OUR RESPONSE TO FRC CONSULTATION:

PROPOSED REVISION TO THE UK STEWARDSHIP CODE

29 March 2019

Our response

Our response is made up of three parts:

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2. Responses to the specific questions

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1. Our general view

We are pleased to submit a response to the FRC consultation "Proposed Revision to the UK Stewardship Code".

Royal London is the largest mutual life, pensions and asset manager in the UK, with funds under management of £114 billion. Our insurance entity 'Royal London Mutual Insurance Society (RLMIS)' has stewardship responsibility as an 'Asset Owner' and our asset manager 'Royal London Asset Management (RLAM)' who manages the majority of RLMIS's assets in addition to assets on behalf of external clients has responsibility as an 'Asset Manager'.

Historically RLAM have led Royal London's stewardship activities on behalf of RLMIS as a signatory to the Stewardship Code. RLAM has a strong track record of promoting greater accountability and transparency in the organisations in which it invests. RLAM and RLMIS are strongly committed to representing the views and wishes of their customers, members and clients.

RLMIS has well-established processes in relation to the setting of investment beliefs, asset allocation, awarding investment mandates and monitoring performance of service providers. However, over 2018 RLMIS has reviewed our approach to Responsible Investment and we plan to significantly increase our focus in this area and strengthen our stewardship activities.

We strongly support the additional clarity the revised proposed code changes provide on the split of responsibilities between 'asset owner' and 'asset manager'. Consequently RLMIS will sign up to the Stewardship Code, producing separate disclosures as an 'asset owner'.

We have reviewed the proposed code changes and jointly support the proposal to widen the scope to incorporate 'other asset classes' and 'investment activity' (i.e. ESG integration). In the response to Question one, we have highlighted some amendments to the definition of stewardship to strengthen the proposal.

However, the review highlighted concerns around the practical implications of implementation, and potential duplication of effort with other initiatives such as the Principles for Responsible (PRI). These concerns are raised within our responses to Questions 2-16.

We are keen to ensure that compliance with the Stewardship Code does not become a 'tick-box' exercise and that there is significant value in allowing investors to take a nuanced and varied approach to stewardship, provided they demonstrate they are meeting the main Principles. The purpose of the Stewardship Code should be to encourage greater transparency and higher standards, not to create a 'one size fits all' stewardship framework.

We believe it would be beneficial to address these concerns to maximise the impact of the revised code and ensure it complements and supports adoption of other related initiatives.

We would welcome the opportunity for further dialogue on this topic to support the strengthening of stewardship activity across the industry.

2. Responses to the specific questions

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.

We propose the change below to the definition of stewardship, to make it clear that capital is not allocated to or within the institutional investment community, but rather to companies to support economic activity:

> "Stewardship is the responsible allocation and management of capital ~~across the institutional investment community~~ to create sustainable value for beneficiaries, the economy and society."

We also echo the comments made by Professor Alex Edmans in his consultation response, which argues that the decision to trade in a security (buy or sell) is also an important stewardship mechanism which is somewhat overlooked in the new Code. We encourage the FRC to revisit its definition and scope of stewardship in light of his comments. We discuss our views on this further in Question 10 below.

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

Overall we believe the expectations are high and stretching, but we have some concerns on how some of the provisions can be implemented in practice.

The level of detail required in the Code disclosures will create an increased reporting burden on investment firms and we note that many of the disclosure requirements in the draft Code are already disclosed in other documents or initiatives. However, we recognise that there could be a benefit in presenting the disclosures in one document.

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

No. We believe the dual use of 'apply and explain' and 'comply and explain' to be confusing and problematic. The purpose of the annual Outcomes and Activities report and the FRC tiering system is to disclose and assess whether the Principles and Provisions have been appropriately applied, which negates the need for the 'apply and explain' approach. Furthermore, investors that are unwilling to apply the Principles should not sign up to the Code in the first place.

The 'apply and explain' approach is also not consistent with the UK Corporate Governance Code which recommends only a 'comply or explain' approach. We strongly recommend adopting a 'comply or explain' approach for both Principles and Provisions.

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

It would be useful to have a document which sets out the guidance notes next to each Provision for easier reference and use.

