Climate Change & Responsible Investment Team
DWP
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Dear Climate Change & Responsible Investment Team,

RE: Investment Association response to 'Climate and investment reporting: setting expectations and empowering savers'

The Investment Association[1] (IA) welcomes the opportunity to respond to DWP's consultation on climate and investment reporting. The IA and its' members have played an active role in the ongoing regulatory process to implement TCFD reporting throughout the UK economy, as well as broader discussions around the role of stewardship in the relationship between pension schemes and asset managers. The issues raised in this consultation are important in helping to ensure good outcomes for pension scheme members.

Measuring and reporting Paris alignment

We believe strongly in the ability of investors to contribute to the achievement of the government's 2050 Net Zero target. Earlier this year the IA became the first supporting partner organisation of the Net Zero Asset Managers (NZAM) initiative, allowing us to play our role in galvanising the investment management industry to commit to the goal of net zero emissions by 2050. IA members with assets under management of more than £7trn have now made a net zero commitment through this initiative and in effect, have set interim targets for reducing emissions in their portfolios by 2030 with the ultimate aim to achieve net zero by 2050.

[1] The Investment Association (IA) champions UK investment management, a world-leading industry which helps millions of households save for the future while supporting businesses and economic growth in the UK and abroad. Our members range from small, independent UK firms to Europe-wide and global players. Collectively, they manage over £9.4trillion for savers and institutions, such as pension schemes and insurance companies, in the UK and beyond. That is 13% of the £75 trillion global assets under management.

Accordingly, we are supportive of pension schemes aligning their own portfolios with the Paris goal of limiting the average temperature rise globally to no more than 1.5℃ above pre-industrial levels. However, while we are supportive of the ambition of forward-looking metrics being developed, we do have a number of concerns with the current proposals.

1. Some of the current approaches to measuring portfolio alignment are experimental and yield inconsistent and unreliable results.

While we support the need to develop an approach for measuring the alignment of a portfolio to a certain climate pathway, current methodologies are still immature and need to evolve further, limiting their usefulness at this time[2]. Leaving aside the broader issues of data availability across asset classes and jurisdictions which affect all climate-related metrics[3], each of the proposed measures has its own issues:

- **Binary target measurements:** While straightforward to calculate, this measure is likely to be limited in its usefulness since commitments by investee companies to Paris-alignment targets may not be reliable.

- **Benchmark divergence models:** Challenges arise both in forecasting the GHG emissions associated with holdings in the portfolio, as well as the selection of a suitable benchmark. Assumptions made in calculating this metric could lead to significant variation in the results across pension schemes.

- **Implied temperature rise (ITR) models:** On the face of it, this is the most intuitive metric and most directly captures performance against the temperature goal encompassed in the Paris agreement. However, measuring the ITR of a portfolio is currently highly experimental, with differing approaches to doing so as a result of subjectivity in data and assumptions[4]. This can result in significant differences in temperature scores on the same portfolio at a given point in time, as well as significant variation over time.

Furthermore, the second and third of these metrics are highly dependent upon the assumptions and methodologies of a small number of unregulated data providers[5] who themselves advise caution on the use of their data when assessing the alignment of a portfolio.

[2] See for example the PAT technical report (p73) and the Alignment Cookbook (p6) for detailed discussions on the challenges with portfolio alignment metrics.
[3] The issue of data gaps in TCFD reporting was discussed at length in our responses to the DWP's January 2021 consultation on managing climate risk as well as to the FCA's consultation on TCFD reporting by asset managers.
[4] For a discussion of the variation across providers that results in different temperature scores being assigned to a portfolio, see 'Understanding the climate performance of investment funds', Cambridge Institute for Sustainability Leadership (2021).
[5] We note that the issue of whether providers of climate-related data and ratings should be regulated is of increasing concern to regulators both in the UK and globally.

Ultimately, these characteristics currently make it extremely challenging for trustees and their investment managers to calculate reliable portfolio alignment metrics that are comparable over time. This is extremely problematic when considering how portfolio alignment metrics might be used to drive trustees' investment decisions.

2. An undue emphasis on portfolio alignment metrics could incentivise pension scheme investment behaviour which has a negative impact on the transition to net zero.

We are concerned that a statutory requirement to calculate a portfolio alignment metric and measure the extent of a portfolio's Paris-alignment could skew trustee incentives, leading to investment decisions that are focused more on improving the alignment score of the portfolio, rather than actively managing the climate-related risks and opportunities contained within it. Trustees may be incentivised to divest from assets associated with high carbon emissions, rather than continuing to hold those investments and seeking to change the behaviour of the counterparties to those investments through engagement. This would be counter to the Government's focus, set out in the Green Finance Roadmap[6], on the role of stewardship in supporting the transition to a low carbon economy. Such actions could arise due to pressure from scheme members and other stakeholders. The pressure to take such actions might be intensified by focusing on temperature scores, which can be understood intuitively. The consequences of such a focus may flow through the investment chain, with asset managers and pension schemes facing commercial incentives to create products and portfolios that are categorised according to a particular alignment score. While such actions can improve the alignment scores of portfolios, they will not lead to the required changes in the real economy that are necessary for large scale decarbonisation to be achieved.

3. The proposals create an added burden on trustees at a time when they are still familiarising themselves with their existing climate-risk management and reporting obligations.

