

29 March 2019

Dear FRC,

Hermes Investment Management Response to the FRC Proposed Revisions to the UK Stewardship Code

Hermes welcomes the opportunity to provide our comments on this consultation. Hermes Investment Management is an asset manager with a difference. With £33.51 billion¹ in assets under management, we focus on holistic returns – outcomes for our clients that go far beyond the financial – and consider the impact our decisions have on society, the environment and the wider world. Our stewardship team, Hermes EOS, is one of the world's leading engagement resources, advising on £389 billion² on behalf of over 40 international institutional investors. The views expressed in this communication are those of Hermes EOS and do not necessarily represent the views of all clients.

We would like to again express our strong support for an updated and strengthened Stewardship Code in the UK. We believe this is a timely and necessary intervention to continue to raise awareness and performance on stewardship. We welcome the emphasis placed on the alignment of organisational purpose and stewardship. We also welcome the extension of the Code to global assets and asset classes beyond equity, as in our experience effective stewardship can be conducted in other classes, public and private.

In our view, Stewardship should be evidence based and focused on quality and achieving real outcomes on material issues. As such we welcome the introduction of an annual Activities and Outcomes Report for signatories, which will bring the same level of accountability as for corporate governance requirements. These reports will be the key mechanism for clients, beneficiaries, the FRC and other authorities and the signatories themselves to understand and assess stewardship performance.

Our main area of outstanding uncertainty and concern is related to the ongoing monitoring and enforcement of the Code. To truly achieve its objectives and potential positive impact the annual Activities and Outcomes Report must be assessed for quality and materiality.

Below we set out our response to the consultation. We hope that our comments and suggestions are of assistance. If you would like to discuss our views in further detail, please do not to hesitate to contact us at (ingrid.holmes@hermes-investment.com and andy.jones@hermes-investment.com).

Yours sincerely,

Ingrid Holmes, Head of Policy and Advocacy, Hermes Investment Management
Andy Jones, Associate Director, Hermes EOS

¹ Hermes as at 31 December 2018 with the exception of two portfolios totalling US\$4.5m / £3.5m / €3.9m valued as at 30 September 2018. See www.hermes-investment.com/uki/about-us/ for latest figures.

² As at 31 December 2018

General comments

We are highly supportive of the new Stewardship Code, which looks excellent although some areas could be strengthened. Ahead of the updated draft Stewardship Code being published, Hermes set out '5 tests' for what we believed was needed for an impactful update. These were to create a code that:

- a. Comprehensively articulates the purpose of stewardship as a guiding principle for signatories;
- b. Applies globally and across all asset classes;
- c. Has a firm and a fund level approach and focuses on outcomes not just processes;
- d. Has an easy to understand binary signatory/non-signatory status; and
- e. Is voluntary to sign up to but is monitored and enforced.

We believe the tests are largely met, although there are some areas where the Code could be strengthened. For example: expanding the definition in line with our original proposal and focusing on sustainable wealth rather than value creation²; setting an explicit expectation on undertaking in both UK and global markets, notwithstanding that there will be different hurdles in different markets; setting an explicit expectation that reporting will be at fund level as well as firm level; and strengthening of oversight and enforcement provisions. In addition, we believe that expectations on services providers should be significantly strengthened and provide some ideas on how this can be achieved.

Our comments below reflect this view.

Responses to 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.

Yes. In particular, we support the proposed definition of Stewardship. We see no conflict with the practice of stewardship as defined and fiduciary duties. The crystallisation of medium- to long-term risks that face society, the economy and the environment could be severe, both in terms of the financial value of individual issuers and across the portfolios of investors. Climate change is a particularly pertinent example of this. Therefore, undertaking action to mitigate such risks is, in our opinion, the action both of a good steward and of a

² We had suggested the following: *"The purpose of Stewardship across the investment chain is to promote the long-term success of companies and create financially, economically and socially sustainable wealth for investors and the economy and society in which they live. Good stewardship is defined by: the responsible allocation and management of capital; deep understanding of investments; and purposeful engagement and deployment of contractual rights, collaborating with other investors, where necessary, in pursuit of these objectives. This purpose should apply to stewardship of assets wherever they are in the world."* However, we would be content with the current definition – as a minimum - as it stands.

good fiduciary. Given the evolution happening in how policy makers both in the UK and EU³ approach about fiduciary obligations on ESG issues, we believe it will not be long before the consensus view becomes one where the failure by investment managers to act to mitigate such risks and of asset owners to require their investment managers to do so will be considered a clear breach of fiduciary duties.

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

Yes. However, there would be value in strengthening some of the provisions around service providers, which currently are left quite vague.

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

Yes, we do. However, care should be given, in assessing reports, to focus on quality of outcome reporting and efforts made to achieve those outcomes.

