THE CHURCH OF ENGLAND

FRC Consultation on the UK Corporate Governance Code.

Response on behalf of the Church Commissioners for England, the Church of England Pensions Board and the CBF Church of England Funds

Background information

1. The Church Commissioners for England and the Church of England Pensions Board are both charitable statutory corporations. The Church Commissioners are a charity established with a number of purposes. The Commissioners contribute 15% of the costs of the Church of England as well as meet some historical pension liabilities. The Church of England Pensions Board is a regulated pension fund which exists primarily to pay clergy pensions accrued in respect of service after 1997, but also holds some charitable funds for other purposes. The CBF Church of England Funds are collective investment schemes managed by CCLA Investment Management Ltd in which nearly 13,000 Church of England parishes, dioceses, schools and church charitable trusts invest. The three bodies are collectively known as the Church of England National Investing Bodies ('NIBs') and together represent funds exceeding £13 billion.

2. The NIBs receive recommendations on ethical investment policy from the Ethical Investment Advisory Group of the Church of England ('EIAG'). The EIAG frames its advice to be consistent with the NIBs' fiduciary duties. However, the fiduciary duties rest entirely with the NIBs and policies are only implemented once they have been adopted by the NIBs.

Overarching Comments

3. **Our approach.** The Church Commissioners, Church of England Pensions Board and CBF Church of England Funds are ethical investors. The way we invest is an integral part of the Church of England's witness and mission. In practice this means that we seek to:

- Avoid profiting from, or providing capital to, activities that are materially inconsistent with Christian values
- Select investment managers who are able to analyse the environmental, social and governance ('ESG') issues relevant to their strategies
- Act as good stewards of our investments including through voting at company general meetings and engaging actively with companies in which we invest
- Promote ethical behaviour, corporate responsibility and sustainability in our interactions with investment managers, companies and public policy makers.
- Collaborate with other like-minded investors, such as the ecumenical Church Investors Group (with whom we have developed a voting template) and the Transition Pathway Initiative (where we have led, with the Environment Agency Pension Fund, a coalition of asset owners and managers with £5tn AUM that shares an approach to assessing companies' transition to a low carbon economy consistent with the Paris Climate Change agreements.)

4. **In general.** Board effectiveness, composition and succession are critical to the long-term success of companies. We support increased consideration of the purpose and role of businesses in society, and the increased emphasis on diversity and inclusion. We welcome the requirement for companies to be responsive to shareholder concerns (where there is a significant vote against management).

5. **Joint Ventures.** As we have noted in relation to Extractive Industries (The Church of England National Investing Bodies' Ethical Investment Policy on Extractive Industries, November 2017), we believe that the disclosure requirements for non-financial aspects of Joint Ventures and other similar corporate vehicles should be improved. While equity held in JV's appears in annual reports, other relevant elements such as the Health and Safety, sustainability records and other 'ESG' aspects of JVs are not always reported by the JV partners (including non-operating partners).

6. The current consultation draft widens 'employees' to 'workforce' in order to be more inclusive, and along similar lines we would recommend that reporting be widened to include Joint Ventures (and in particular 'ESG and wider social impact'). There is potentially a reporting and oversight gap, which can prevent shareholders from understanding the governance, performance, and standards associated with Joint Ventures particularly where the Joint Venture partner is a minority or non-operating partner. It is worth recognising that London has a large number of companies listing that operate joint ventures. Whilst recognizing this is often an important part of certain business activities and can be a requirement in some jurisdictions the risk is that investors are exposed to companies that are not reporting on a significant part of their business activity in line with the reporting on standards we have come to expect.

7. CONSULTATION QUESTIONS

UK Corporate Governance Code and Guidance on Board Effectiveness Questions

Q1. Do you have any concerns in relation to the proposed Code application date?

None

Q2. Do you have any comments on the revised Guidance?

We welcome the revised Guidance and in particular the recommendations regarding corporate culture, purpose, independence, diversity and director duties. We hope that its concise formulation will help companies to comply with the Code. As active owners committed to stewardship, we are fully supportive of the comply or explain mechanism which enables companies to be transparent on their corporate strategies and how they flexibly weight risks and opportunities. We would like to see lower levels of non-compliance, and improvements in the quality of 'explain' narrative reporting that supports non-compliance. Though it is covered by separate FRC Advice, we would support greater emphasis on the Board's oversight and vigilance in relation to internal and external audit functions. See also 'Overarching comments' above.

Q3. Do you agree that the proposed methods in Provision 3 are sufficient to achieve meaningful engagement?

Yes, we believe that the proposed methods in Provision 3 are sufficient. We note that the proposal is not prescriptive, and welcome the language of 'workforce', intended as it is to extend consideration beyond those with formal employment contracts.