The cost to trustees in terms of time and resources in calculating portfolio alignment metrics could be significant, particularly for the more sophisticated metrics, which will involve a large data gathering exercise and use of third-party analytics. This comes at a time when trustees are still familiarising themselves with the requirements to calculate and interpret the existing suite of metrics under the first round of TCFD reporting. While we recognise that under the DWP's proposal, portfolio alignment metrics should be only calculated by trustees as far as they are able, it is still the case that requiring an additional metric, which is challenging to calculate and currently has limited benefits due to the issues described above, would be unhelpful for trustees at this time.

Proposed way forward

These concerns do not mean that we are not supportive of the development and use of portfolio alignment metrics over time. Indeed, we support the current regulatory approach, which allows trustees to calculate a portfolio alignment metric as one of their additional

[6] Greening Finance: A Roadmap to Sustainable Investing, HM Government, 2021.

climate change metrics. This has the benefit of allowing those schemes which do want to use portfolio alignment tools to do so, while giving flexibility to those schemes which are less comfortable with such approaches.

By not mandating portfolio alignment metrics, the placing of undue emphasis on them and the unintended consequences that arise in terms of investment behaviour can be avoided. This approach also fits better with the FCA's rules for asset managers' product level TCFD reports, which require the production of forward-looking metrics as far as reasonably practicable[7].

In the meantime, the investment management industry is looking at ways to standardise the data and methodologies across climate change metrics, including portfolio alignment tools, for the benefit of investors.

We have recently completed a piece of work in conjunction with the PLSA, the ABI and a number of their members, to develop a standard data template to help pension schemes meet their obligations under the Climate Change Governance and Reporting Regulations and associated DWP Statutory Guidance. The first phase of the group's work has involved creating a standard template and data specification to provide pension schemes with the core data required to calculate the current three mandatory metrics and to make the required disclosures about data coverage and data quality. The template will be in place in time to provide data for use by pension schemes in relation to their scheme years ending 31 December 2021. The second phase of our work will develop the standard further to reflect the evolution of quantitative scenario analysis, the recent TCFD work on portfolio alignment, and the recently-finalised FCA rules for asset managers' own TCFD reports.

In addition, it is important to highlight that three quarters of UK assets under management are now committed to the NZAM initiative, which in turn is part of the broader the Glasgow Financial Alliance for Net Zero (GFANZ). This grouping will be carrying out further work to support the development and effective implementation of portfolio alignment metrics and drive convergence in the way portfolio alignment is measured and disclosed. In practice this means that asset managers signed up to the NZAM will be following guidance like the Net Zero Investment Framework and the SBTi FS guidance, which will mean that portfolio alignment metrics will inevitably but gradually be applied to the investments made on behalf of clients. This demonstrates the investment management industry's commitment to adopting portfolio-alignment tools at an appropriate pace that reflects the industry's confidence in these metrics reflecting a genuinely science-based approach.

Over the next few years, these initiatives will help to standardise portfolio alignment metrics and we recommend that the DWP wait for this work to be concluded before making portfolio alignment metrics mandatory for pension schemes. Reviewing the position in a few years' time, when data and methodologies have improved and become more consistent, will help avoid the risks of early adoption that we have highlighted here.

Expanding the list of additional climate change metrics

[7] See ESG 2.3.13 R

We have concerns with the expansion of the list of additional climate change metrics since many of these would be reflected at entity level rather than strategy/fund level and therefore investment managers will be reporting on these metrics in their TCFD entity-level reports as opposed to their TCFD product reports. Including them in the list of additional climate change metrics for pension schemes therefore increases the risk of a mismatch between what investment managers must report at a product level and what pension schemes may choose to report on. We therefore recommend that the DWP leaves the list of additional climate change metrics as it is.

Stewardship and the Implementation Statement

The IA welcomes the DWP's focus on the importance of stewardship as an integral way by which trustees can seek to improve investment returns by encouraging practices that ensure long-term value for savers, and therefore fulfil their fiduciary duty. We were particularly pleased therefore to see in paragraph 16 of the consultation that DWP intend for the guidance to clarify that trustee's should explain in their SIP and IS how stewardship or engagement policies and their implementation are in the scheme members' and beneficiaries' best interests.

For stewardship reporting (including engagement and voting reporting) to effectively and accurately demonstrate how investment managers have implemented their engagement policies on behalf of trustees it needs to be focused on the deliverance of stewardship outcomes. We encourage the DWP to reconsider some elements of the guidance to ensure that it encourages trustees to request information from managers that is consistent with a focus on stewardship outcomes that contribute to sustainable long-term returns for scheme members:

Definition of Most Significant Vote

Our principal concern with the current drafting of the guidance is that it heavily implies that "most significant votes" should be defined thematically, according to the trustee's stewardship policies. Thematic issues do not have dedicated resolutions at company AGMs and so such a definition is unlikely to capture the votes which have had the most significant impact or contributed to the achievement of stewardship outcomes. Requests for "most significant vote" reporting with a thematic definition will, therefore, not allow the manager to display to trustees, and consequently, members, how they implemented their engagement policy and achieved stewardship outcomes that are in beneficiaries' best interests. We suggest that DWP should amend the guidance to retain the flexibility that is provided in The Occupational Pension Schemes (Investment and Disclosure) (Amendment) Regulations 2019 and allow managers and asset owners to arrive at a definition of "most significant votes" that reflects their individual stewardship and investment objectives and/or the size of the holding in the company.