We note that under the Guidance number two there is an underlying assumption that collective action and 'working with other participants' is a preferable approach to stewardship. RLAM do not believe collective engagement is a silver bullet and that there are very legitimate reasons for not engaging in collective action with other investors. In RLAM's experience collective engagement can sometimes lead to a 'lowest common' approach to an issue or prevent investors from making their views known publically. In some cases, to act collectively could be considered anti-competitive. In fact, investment managers may be selected on the basis that they take an alternative view or approach which is differentiated in the market.

We think the Stewardship Code should require signatories to be transparent about the engagement approach they take, and not make assumptions regarding the preferred approach to engagement. Please also see question 13 for more on this point.

We also think it is worth noting that in some cases, we may even be prevented or discouraged from working with or discussing companies with other investors due to risks around concert party rules or collusion in advance of IPOs, where the FCA has issued recent fines. We would encourage greater cooperation and clarity from the FRC and FCA on what constitutes acceptable collective action. We think the guidance on collective engagement needs to be written in a neutral way asking investors to explain their approach, rather than assuming collective engagement is always a preferable approach.

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 we support the proposal to produce two reports – one high level document outlining our approach and one report specifying the activities we undertook in the year. However, we are cautious about the level of detail that may be required under the draft Code and the potential duplication of reporting across different initiatives.

We believe it will be difficult for the FRC to evaluate whether stewardship is effective. We would urge the FRC to consider the quality of stewardship activities and not just the quantity, recognising that smaller asset managers with smaller teams will need to be more selective and targeted in their approach to stewardship. We would be very concerned if larger firms were provided an advantage over smaller firms because they are able to dedicate more resources to stewardship. Case studies describing how voting, engagement and/or investment decisions helped enhance value or reduce risk can provide effective insights into how stewardship operates in practice.

The FRC should also consider effectiveness in the context of 'value for money', recognising that stewardship activity is not free and comes at a cost to our clients. We believe firms should focus their efforts on where they can have the most impact rather than aim to be active on all issues (see Question 11 below on considering the cost of engagement).

Q6. Do you agree with the proposed schedule for implementation of the 2019 Code and requirements to provide a Policy and Practice Statement, and an annual Activities and Outcomes Report?

No. We have serious concerns about the proposed timeline and due dates. Given the extensive nature of the changes proposed in this draft, we do not think the deadline of 31 December 2019 for the first signatories of the Stewardship Statement is reasonable, particularly since we must receive Board level approval.

We also strongly disagree with the proposed annual deadline of 31 December for producing the Activities and Outcomes report. First, we would be unable to provide calendar year end statistics or reporting. If we wanted to be one of the first signatories to the Code, this would mean we could only use information and data from the end of Q3 2019. Second, this reporting schedule is out of line with the reporting schedule of other initiatives such as the Principles for Responsible Investment (PRI, 1 April) and Global Real Estate Sustainability Benchmark (GRESB, 1 July), meaning we would have to produce several different sets of data and statistics throughout the year, which would make our reporting look inconsistent to the public and our clients. Our preference is to produce reports which can meet the needs of both the Stewardship Code and the PRI to avoid duplication of effort.

We strongly urge the FRC to set a deadline for the first Stewardship Statements of 31 March 2020 and to set the deadline for the subsequent Activity reports to 31 March 2021. This will allow us more time to comply and receive Board level sign off for our initial Statement and ensure our reporting to the FRC and PRI are aligned to the same schedule.

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?

We agree with the need to focus on outcomes and not just on policy. However we reiterate the point we made in our summary – namely that investors' duties are to their clients and beneficiaries and not to companies or other market participants. We welcome higher expectations of stewardship from the investment industry, but caution that the duties of investors should not be conflated with the duties of company directors.

We would welcome further guidance, after consultation, regarding what 'good' stewardship looks like at both large and small asset managers. This would help address the Kingman Review comments that the FRC must distinguish between signatories that execute stewardship well and those that require improvement.

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

Yes, we agree this is a good addition to the Code and we have included this in our 2019 Stewardship and Responsible Investment Statement.

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?

Yes, we agree with the expansion beyond listed equity and have included some information on our approach to stewardship in Fixed Income in our 2018 and 2019 Stewardship Statements. We believe reporting should cover all asset class considerations in one report per signatory. However, we would caution against the Code seeking to replicate the reporting requirements that are already set out by the PRI.

Q10. Does the proposed Provision 1 provide sufficient transparency to clients and beneficiaries as to how stewardship practices may differ across funds? Should signatories be expected to list the extent to which the stewardship approach applies against all funds?

