employer has a 'default' pension option which employees are automatically enrolled into, then that default option should be an ethical or sustainable pension plan. Other results include:

- 54 per cent who hold investments, a record high, want their pensions or savings to have some positive impact on the world beyond just making money.
- Almost a third (32 per cent) of all adults want a fossil free option for their savings or investments, rising to 46 per cent among under-35s.
- 47 per cent of those with investments would be interested in annual updates on their environmental/social impact, rising to 58 per cent of under-35s.
- 39 per cent think large pension funds should be required to measure and if necessary, reduce the carbon footprint of their investments.

The UKSIF and NAPF document 'Ownership Matters' also discusses responses to ownership issues from both the pensions and individual savers' perspectives: http://www.plsa.co.uk/PolicyandResearch/DocumentLibrary/0379_attitudes_to_ownership_report_2014.aspx.

7. The role of other service providers

7.c. To what extent do investment consultants consider the asset managers' approach to ESG issues and active asset ownership when advising institutional investors about the selection of asset managers?

Investment consultants approach these issues in a number of ways. Some Investment Consultants are much more active in considering the ESG records of managers and brining this to the attention of their clients. A number actively monitor asset managers on their approach to active ownership and ESG issues and encourage them to improve their reporting to clients in this area. However, the Pensions and Lifetimes Savings Association's recent survey of pension funds showed a continued poor response to the role of Investment consultants. For example, "most respondents said that their investment consultants, who might be expected to encourage a rigorous approach to stewardship, had not raised these issues in discussions", with fewer than a third of respondents stating that the Investment Consultant had proactively raised such issues.

In the UK, much focus has recently fallen on investment consultants. The Investment Association's Productivity Action Plan and the FCA's Asset Management Study both look at the role of investment consultants and their consideration of ESG and Value, so you may find the results of their conversations of interest.

7.f. What are the best practices as regards independent external assurance (for example auditor review) for the disclosure by companies of material medium- to long-term risks and opportunities, particularly ESG issues?

The FRC considers that demand for assurance of ESG information should be investor-led, and at this stage general investor feedback is that it is not required.

Whilst some investors take comfort from the assurance, many consider that the market for this information is new and should be allowed to develop before such assurance is mandated. A number of investors felt that assurance over information will become more valuable as this information becomes more integrated into investment processes.

Auditors are already required to check for consistency between the front half of the annual report and the financial statements under ISA720, so there is some assurance for investors on the consistency of information. Where companies do have information assured, investors feel that these areas should be more clearly highlighted.

9. Legal or regulatory constraints

9.b. Do you believe that there are any barriers to the understanding by institutional investors and asset managers of their fiduciary duties that would not enable them to appropriately take ESG factors into account in their investment decisions? Please explain.

The UK's Stewardship Code encourages assessment of ESG issues where these are material and relevant to the investment model. In turn, compliance with the Corporate Governance Code is monitored by investors. The topic of fiduciary duties is sometimes discussed as a possible barrier to further investment in ESG issues. As a result of the Kay review, the UK's Law Commission was asked to consider the fiduciary duties of investment intermediaries in the UK investment chain. The Law Commission's recent report dismissed the contention that there were legal obstacles to investing responsibly. The Law Commission also produced some helpful guidance for asset owners, outlining that fiduciary duties are not an obstacle to responsible investment and that ESG factors should be taken into account where the Trustees consider them material to financial return. The Law Commission's report is still relatively recent and there may be less clarity about the interplay between fiduciary duty and responsible investment in the EU.