Vote and Engagement Reporting Templates

Whilst recognising there is a need for standardised reporting and reporting requests of voting and engagement activities, we do not believe that the guidance should incorporate the templates directly. Reporting templates will need to be amended over time to reflect emerging best practice and evolving client needs and to address outstanding issues. Embedding them into regulatory guidance does not allow for them to be updated dynamically nor will it allow the industry to collaborate and make the amendments that are required to make the template work effectively. Instead, we suggest that DWP *refer* to vote reporting template and engagement reporting guidance that are externally managed by the PLSA and ICSWG respectively.

Expression of Wish

The concept of an ‘expression of wish’ is an important development and will, if implemented effectively, allow managers a greater level of insight on the views of their clients on how they would like their voting policy to be implemented. However, the concept is still in its infancy and has not had an opportunity to embed itself in market practice. For the concept to be a success in facilitating greater consideration of client views in the voting process and contributing to positive stewardship outcomes there are several issues that need to be addressed both with regards to practical implementation and what form an ‘expression of wish’ may take. Asset owners, and managers will need some time to establish solutions for these issues and for market practice to establish. Given the above we do not think it is an appropriate time for DWP to introduce statutory guidance on expressions of wish. This is especially so given the prescriptive approach implied by the proposed wording which suggests a form of expression of wish which is far more precise and is in relation to specific securities it also implies that managers should follow the expression as opposed to taking it into account.

Increased Focus on Non-Equity Asset Classes

The guidance is currently heavily focused on stewardship in listed-equities. We would like to see the guidance amended such that is more reflective of the broad range of asset classes that pension schemes invest in. SIPs and IS’ that focus almost solely on voting and engagement in listed equities risk becoming unrepresentative of the stewardship conducted on behalf of scheme members. This is especially true for DB schemes where on average only 20% of assets held are equities.

Integration of Implementation Statements with Stewardship Code Reports

There are a number of overlapping requirements between the IS and the FRC’s revised Stewardship Code. We encourage the DWP to allow trustees to use their Stewardship Code Reports as a location for their IS. This would streamline the reporting burden on trustees, and allow members to resort to a single document when assessing how trustees have implemented their stewardship policies. The Code’s focus on stewardship outcomes and effectiveness provides a context for the IS to demonstrate to members how stewardship activities conducted on their behalf have been in their best interests.

Please see Appendix A below for our response to the questions in chapter 2 of the consultation. We have only provided responses to questions 7, 8.c-d, 9.a-b, and 13.

We hope this response is useful and would be delighted to discuss these comments further if helpful.

Yours Sincerely,

Imran Razvi, Senior Policy Adviser, Pension & Institutional Markets

Rhydian Campbell, Policy Adviser, Stewardship & Corporate Governance

Appendix A

Questions

7. Should DWP include a vote reporting template in its implementation statement guidance which trustees are expected to use? If so, should such a template be based on the PLSA's vote reporting template? What changes, if any, would be needed to the PLSA template if it were to be adopted?

The principle aim of stewardship is to generate sustainable and long-term value for clients and their beneficiaries through ensuring the long-term quality and performance of the assets invested in. Effective stewardship reporting, therefore, should be focused on the outcomes of stewardship and demonstrate how stewardship outcomes and effectiveness over the relevant reporting period has contributed to long-term quality and performance of assets and produced value for clients and beneficiaries. This shift in emphasis away from policies and processes and towards stewardship outcomes and effectiveness is the key feature of the revised UK Stewardship Code as recommended by Sir John Kingman's Review of the Financial Reporting Council[8].

Stewardship reporting from investment managers to their pension scheme clients should demonstrate that they have fulfilled their stewardship obligations to enhance long-term value on behalf of pension scheme beneficiaries. In turn, stewardship reporting from pension schemes to their own scheme beneficiaries should demonstrate how oversight of their managers and the stewardship activities conducted on their behalf have contributed to the long-term value of the pension scheme assets.

Vote reporting is one way in which managers can display to clients that they have taken actions consistent with their stewardship objectives. It is important to note that voting is only one tool in a broad range of stewardship activities that managers will engage in over the course of many years to achieve positive stewardship outcomes on behalf of their clients. These activities include research, monitoring, setting of expectations, engagement, escalation, exercising rights, and making investment choices. Voting against management or filing a shareholder resolution is often an escalation strategy where the manager believes that despite engagement activity, the company is not adopting behaviours consistent with long-term value creation for their clients.

Transparency and accountability on voting activity and how this relates to engagement activity in listed equities is an important component of stewardship reporting. However, this vote reporting should allow managers to articulate to trustees how they have exercised voting rights as part of their wider stewardship strategy to achieve positive outcomes. Consistent with this, vote reporting needs to reflect that voting is only a means to affect positive outcomes and that voting is not an outcome in itself.

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[8] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/767387/frc-independent-review-final-report.pdf

The Shareholder Rights Directive II was introduced to enhance this transparency and accountability on institutional investors and introduced new obligations for both investment managers and asset owners.