Although we are supportive in principle of expanding the Code to include integration of stewardship into investment decision-making, we are cautious about how this can be reported in an effective and efficient way by asset managers. For example, RLAM as a moderate sized asset manager, manages over 200 funds, each with a different investment objective, mandate, time horizon and client requirement. Some of these funds are run on behalf of RLMIS, while others are on behalf of external clients. Currently, RLAM's approach to stewardship is consistent across funds and asset classes, which allows us to speak with one voice and be consistent in our messaging with companies and our clients. We believe there are significant benefits to this approach, but we recognise that for certain clients there could be divergence of views. We are committed to having an ongoing dialogue with customers and clients to ensure our approach is consistent with their needs and investment objectives.

For ESG integration to work well and add value to clients, the practical matter of exactly how ESG issues affect the investment decision MUST be tailored to the investment mandate, team, investment process, and client. While we can have a 'house view' on an ESG issue at a company or issuer, whether and how this affects the investment decision at the security level is highly dependent on the nature of the fund and the client requirements.

For example, poor corporate governance practices at a company may lead our investment teams to decide to sell our equity holdings because the company is not responsive to engagement and we do not feel we are being compensated for the risk. Alternatively, we may choose to sell our equity position from more conservative client portfolios, but keep the holding in portfolios where our clients have told us they are more willing to take risk and where we feel there is still a compelling investment rationale. At the same time, it may not be suitable to sell our bond holdings in the company, as we may not consider the governance issue to be financially material to our fixed interest holdings. For example, we may have purchased secured or senior bonds that protect our clients' capital from any significant disruption as a result of governance issues.

As this example shows, while we may take a single overall approach to stewardship and engage and vote on that basis, how we apply this in investment decision-making is necessarily nuanced. We urge the FRC to give further thought and consideration to the practical implications of how signatories should report on stewardship in cases where ESG integration decisions and processes may legitimately differ by fund or strategy.

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?

We do not think it is always desirable to explicitly state the investment time horizon (Provision 10).

We are supportive of disclosing our general investment beliefs, along with our purpose, values, strategy and culture. RLMIS and RLAM have some general, overall investment beliefs that guide us as asset owners and asset managers. For example, as a mutual insurance society our investment beliefs recognise that we exist to create value for members as well as our external and internal clients. This means we are not beholden to expectations of external shareholders who might want short-term financial returns, but we are committed to operating a commercial business with the aim to generate capital for the prudential operation of the Group and to share a proportion of profits with our members.

However at a granular level, investment philosophy, approach and timeframe may differ by fund based on client requirements. Even though our approach is long-term in nature, we have short-term funds and may hold securities for the short-term (i.e. money market funds or short duration funds). We may also decide to make short-term trading decisions, which are reasonable and legitimate, even if not considered 'long-term' as described in the draft Code.

We would once again point to Professor Alex Edmans' consultation response,[1] which highlights that trading is a legitimate stewardship activity that is not clearly acknowledged in the draft Stewardship Code. According to the draft Code, it may be considered 'short-term' to sell a security rather than remain invested for the long-term in order to engage with a company to make improvements. However this view does not take account of the opportunity cost of remaining invested over the long-term in a sub-optimal company, as opposed to allocating clients' capital to another more suitable investment. In fact, we think asset managers and asset owners play a critically important role in the financial system as allocators of capital. With the growth of passive investing, we think there is an even greater need for active managers to allocate capital to companies that are well governed and create long-term sustainable value for our customers and clients (and away from companies that do not).

The draft Code also does not take account of the costs associated with long, protracted engagements. While we are strong believers in engagement, the FRC should acknowledge that engagement has its limitations. We do not think it is suitable for the Code to encourage engagement at all costs and over very long periods of time, as we must be mindful of the costs we are passing onto our end beneficiaries.

Equally, allocation of capital away from companies with poor governance can be an effective tool to influence behaviour, particularly if undertaken by many actors in a robust and well-functioning market of active investors. Similarly, engaging with companies prior to allocating capital can be equally effective in improving practices and creating conditions that would allow us to invest with more confidence.

[1] http://alexedmans.com/wp-content/uploads/2015/02/FRC-Stewardship-Code-Response.pdf

We have concerns that the guidance notes state that a long-term perspective is required. Does this preclude asset managers with short holding periods from becoming signatories to the Code? We think this is problematic because the FRC should be encouraging good stewardship, even if holding periods are short for legitimate investment reasons.