We would expect companies also to have adequate whistleblowing policies in place, as an alternative method for the board to be made aware of workforce concerns

Q4. Do you consider that we should include more specific reference to the UN SDGs or other NGO principles, either in the Code or in the Guidance?

> We believe that in considering companies' contribution to (and impact on) society, the UN SDGs ought to be referenced specifically, as they are a significant multilateral set of goals that have been adopted by the world's governments. They are quite different and set apart from NGO principles given their wide governmental endorsement.
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> We believe that the SDGs are likely to be a popular framework for companies to report on their contribution to wider society. Further, as asset owners, we require certain disclosures in relation to e.g. companies' preparedness for the transition to a low carbon economy, that are consistent with the SDGs.
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> The Guidance might also make reference to other principles that support the SDGs, such as the Corporate Human Rights Benchmark and the Transition Pathway Initiative (TPI).
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> We would underscore the importance of addressing climate change, and the transition to a low carbon economy. In relation to SDG 13, which aims to promote urgent action to combat climate change and its impacts, we note that corporate governance is closely tracked by the Transition Pathway Initiative (TPI), which is supported by asset owners and managers with £5 trillion AUM. More information is available at http://www.lse.ac.uk/GranthamInstitute/tpi/

Q5. Do you agree that 20 per cent is 'significant' and that an update should be published no later than six months after the vote?

> Yes, 20% dissent is significant, and an update should be published no later than six months after the vote.

Q6. Do you agree with the removal of the exemption for companies below the FTSE 350 to have an independent board evaluation every three years? If not, please provide information relating to the potential costs and other burdens involved.

> In principle we support wider uptake of best practice in relation to corporate governance. That said, we are not in a position to comment on the cost implications and burdens for the range of companies below the FTSE350.

Q7. Do you agree that nine years, as applied to non-executive directors and chairs, is an appropriate time period to be considered independent?

> We agree that nine years is an appropriate length of time for non-executive directors and Chairs to be considered independent. It balances the benefit of long term commitment with the risks of stagnation. We do not expect the director to retire at nine years, but at that point for the purposes of board/committee balance (on which basis we exercise our voting rights), the NED/Chair should not be considered independent.

Q8. Do you agree that it is not necessary to provide for a maximum period of tenure?

Yes. Other things being equal, there is value in continuity, corporate memory and the retention of expertise. Fixed terms are therefore not essential, provided that adequate challenge and diverse perspectives are secured on the Board.

Q9. Do you agree that the overall changes proposed in Section 3 of revised Code will lead to more action to build diversity in the boardroom, in the executive pipeline and in the company as a whole?

We welcome increased emphasis on diversity (and diversity of skills), and believe that increased resilience that will come with the principles and provisions in Section 3.

The Church Commissioners and Pensions Board are members of the Church Investors Group, and our shared 2018 voting template is an example of how we emphasise gender diversity. We vote against the chair of the board nomination committee at listed UK companies where women account for less than 33 per cent of board members. We will also vote against all directors on the nomination committee if the company has less than 25 per cent female board directors. In 2017, the Church Commissioners and the Pensions Board voted against management 109 times in relation to the re-elections of board members in those companies where we had concerns over committee's actions to address gender diversity.

Q10. Do you agree with extending the Hampton-Alexander recommendation beyond the FTSE 350? If not, please provide information relating to the potential costs and other burdens involved.

We agree with and support the extension of best practice in corporate governance, including beyond the FTSE 350, and to include the sub-board level/pipeline of executives. However we are not in a position to comment on the potential costs and other burdens involved.

Q11. What are your views on encouraging companies to report on levels of ethnicity in executive pipelines? Please provide information relating to the practical implications, potential costs and other burdens involved, and to which companies it should apply.

We welcome the Parker Review's recommendation that companies both develop a pipeline of candidates and plan for succession through mentoring and sponsoring; and enhance transparency and disclosure to record and track progress.

The proposed encouragement would therefore be desirable. We are not in a position to comment on the potential costs and other burdens, but would suggest that the reporting on ethnic diversity pipelines ought to occur before the Parker Review's suggested dates of 2021 (FTSE100) and 2024 (FTSE250) which are targets for UK Boards to have at least one director from an ethnic minority background.

Q12. Do you agree with retaining the requirements included in the current Code, even though
there is some duplication with the Listing Rules, the Disclosure and Transparency Rules or Companies Act?

We do agree that the requirements ought to be included, and note that some overlap in rules relating to best practice will be inevitable. However, we believe that clear mapping of areas of overlap should be included especially for the benefit of smaller companies.

Q13. Do you support the removal to the Guidance of the requirement currently retained in C.3.3 of the current Code? If not, please give reasons.