To ensure that vote reporting empowers trustees to properly assess how a manager is exercising its voting rights and contributing to the achievement of stewardship outcomes on behalf of beneficiaries, there is a need for a standardised approach across the industry. Without greater comparability and consistency in vote reporting, trustees will lack disclosures that are comparable across different mandates and will not be able to scrutinise different managers. There are some structural challenges that make vote reporting difficult such as those identified by the Law Commission's Scoping Paper on Intermediated Securities[9] relating to the difficulty of confirming votes have been received and counted correctly, or when schemes allocate capital to a fund of funds structures.

The current fragmentation of vote reporting and volume of requests for disclosures on most significant votes means that managers can struggle to dedicate enough resources to respond to requests as comprehensively as they wish to. Different clients within the same pooled vehicles are making vote reporting requests over different time periods, sometimes with differing definitions of 'most significant votes' meaning that managers are having to respond to an increasing number of requests within the same funds over very short time periods. The information being requested is often more detailed than voting data, making the process difficult to automate. A streamlined and standardised system of vote reporting (and requests) will allow for a more efficient allocation of resources that produces both better reporting and, more importantly, better stewardship outcomes for clients and beneficiaries.

Use of Vote Reporting by Trustees

There is an important distinction between the two elements of vote reporting; disclosure of how votes have been cast, and the reporting of 'most significant votes'. Whereas vote reporting data provides an objective way for trustees to scrutinise if managers are actively exercising their voting rights on behalf of clients, the reporting on 'most significant' votes is a more subjective assessment.

We ask that DWP provide greater clarity over its policy objectives with specific regard to vote reporting, and what it hopes the outcomes of significant vote reporting are.

Vote Reporting Template

The PLSA template can facilitate more standardised information requests from trustees and therefore more standardised disclosures from managers. However, we do not believe that DWP should directly include a vote reporting template in its implementation statement guidance. Instead, the guidance should refer to the PLSA's template, without incorporating it directly into the guidance. The template requires further improvement and allowing it to be externally managed by the PLSA will enable the template to evolve over time in response

[9] https://s3-eu-west-2.amazonaws.com/lawcom-prod-storage-11jsxou24uy7q/uploads/2020/11/Law-Commission-Intermediated-Securities-Scoping-Paper-1.pdf

to emerging best practice and to make the necessary amendments through industry consultation in a timely manner.

The PLSA's template which was developed in consultation with investment managers, consultants, and asset owners has achieved a significant level of momentum amongst trustees and their consultants. It has become the most ubiquitous template and is embedded into the industry's current practices, with some managers having built systems around this template to support them to process requests efficiently.

However, the template will need to be amended over-time in response to a changing regulatory environment, client demand and dynamic best practices. The best way for the template to be amended in response to the above, and for it to be able to facilitate vote reporting that works for all parties is for it to be maintained externally by the PLSA. Through incorporating it into the guidance the template will not be able to respond dynamically to external developments.

Some teething issues remain with the PLSA's template, which need to be resolved to ensure that the template can work effectively. The template was published in September 2020 and to date there have been a number of implementation issues that managers continue to experience.

These issues include:

- The number of most significant votes. The number of 'most significant votes' reported for any given fund, should be driven by the definition of 'most significant' being used. We agree with the flexibility provided by the PLSA in its guidance for the template and a definition of what constitutes 'most significant votes' – see below for further commentary.
- Reporting Periods – We believe that the FAQs to the template's statement that trustees should seek, *at a minimum*, to receive information annually be removed. Instead, we suggest that the template is used to receive information annually, and in keeping with the scheme year end. This will clarify that clients should be seeking to receive the information annually aligned to their own reporting requirements.

We encourage DWP to only refer to the template as it does in the following sentence from paragraph 52 of the proposed guidance "*Trustees may wish to use the PLSA Vote Reporting Template to request voting data from asset managers or any other third-party making decisions on the trustees' behalf …".*

Anecdotally, we understand that many investment managers are providing clients with 'rationales' for all votes against management. In addition, some managers are producing rationale on a more nuanced definition of significant votes where they have entered into bespoke agreements with clients.

<u>Definition of 'most significant vote'</u>

As mentioned, the purpose of stewardship reporting should be focused on allowing managers to display to their clients how the actions they have taken have achieved stewardship outcomes that generate sustainable long-term term value for beneficiaries.

The SRD II requirements for investment managers and pension schemes were designed to enhance transparency and accountability on the implementation of engagement policies and to demonstrate to clients and beneficiaries how stewardship activities taken by on behalf of trustees are in scheme members' best long-term interests[10].

For members and trustees to be able to properly scrutinise and question the way that managers have implemented their engagement policy, reporting on 'most significant votes' should be focused on how voting rights have been exercised to deliver positive outcomes that support long-term value for scheme members.

We do not think that the way the guidance is currently drafted is consistent with this and as such it will not facilitate best practice stewardship reporting in the implementation statement. This is because the guidance's paragraphs 59-61 heavily imply that trustees should set a definition of "most significant votes" driven by thematic stewardship priorities (e.g. Climate-change, Bio-diversity, or Modern Slavery).