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

Hermes has a well-established outcomes-based philosophy that underpins our approach to stewardship. Others are not so far along the journey and so, as noted above, guidance will be helpful in developing a strengthened approach. From our own experience, we have found the following works:

- Adopting a systematic approach to identifying companies for engagement. We select companies based on the responsible investment policies of our clients, the size of their holdings, materiality of the risks and likelihood of success and feasibility of achieving change through engagement.
- Putting in place a milestone system allows us to track progress in our engagements relative to objectives set at the beginning of our interactions with companies.
- Using specific milestones used to measure progress in an engagement, depending on each concern and its related objective. They can broadly be defined as follows:
 - Milestone 1: Concern raised with company
 - Milestone 2: Acknowledgement of the issue
 - Milestone 3: Development of a credible strategy to address the concern
 - Milestone 4: Implementation of a strategy or measures to address the concern
- Publishing a number of case studies describing our engagement with companies, including our reasons for engagement, the actions we have undertaken and the results.
- Undertaking ‘intelligent voting’, which is engagement-led. This involves communication with company management and boards around the vote to ensure voting decisions are well-informed and include engagement insights where possible.

³ Examples include new requirements from the DWP for pension trustees to take climate change and ESG issues into account in setting strategy and in the EU new ESG disclosure requirements on asset owners and asset managers.

- Undertaking quarterly screening to identify companies which are in or near breach of international norms and conventions to assist with the identification of higher risk companies in the investment portfolios of our clients. This information is designed to integrate ESG factors into their investment processes.
- Undertaking a comprehensive programme of engagement with legislators, regulators, industry bodies and other standard-setters to help shape capital markets.
- Reporting on a quarterly and annual basis on engagement and voting activity, including statistics⁴.

In efforts to accelerate market learning and widespread adoption of the Code this – and other best practice approaches identified in the market – could be included as *examples* (rather than *requirements*) in any follow-on guidance the FRC drafts. We also suggest the FRC could consider running a series of seminars that showcase different best practice approaches to stewardship and enable others to learn and adopt elements in their own evolving approaches.

In Annex 1 we provide an example of how we structure our Reporting. It placed there for information only – as we concur with the FRC that prescribing a template such as this would encourage rather than discourage tick box reporting.

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 do. This will introduce the same level of accountability as there is for corporate governance requirements, manifested as a requirement to produce an annual report. Without this we think it will be difficult for the FRC to assess Code signatories' efforts. While prescriptive guidance on how to prepare a good report risks signatories adopting a tick box approach, which must be avoided, there would be value in setting out a principles-based view of what best practice is likely to be – and make suggestions as to how this could be achieved, as set out above.

From our perspective we think the Activities and Outcomes Report should be in three parts (reflecting the above methodology). Firstly, the signatory should set out their targets for stewardship – the outcomes that they are hoping to achieve. Secondly, they should set out their strategy for achieving these targets, including a disclosure of the resources that they deploy and the rationale as to why they believe that those resources are adequate. Thirdly, deliver a report on the outcomes achieved – including case studies. If not covered elsewhere, an appendix should be included to provide transparency over the level and type of activities undertaken, including collaborative engagement and voting records.

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?

We do.

⁴ See more detail at <https://www.hermes-investment.com/ukw/wp-content/uploads/2019/01/hermes-eos-stewardship-brochure-2018-english.pdf>

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?

They do. It will be vital, however, that the updated Code is properly monitored and - in due course - enforced. We strongly believe that the Code should have a binary status – with signatories either meeting it or not (i.e. no tiering). For those less far along the journey, the baseline stewardship requirements set out by the Shareholder Rights Directive 2, should suffice in the first instance. These firms working to lower levels of ambition on stewardship can then choose to work toward the higher standard – or not. This will help promote market clarity on what constitutes high quality stewardship.

We have suggested monitoring and enforcement could be undertaken either by the FRC, if enhanced powers are endowed by the Government - or by the FCA.

Monitoring/enforcement could be achieved through a combination of spot checks and removal from the list of signatories and potentially, further enforcement action (e.g. a fine), if signatories are found not to be matching effort with their stated policies and intent.

If the FRC is to lead on enforcement, this will – as noted above - require a change in the FRC mandate. As such it should form part of the consideration of the FRC reform process recently activated by the Government. Alternatively, the FRC's Stewardship Code team could be both bolstered and moved to the FCA, where it would have the benefit of the FCA's oversight and enforcement powers – which would give the Code 'teeth'.

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

Absolutely. It is only through this approach that stewardship will become properly integrated into business operations and guide business purpose to deliver better outcomes for clients.

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?

They could be. Our experience is that effective stewardship can be conducted for all asset classes – public and private – using the same broad approach.

This encompasses: due diligence on potential issues of concern; setting objectives and milestone for addressing them; putting sufficient resource in place to meet them; and reporting on progress made and – in the event of failure to achieve goals - impact on any investment decisions.