We agree that the requirement to make available the terms of reference of the audit committee may be transferred to the Guidance, in the interests of a concise code.

Q14. Do you agree with the wider remit for the remuneration committee and what are your views on the most effective way to discharge this new responsibility, and how might this operate in practice?

We are supportive of remuneration committees having greater awareness of corporate culture and responsibility for levels of remuneration across the workforce. We hope that these new responsibilities might act as a moderating force in relation to excessive executive pay.

In 2017 the Church Commissioners and the Pensions Board did not support 92 Remuneration Policies and 156 of Remuneration Reports as proposed by FTSE 350 constituent companies. The majority of dissent votes were triggered by multiple concerns related to breaches of our bespoke voting template recommendations as well as diversions from local good practices.

We would caution that remuneration committees will need to ensure they have the capacity to take on wider responsibilities. Perhaps reducing the complexity of remuneration policies might give the committee capacity to review wider remuneration issues.

Q15. Can you suggest other ways in which the Code could support executive remuneration that drives long-term sustainable performance?

As stated above, we are supportive of remuneration committee having greater awareness of corporate culture and levels of remuneration across the workforce, the extension of LTIP vesting periods and the disclosure of pay ratios. See, for example, the Church of England's National Investing Bodies' policy on Executive Remuneration, sections 71, 86 and 87 (on corporate culture) 72, 88 and 89 (on remuneration across the workforce) and 83-85 (on prioritising long-term performance).

The Church of England's National Investing Bodies' policy on Executive Remuneration is available here.

Q16. Do you think the changes proposed will give meaningful impetus to boards in exercising discretion?

> We believe the changes proposed could give meaningful impetus to board in exercising discretion as there would be more clarity on the director duties and there is a stronger emphasis on boards to take into account the long-term interests of shareholders. We would emphasise that the quality of the explanation relating to the use of discretion will come under review by shareholders.

UK Stewardship Code Questions

Q17. Should the Stewardship Code be more explicit about the expectations of those investing directly or indirectly and those advising them? Would separate codes or enhanced separate guidance for different categories of the investment chain help drive best practice?

> We are concerned that the investment and fiduciary chain of actors (and advisors) should be supported by a clearer set of expectations and norms in relation to stewardship. In the face of evident challenges in relation to agency and stewardship (see for example Bebchuk, Lucian A., Alma Cohen, and Scott Hirst. 2017. "The Agency Problems of Institutional Investors." Journal of Economic Perspectives, 31(3): 89-102.), we would welcome specific guidance for the various kinds of actors.
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> We are agnostic on whether it is best to publish separate codes, however we do believe that enhanced guidance for different categories of actors in and around the investment chain would provide greater clarity.
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> We believe that the FRC should consider aligning its broad definition of stewardship with the Pensions Regulator and Law Commissions [Stewardship: The exercise of ownership rights, including engagement and voting, to protect and enhance the long-term value of investments. <http://www.thepensionsregulator.gov.uk/guidance/db-investment.aspx#s24300>]. We also note that Part 3 of the ICGN Global Stewardship Principles "Ecosystem of Stewardship" (available here) provides a useful starting point for the kind of expectations in question.

Q18. Should the Stewardship Code focus on best practice expectations using a more traditional 'comply or explain' format? If so, are there any areas in which this would not be appropriate? How might we go about determining what best practice is?

> We are supportive of the comply or explain format. This would also enable to signatories to fully report on the code while undergoing changes within the organisation.

Q19. Are there alternative ways in which the FRC could highlight best practice reporting other than the tiering exercise as it was undertaken in 2016?

> We would be supportive of periodical re-runs of the FRC's tiering exercise assessing the quality of stewardship reporting by Stewardship Code's signatories.

Q20. Are there elements of the revised UK Corporate Governance Code that we should mirror in the Stewardship Code?

Like the proposed revised corporate governance, the Stewardship Code could ask signatories to report on how they take into account views of their beneficiaries, workforce, customers, suppliers and wider stakeholders. In addition, as discussed under Q30, the Stewardship Code could integrate provisions similar to C.2.2 which require signatories to take account of their current position in the industry, principal risks and how they have assessed their prospects.

Q21. How could an investor's role in building a company's long-term success be further encouraged through the Stewardship Code?

See Q24.

Q22. Would it be appropriate to incorporate 'wider stakeholders' into the areas of suggested focus for monitoring and engagement by investors? Should the Stewardship Code more explicitly refer to ESG factors and broader social impact? If so, how should these be integrated and are there any specific areas of focus that should be addressed?