We believe that there are some issues with this definition; save for a few specific examples, the resolutions that appear on a proxy card at company meetings rarely correspond to a specific stewardship priority. The majority correspond to governance and share capital management issues (e.g. executive remuneration; Annual Report and Accounts; pre-emption rights; Director Re-election). Investment managers will often consider a range of issues when choosing to vote against a company resolution. For example, they may use the vote on the Chair of the Board to signal concerns regarding board diversity, over boarding or climate change, or potentially a combination of issues. In addition, following engagement on the issue of a company's response to climate change, where the company has failed to make adequate changes or commitments, the managers may choose to vote against the Board on several resolutions including (receiving the reports and accounts, re-election of the Chair, re-election of the Chair of the Audit Committee, Remuneration Resolutions, or in the rare cases where one is on the ballot, a climate-specific resolution).

Vote reporting, therefore, does not translate effectively into thematic priorities. Using this model may result in no votes that contributed to any stewardship-related outcomes appearing in the disclosures. In addition, it is often the case that a vote is significant and contributes to the generation of value due to wider market or company specific issues which cannot be represented by thematic priorities. Thematic interpretations of 'most significant votes' may not produce reporting that covers the votes that had the most significant impact or contributed to stewardship outcomes. This will likely be in instances where the manager has a sizeable holding in a security or where voting has been used to leverage comprehensive engagements with a company. A thematic definition of "most significant vote" will therefore not allow managers to display to trustees and beneficiaries how they have used voting to implement their engagement policies and deliver the best outcomes for beneficiaries.

We do not believe that the guidance should attempt to influence how parties define 'most significant votes' and encourage the DWP to align the guidance with the FCA who avoided taking too prescriptive an approach in implementing SRDII in its own rules as this "will give

[10] https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32017L0828&from=EN

asset owners and asset managers flexibility in how they meet the requirements, allowing them to best reflect their business models and investment strategies."

The Occupational Pension Schemes (Investment and Disclosure) (Amendment) Regulations 2019 similarly do not define "most significant votes" nor do they stipulate who should determine the definition. This sets the regulatory baseline on "most significant votes" and allows managers and trustees the flexibility to decide how managers can best display they have been effective stewards of client money with regards to voting rights.

We suggest that DWP amend the guidance to retain the flexibility that is provided in The Occupational Pension Schemes (Investment and Disclosure) (Amendment) Regulations 2019, and allow managers and asset owners to arrive at a definition of "most significant votes" that reflects their individual stewardship and investment objectives and/or the size of the holding in the company. Making such an amendment to the statutory guidance will also ensure that there is regulatory alignment between the reporting requirements on trustees and the disclosures asset managers are required to make as part of their COBS (2.2.b.7 obligations)[11].

Where clients are particularly concerned about thematic issues, they can enter into agreements with their managers to provide them with voting disclosures on thematic issues. This is reflective of the current industry position; we understand from our members that the most common approach is to provide rationales for all votes against management. However, 'for' votes may also be considered most significant, for example where the firm supports management on a particularly controversial vote. Typically, this criterion is being used as the foundation stone over which firms are adding a mixture of the additional criteria as appropriate to their stewardship strategy.

Finally, we note that the suggested way of determining "most significant vote" in paragraphs 59-61, will cause issues with the guidance sections that point towards the PLSA's vote reporting template. The PLSA's template and accompanying guidance provides flexibility for firms completing the template to determine what constitutes a "most significant vote" and notes that the manager's definition should take into account the views of the asset owner community and client interest specifically.[12]

What are your views on the adoption of an engagement reporting template? Should it be separate from any vote reporting template or integrated with it, so that – in relation to equities – both voting and engagement activities are described for the same set of assets?

Again, we do not believe that the DWP should incorporate a template directly into the guidance, for the same reasons as outlined above for a vote reporting template.

We also note that engagement reporting is not suitable to be captured by a template in the same way as voting data. Managers do not engage with investee companies at a fixed point

[11] https://www.handbook.fca.org.uk/handbook/COBS/2/2B.html
[12] https://www.plsa.co.uk/Portals/0/Documents/Policy-Documents/2020/IS-Asset-Owners-template.pdf

in time, and occurs over various time-frames, the ways that they engage are not easily captured by set outcomes such as a vote for/against/abstain. This has been recognised by the ICSWG who moved their framework for engagement reporting from a *template* towards a *guide*[13]. This distinction is an important one and ensures greater flexibility that facilitates reporting which is appropriate to each asset manager and their clients.

As with the vote reporting template we believe that the guidance should refer to the ICSWG's engagement reporting guidance without incorporating it directly into the guidance. ICSWG's guidance is still in its infancy and will require future amendments to ensure that the guidance facilitates the best disclosures for clients. Incorporating the engagement reporting guidance into DWP's guidance will not allow the ICSWG to review the guide for improvement as best practice evolves as it has committed to do.

We would also like to take the opportunity to emphasise some features of an appropriate engagement reporting guide.

- Interaction with existing disclosures made by asset managers namely, Stewardship Code reporting. The new Stewardship Code was designed to capture the outcomes of stewardship activities, those managers who are signatories to the Code should be able to refer to section of their Code responses.
- Flexibility to provide nuanced information. We think this is one of the primary benefits of the move from a template to a guide. This will result in reporting that is in the spirit of flexibility and innovation that allows mangers to make the disclosures that best informs clients (e.g. a different number of case studies depending on a variety of issues, including theme, client requirements, and time frames).
- Avoid quantification. A guide should not seek to over-quantify stewardship engagement as engagement is a qualitative activity and cannot be properly captured through quantification. Summary statistics do have some informative value, however assigning nominal values to outcomes of engagement or reducing a manager's engagement to only summary statistics run the risk of mistaking activity for achievement. This may also incentivise some market participants to focus on activities (e.g. number of letters sent) rather than outcomes that support long-term value on behalf of beneficiaries.
- Time-frames – As with a vote reporting template, the time frame of an engagement reporting guide should make clear that the guide is used on an annual basis and synced with the scheme year-end. Engagements often occur over a long time period and quarterly reporting of engagement activities is not appropriate to capture this.