Finally, it is not clear how 'long-term' is defined in the draft Code.

We believe the FRC should delete Provision 10. The definition of stewardship in the Code inherently requires asset managers to act in the best long-term interests of their clients by committing to create "*sustainable* value for beneficiaries, the economy and society" (emphasis added).

Assurance

We believe that an organisation's culture and its governance of stewardship is more important than any external assurance process. Our experiences of assurance processes have been mixed. In some cases assurance processes create the need for mechanistic and rules-based behaviour that is auditable. On the one hand this is understandable as it gives external parties a framework to judge whether we have done what we said we would do. However many of the stewardship and investment decisions we make rely on judgement and are not black and white. In some cases, rigid assurance processes may lead the industry to adopt boilerplate or standardised processes that do not result in better customer outcomes, but lend themselves to more straightforward assurance and monitoring. External assurance also comes at a cost, and may not always be suitable or achievable for smaller investors.

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

Yes. Also see our response to question 16.

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

When engaging with companies, our starting point is always to work together with directors and management to find mutually beneficial outcome. We will do this in private in the first instance, often through writing letters or company meetings. However, we think it is legitimate and necessary to reserve the right to escalate our engagement if the company is not responsive or where we have serious concerns. To this end, we believe the FRC should recognise that not all engagement is 'collaborative' or 'constructive'; sometimes engagement between companies and investors is adversarial. In some cases, raising challenging questions and having challenging conversations can help move an agenda forward in a way that collaboration may not.

We also reiterate our previous statement that the primary duty of investors is to our clients and beneficiaries, not to companies. We do not own a specific duty of care to companies; however we do see the benefit of engaging with them to deliver better outcomes to our customers. Boards have a fiduciary duty to set corporate strategy and chart an appropriate course to achieve this. The Board has a duty to hold management to account for its delivery.

As mentioned previously not all investors agree, nor would we expect them to in a well-functioning market. In fact, it is these disagreements and differences of opinions that create investment opportunities. For this reason we would be cautious about the emphasis and preference that the draft Code places on collective engagement. In the spirit of 'comply or explain', it would be more prudent for the Code to ask investors to disclose whether and how they participate in collective engagement.

Q14. Should there be a mechanism for investors to escalate concerns about an investee company in confidence? What might the benefits be?

We agree with the recommendation of the Kingman Review and believe there should be a confidential 'safe harbour' mechanism for investors to raise concerns with the FRC or equivalent body in cases where we have serious concerns about the long-term viability and management of a company. Please refer to the Investment Association's consultation response to the Stewardship Code for more details.

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

The FRC should encourage signatories to disclose practical examples and case studies outlining how signatories have implemented stewardship in other asset classes. We do not think additional provisions are required at this time, as best practice is still developing. Creating additional requirements for other asset classes runs the risk of encouraging a 'tick-box' approach, and also replicates the types of disclosures we already make to initiatives like the PRI.

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?

We expect a high level of service and accountability from our service providers. We believe some improvements still need to be made to adequately capture the views and feedback of corporate issuers on proxy voting matters or ESG research. However, we think improvements in the quality and accuracy of data and service providers will increase over time. We strongly believe it is the duty of investor signatories to ensure they have robust processes for appointing and monitoring service providers.

We do not think it is prudent for investors to follow the voting advice of third parties without applying additional oversight and scrutiny of that advice. For example, RLAM has an in-house team of governance specialists to assist in executing proxy votes. We do this with the aid of third parties, but we apply customised criteria to all of our votes and have internal oversight of each vote. We do not follow third party advice, but make our own decisions.

We think it is worth noting that service providers like proxy voting agencies and ESG research houses provide services on the request of the investment industry, and on the whole they provide a good service. We accept that at times the data, advice or opinions are not perfect, but we would argue that service providers offer *opinions* and *advice* and it is up to investors to decide whether and how to act on or disregard that advice. Ultimately, *investors* should be held accountable for how they procure and use advice from service providers.

3. About the Royal London Group

Royal London is the largest mutual life, pensions and investment company in the UK, with funds under management of £114 billion, 8.8 million policies in force and 3,893 employees. Figures quoted are as at 30 December 2018.

The Royal London Group's specialist businesses provide pensions, protection and investment products. These products are predominantly sold through intermediaries however we also provide a direct to customer proposition.