We believe that Stewardship Code would be strengthened by incorporating "ESG and broader social impact" more explicitly in the Stewardship Code. For long term investors, ESG and broader social impacts are an integral part of stewardship. Currently only referred to under Principle 4 (where "social and environmental matters" are used as an example of concerns that may lead to an escalation of stewardship activities), we believe that investors should be prompted to give consideration to ESG and wider impact in relation to monitoring (Principle 3), collaboration (Principle 5), voting (Principle 6) and reporting (Principle 7), and across the stewardship chain.

Q23. How can the Stewardship Code encourage reporting on the way in which stewardship activities have been carried out? Are there ways in which the FRC or others could encourage this reporting, even if the encouragement falls outside of the Stewardship Code?

The Stewardship Code could encourage signatories to report on additional items. Our priorities would be that signatories focus reporting on engagement (including the provision of an explanation where there is no engagement policy) as well as reporting on policy advocacy and membership of industry associations.

Q24. How could the Stewardship Code take account of some investors' wider view of responsible investment?

We would suggest that investors could be prompted to give consideration to ESG and other responsible investment matters throughout the entire stewardship chain (see our answer to Q22 above), however we are aware that different types of investors may have different views on and take different approaches. If an investor does not wish to take ESG into account then this should be done on a comply or explain basis.

Considering ESG and wider impact across the stewardship chain could potentially align the Stewardship Code with section 172 of the Companies Act, according to which a director of a company is required to have regard (among other matters) to the impact of a company's operations on the community and the environment. . We believe that future development of the Stewardship Code should take into consideration the work currently being undertaken by EU High-Level Group on Sustainable Finance (HLGS).

Q25. Are there elements of international stewardship codes that should be included in the Stewardship Code?

The majority of the international stewardship codes are voluntary, but some also contain mandatory requirements. We believe that the Stewardship Code ought to align with the EU Shareholder Rights Directive requiring mandatory disclosure of stewardship policies. The Stewardship Code could also become more stringent in relation to the monitoring of signatories' compliance against the code.

We are also looking forward to seeing the future work which the FRC plans to undertake on the mandatory & comply or explain elements of EU Shareholder Rights Directive, which will potentially require increased disclosure between asset managers and asset owners and asset owners and beneficiaries.

Q26. What role should independent assurance play in revisions to the Stewardship Code? Are there ways in which independent assurance could be made more useful and effective?

Independent assurance should be retained as it certifies the credibility of the public statements made by the signatories of Stewardship Code on their compliance of the code.

Q27: Would it be appropriate for the Stewardship Code to support disclosure of the approach to directed voting in pooled funds?

We would strongly welcome the Stewardship Code supporting the disclosure of managers' approaches to direct voting in pooled funds, in order to help asset owners evaluate the chain of stewardship that applies to their assets. We are cognisant of the operational barriers to extracting voting rights from pooled funds: In 2014, EIAG (Ethical Investment Advisory Group) recommended, and the Church of England National Investing Bodies adopted a Pooled Funds Policy which is available here. The Policy commits the NIBs to monitor pooled funds and vehicles no less frequently than quarterly in order to ascertain that spirit of our ethical policies is not breached, including, for example, the integration of environmental, social and governance factors into investment management, and stewardship (especially proxy voting and corporate engagement).

This disclosure should be understood in the context of signatories being required to report on how they outsource their stewardship responsibility to external managers and report on the contractual terms of the managers' appointment.

Therefore:

1) Managers should make their voting policy and guidelines public so potential and underlying clients can understand the manager's approach.
2) Managers should report clearly when they diverged from the policy (e.g. did not vote)

3) Where a manager does not allow client instruction on voting in pooled vehicles it should set out the reasons why.

Q28: Should board and executive pipeline diversity be included as an explicit expectation of investor engagement?

We maintain that investors should consider board and executive pipeline diversity when setting up engagement priorities.

Q29: Should the Stewardship Code explicitly request that investors give consideration to company performance and reporting on adapting to climate change?

We are fully supportive of Stewardship Code explicitly requesting that investors consider company performance and reporting on adapting to climate change. Indeed, through the Transition Pathway Initiative (TPI), we have encouraged other investors to assess and take into account company performance and reporting in relation to Climate Change. http://www.lse.ac.uk/GranthamInstitute/tpi/

Q30: Should signatories to the Stewardship Code define the purpose of stewardship with respect to the role of their organisation and specific investment or other activities?

Investors could be prompted to explain where their understanding of stewardship differs from that laid out by the Law Commission and Pensions Regulator [Stewardship: The exercise of ownership rights, including engagement and voting, to protect and enhance the long-term value of investments.
<http://www.thepensionsregulator.gov.uk/guidance/db-investment.aspx#s24300>].

Q31: Should the Stewardship Code require asset managers to disclose a fund's purpose and its specific approach to stewardship, and report against these approaches at a fund level? How might this best be achieved?

In general we are supportive of improved disclosure and reporting in relation to purpose and stewardship by asset managers.