With regards to integrating vote and engagement reporting so that activities are described for the same set of assets we do not believe that this would facilitate the best reporting for clients.

We recognise that, provided the definition of most significant is based around votes against management, there will likely be an overlap of most significant engagements and most

[13] https://www.icswg-uk.org/resources

significant votes, and that comprehensive reporting on voting will refer to how it was supported by engagements and vice versa. However, tying engagement reporting explicitly to voting reporting and requiring coverage of the same securities is not reflective of how managers conduct stewardship and will not allow them to make the most informative disclosures to clients. In addition, managers will engage with investee companies across almost all asset classes and will conduct significant engagements that result in positive outcomes beyond equites. Conversely vote reporting template will be limited to the exercising of voting rights in listed equities, and so tying vote and engagement reporting will artificially limit engagement reporting to listed equities.

8. Do you have any comments on our cross-cutting proposals for the draft Guidance on Statements of Investment Principles and Implementation Statements, in particular that:

(a) **they are written for members**?

We do not have any comments.

(b) these are trustees' statements, not their consultants'

We do not have any comments.

(c) Implementation Statements should set out how the approach taken was in savers' interests?

This proposal is consistent with the definition of stewardship in the UK Stewardship Code that emphasises the creation of long-term value for clients and beneficiaries, and Principle 1 which clarifies that signatories should disclose "as assessment of how effective they have been in serving the best interests of clients and beneficiaries."

The proposal is also consistent with the recommendation 15 of the UK's Asset Management Taskforce Report "that UK pension schemes should be required to explain how their stewardship policies and activities are in scheme members' best interests".

(d) trustees should be able to include material from voluntary disclosures, such as Stewardship Code reporting, as long as they meet the requirements in the Regulations?

We strongly endorse this proposal and encourage all agents along the investment chain to become signatories of the FRC's Stewardship Code. However, we encourage DWP to be more ambitious in in the way it allows Stewardship Code Reporting to interact with Implementation Statements and take an analogous approach to the FCA's implementation of SRD II.

There are a number of overlapping requirements between the Implementation Statement and the required disclosures that Asset Owners would have to make under the Stewardship Code e.g. Principles 2, 3, 4, 7, and 8 are all aligned with various elements of the Implementation Statement.

The FCA, in its implementation of the disclosure requirements of SRD II that apply under its regulatory scope, clarified that firms could provide their SRDII disclosures in the same document as their reporting under the Stewardship Code.

We encourage DWP to align itself with the FCA and allow trustees to use their Stewardship Code Reports for the purposes of fulfilling their implementation statement requirements, it would both streamline the reporting burden on trustees, and be in the best interest of members who would be able to resort to a single document when assessing how trustees have implemented their stewardship policies. We also note that the revised Code's focus on the achievement of stewardship outcomes and effectiveness provides a context for the IS that enables trustees to demonstrate to members how stewardship activities conducted on their behalf have been in their best interests.

9.

(a) Do you have any comments on our proposed Guidance on stewardship policies?

We encourage DWP to consider how the guidance might be made more representative of the broad range of asset classes that pensions schemes invest in. There has been a significant shift in asset owners' asset allocation from equities to fixed income, private markets, real estate, and infrastructure over the last two decades. DB pension funds' allocation to equity asset classes fell to only 20% in 2020[14]. While we note that DC pension schemes continue to have significant equity exposure, reflective of their less mature memberships, we do expect this to change over time in line with shifting member demographics, resulting in more diversified portfolios.

To reflect these developments the updated UK Stewardship Code explicitly recognises that stewardship promotes sustainable value across all assets and securities. Similarly, the Asset Management Taskforce Stewardship Working Group report noted that there was a clear need to improve how stewardship works in practice in the full range of asset classes, and that Asset Owners should set clear expectations for stewardship across the variety of their investment mandates. We encourage DWP to amend the guidance such that it is consistent with this recommendation and produce guidance to encourage trustees to set stewardship policies that are specific to the various asset classes in which they invest. Doing so will aid trustees in setting stewardship policies that are more proportional to their strategic asset allocations.

We believe that the guidance should be more explicit in noting that good examples of stewardship policies will be reflective of the way that stewardship is practiced across the different classes represented in their portfolio. We are concerned that the guidance's current focus on voting is not consistent with this and that it over emphasizes voting on listed equities as the key element of stewardship reporting, despite the fact it will not be relevant for the vast majority of allocations.

[14] https://www.theia.org/sites/default/files/2021-09/IMS%20report%202021.pdf (chart 32).

We recognise that voting is an important part of stewardship in listed equities and that vote reporting is an important accountability mechanism that allows trustees to scrutinise if managers exercise their voting rights in a way that is consistent with their own stewardship policies and the best interest of clients. However, the current guidance's focus on vote reporting risks conflating or reducing wider stewardship activities across various asset classes with voting in listed equities.

Paragraph 35

We would like to draw attention to paragraph 35 of the guidance which lists resources which trustees may find helpful. We encourage the DWP to include reference to IVIS' Company guidelines including the Principles of Remuneration[15,16] and the IA's annual Shareholder Priorities[17]. The Priorities are produced through consultation with the IA's members, who collectively manage over £9 trillion of assets on behalf of institutional and retail clients and own a third of the value of the UK FTSE. They detail the key issues that will drive their engagements and of votes against management and so will give trustees an overview of the principle thematic stewardship priorities for the coming year, for 2021 the Priorities outlined its expectations of companies on issues including: improving the response to and reporting on climate change; improving both gender and ethnic diversity across their board, senior leadership and throughout the workforce; the quality of audit; and company reporting on stakeholder engagement and director duties.

The guidance should be explicit in stating that trustees ensure that they have a process in place through which they review any industry benchmarks which are used to inform their vote policy development. This is particularly pertinent given the fast pace of change in many thematic areas of stewardship, for example, the marked progression of expectations on corporate climate-related reporting since the publication of the TCFD's Recommendations. We also note the link to principle six of the Stewardship Code that signatories should review their policies and assure their processes.

(b) Do you have any comments on our proposed Guidance on significant votes?

Paragraph 56

The IA and our members recognise the importance that stewardship is undertaken in the best interest of the end beneficiary; delivering on those best interests requires that managers have an understanding the views, expectations, and opinions of clients as they undertake various stewardship activities, including voting. The issue of how asset managers achieve a greater understanding of client's stewardship priorities has been one of the focuses of the IA and PLSA's joint steering group on "Investment relationships for sustainable value creation: creating alignment between asset owners and investment managers".

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[15] https://www.ivis.co.uk/guidelines/
[16] https://www.ivis.co.uk/media/13894/principles-of-remuneration-2022.pdf
[17] https://www.ivis.co.uk/media/13888/ia-shareholder-priorities-2021.pdf

Asset managers may solicit the views of their client through various forums including surveying their clients, arranging individual meetings with clients, or employing recent market-led developments and technologies that allow them to take client opinions into account when making voting decisions.

The recently formulated concept of an “expression of wish” is an important development in enhancing the ‘client voice’ in the space of member voting, and could, if implemented effectively, provide additional insights on how clients wish managers to exercise their voting rights at a strategic and policy-level.

However, the concept is new and there is considerable variation in the forms that expression of wish could take ranging from a way for trustees to elucidate how they would like their voting policy to be followed, to more precise expressions on securities that is more akin to directed voting. As noted in the TPSVI report the form and content of expression of wishes is yet to be standardised, and market practice has yet to be established.

There are a number of issues that trustees will need to consider when deciding if they should set an expression of wish and what form it should take and especially how the Expression of Wish will contribute to the achievement of improved stewardship outcomes and long-term value on behalf of scheme members. These include:

- Resource and Governance – Does the scheme have the required resource to review and evolve expressions of wish over time to ensure that they remains in the best interest of scheme members?

- Flexibility – Is the expression of wish sufficiently flexible given the comply or explain nature of the UK Corporate Governance Code, and to ensure that voting decisions are taken in the interest of long-term value creation?

- Segregating Engagement & Voting – Where trustees have selected a product that enables them to direct manager voting, or they have an arrangement in place that their manager will follow any precise expressions of wish, trustees should consider if they are comfortable that separating managers’ voting from their engagement activities will result in better stewardship outcomes? Does the separation impact on a manager’s ability to leverage its entire holding in its engagement to influence the company, thereby serving the best interest of beneficiaries?

There are also a range of practical issues that cannot be overlooked, this was addressed by the FCA in its recently published ESG strategy which recognised it will need to focus on how the voting infrastructure and wider eco-system supports the stewardship activities of asset managers and owners. There are particularly issues regarding how trustees can communicate an expression of wish with their managers where they do not have a direct relationship with their manager or where they have invested through insurance platforms.

The industry and wider market participants will need some time to develop practical solutions for the implementation of expressions of wish to be communicated and for the form of expressions be standardised. The IA and our members are keen to be active participants in these conversations and wish to ensure that there is an effective system in place that facilitates the client’s voice in informing voting decisions.

However, given how nascent the concept is and the lack of any material market practice we have some concerns that the proposed guidance on implementation statements already refers to expressions of wishes, especially given that the guidance is statutory and will be influential for trustees. We suggest that DWP does not include the passage on expression of wish in the statutory guidance, but review its position once the concept has had an opportunity to establish itself in the marketplace. Including it at this stage is unhelpful and will not allow the concept to develop naturally in a way that works efficiently and produces the best stewardship outcomes for the end beneficiary.

We are particularly concerned about inclusion at this stage given the wording of the following sentence in paragraph 56, "*Where the trustee has an expression of wish in relation to any particular investment held, they should indicate in the IS whether this has been followed*".

The passage "*expression of wish in relation to any particular investment held*" implies a far more prescriptive and specific definition over the form an expression should take and is counter to the broader definition earlier in the guidance: "*an expression of wish, a statement which sets out how they would like their scheme's voting policy to be followed*". Given that the guidance is statutory it may lead many trustees to conclude that the only way they can meet the obligation would be to set an expression of wish covering specific securities.

The sentence also risks leading trustees to believe that they will have a greater level of influence over manager voting decisions in pooled funds than is the case. As the TPSVI Report and paragraph 37 of the proposed guidance clarifies "*Trustees cannot direct asset managers to follow their scheme's voting policy. Instead, trustees can set an expression of wish, a statement which sets out how they would like their scheme's voting policy to be followed. It is generally up to the asset manager to decide whether to follow that expressed wish*". There is an important distinction to be made between 'following an expression of wish' and taking the expression into account when making the voting decision. The current wording sets an expectation that managers should follow the expression of wish where it covers investments, and therefore implies that setting an expression of wish is a de-facto form of directed voting. We also note that the FCA only confirmed that there was "*no breach of fund rules where a fund manager takes the expression of wish into account when voting*."

Therefore, If DWP progress with including a section on expression of wish in the guidance, we encourage that it amends paragraph 56 to makes clear to trustees that there is no regulatory expectation that they set an expression of wish which covers any particular investments held and that schemes do not need to give precise expressions. Similarly, the paragraph should reinforce that it is generally up to the asset manager to decide whether to follow that expressed wish. Whilst it will be important for managers to take account of the expressions when making a voting decision, the expression will only be one amongst many factors taken into consideration on making a voting decision aligned with the managers fiduciary duty.

<u>Paragraph 57</u>

We have some concerns about how paragraph 57 may be interpreted by trustees in its current wording.

The following sentence: "*The IS is an opportunity for trustees to set out any steps they took to maximise influence over the way in which the vote has been cast*" may be read by trustees to mean that they should seek to maximise their influence over the way managers exercise their voting rights. Whilst we recognise the importance of managers consulting with their clients when drafting their voting policy and that managers consider the voting policy of trustees when exercising voting rights, we do not believe that all trustees should be encouraged to seek to maximise their influence over how managers vote across all resolutions. There are some large well-resourced pension schemes which have the capabilities and the expertise to conduct the level of research required to make well informed voting decisions. However, there is also a large number of schemes of a smaller size who not have these resources and have not developed the expertise.

The second sentence: "*Trustees should explain whether, and how, they made clear to their managers what they considered to be the most significant votes in advance of those votes being taken.*" may be read by trustees to mean that following communicating to managers what a most significant vote constitutes, that trustees should be active in monitoring all of a manager's votes and assessing whether the vote is considered to be a 'most significant' one. The majority of schemes have arrangements in place with their managers to delegate voting responsibilities and, depending on the trustee's governance resource, they may not have adequate resources or the capability to engage in such a comprehensive and granular level of oversight and monitoring of these responsibilities.

Paragraphs 59- 64
The implication from this section is that trustees should be the ones who set their definition of most significant votes and that this should be aligned to the thematic priorities outlined in the SIP. As mentioned earlier in response to question 7, such an interpretation of most significant votes it is not conducive to an effective vote reporting regime and will not be an effective marker for the stewardship activities of managers nor the outcomes achieved for beneficiaries.

Paragraph 61
The language "most significant votes" stems from the Shareholder Rights Directive II. The section pertaining to a description of how the manager exercises voting rights and annual disclosure of most significant votes applies explicitly to the extent that the firm is investing in shares traded on a regulated market.

We do not think that it is helpful therefore for the guidance relating to voting behaviour and most significant votes to include references to "voting opportunity in private-equity, infrastructure, or other asset classes". Instead DWP should ensure that the guidance focuses most significant vote disclosure on the exercising of shareholder voting rights in listed equities and does not deviate from the design nor the intent of SRDII. This is especially so if the guidance refers to the PLSA vote reporting template which explicitly states that the "*only votes relating to listed equities – shares traded on regulated markets – are within the scope of the template".*

10. Do you have any comments on our proposed Statutory Guidance on the information to be included in the Implementation Statement with regard the requirements under the Disclosure Regulations, Schedule 3, paragraph 30(f)(i)?

We do not have any comments.

11. Do you have any comments on our proposed Statutory Guidance on meeting the Implementation Statement requirements in the Disclosure Regulations relating to choosing investments?

We do not have any comments.

12. Do you have any comments on our proposed Guidance on meeting requirements in the Investment Regulations and Disclosure Regulations relating to investment strategy?

We do not have any comments.

13. Do you have any comments on our proposed Guidance on meeting requirements in the Investment Regulations and Disclosure Regulations relating to financially material considerations (including ESG and climate change)?

The IA welcomes the proposed guidance and note the importance that the stewardship policy trustees create should have links to the trustee's investment beliefs (including those linked to financially material ESG matters).

We also look forward to hearing from DWP on how the guidance on financially material ESG considerations will be integrated with the Sustainability Disclosure Requirements that FCA-regulated pension schemes will have to comply with, as proposed in the FCA's DP21/04[18].

14. Do you have any comments on our proposed Guidance on meeting requirements in the Investment Regulations and Disclosure Regulations relating to non-financial matters?

We do not have any comment.

15. Do you have any comments on our proposed Guidance on meeting requirements in the Investment Regulations and Disclosure Regulations relating to arrangements with asset managers.

We do not have any comment.

[18] https://www.fca.org.uk/publication/discussion/dp21-4.pdf