It is likely to be easier to deliver a result as a direct investor into real estate and infrastructure. Such investors should know their contractors and projects inside outside anyway. In effect the Stewardship Code should just be adding an additional layer of checks and balances that appropriate choices are being made for investors, society and the economy.

For public market investors results may taken longer to achieve. As a result, there would be value in setting this out in the Code and/or guidance that follows how stewardship can be adapted for different asset classes.

On bonds, for example, we have found the shared interests of bond and shareholders in companies provide incentives to jointly engage companies – and generate positive outcomes by doing so. We have only been able to identify two potential instances where interests between equity and bond holders diverge. These are during insolvency and during leveraged buy-outs (LBOs) and mergers & acquisitions (M&As), where bond and equity interests can diverge as investors compete over what remains. In such a situation, we believe that asset owners – who would have appointed bond and equity fund managers – should assert their interests in order to override any conflicting actions⁵.

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?

The provisions as currently drafted – which give a wide scope of interpretation to signatories - seem a sensible approach in the first instance. There would be value for clients to receive information about stewardship activities at a fund level – even if that statement states specific reasons for why stewardship is limited or not being undertaken for a fund (because high quality companies with a positive impact and therefore an excellent ESG score have been selected, for example).

In reality, the relationship between disclosures at firm versus fund level are likely to show a great deal of overlap. However, if the market really is to value stewardship, then fund level reporting is still needed (despite the duplication) because it enables investors to factor it into their selection processes. It may also help flush out any conflicts of interests between different funds run by the same investment manager, so that they can – if needed - be dealt with, which will be good for all clients of that manager.

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?

Yes it is appropriate. It will provide an important top level of accountability among signatory firms to deliver on their stated stewardship aims. It will also provide meaningful insights for clients in that it will give in insight into the motivation of a firm for undertaking stewardship, giving a sense of whether stewardship is core to the investment approach or merely an add on.

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

Yes they do set sufficient expectation.

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

Yes we do support the use of ‘collaborative engagement’. It is a collaboration to achieve a shared outcomes.

⁵ Discussed in more detail in <https://www.hermes-investment.com/uki/wp-content/uploads/2018/10/hermes-we-can-all-get-along-bond-and-shareholder-engagement-part-1-q3-2018.pdf>

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

We are not convinced that it should incumbent on the FRC to step in to resolve issues of poor governance and/or operational decisions at companies. It is the role of the FRC to ensure the proper functioning of the Corporate Governance and Stewardship regimes so that any such issues come to light in a timely fashion and can be resolved by relevant market participants – which is why recent innovations in the Corporate Governance Code, the proposed changes to the Stewardship Code, and overhaul of the audit industry are so important.

Instead the proper channels for escalation are through appropriate challenge by auditors and investors (the latter bilaterally or through the Investor Forum) to drive appropriate change at companies where concerns have arisen - and prevent a potential subsequent significant destruction of value and jobs. This could include introducing shareholder resolutions, voting against chairs and so on until the issues of concern are addressed.

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

The current requirements seem sensible – see our response to Question 9 above.

Going back to listed equities for a moment, however, there could be clearer guidance on expectations wrt avoiding empty voting.

In our view effective stewardship must be underpinned by a policy of recalling stock for voting, when that stock is the subject of a live engagement programme, and steps taken to ensure empty voting is avoided. Therefore, we would expect the FRC require all signatories to disclose their policies on stock lending and how this aligns with stewardship aims and supports good investment outcomes for beneficiaries. This includes how any revenues accruing from such practice are used and what steps are taken to prevent empty voting in the instance that the agenda for an investee company annual general meeting contains one or more significant matters.

In addition, given the Stewardship Code explicitly states the purpose to Stewardship is “to deliver sustainable value for beneficiaries, the economy and society”, we think it would be reasonable for any signatory to commit to abstaining from voting if their short position in the investee company in question is larger than their long position.

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?

Currently the requirements are quite light compared to the rest of the Code. We think there would be a lot of value in strengthening – and expanding them - them to provide clearer market guidance. The default position should be for other service providers also to be held to the same standards of accountability as asset owners and asset managers and service providers – putting stewardship front and centre of how they undertake their duties.

In terms of the opening text we suggest this is amended to state, “Service providers ... must provide services that enable clients to **identify and** deliver quality stewardship”.

Following on from this, stewardship service providers (of which Hermes EOS is one) should have an exemplar asset owner/manager approach, with a clear set of investment advice beliefs; thematic and company level views; focus on outcomes not policies; and exemplar reporting to ensure accountability.

We would support an additional generic provision that service providers:

a) Should publish policies and principles that guide the services they provide, including objectives sought (e.g. good practice advocated in voting recommendations and engagement), methodologies applied, sources used and processes and oversight for quality assurance.

b) Should report annually on their activities that support clients to deliver their stewardship responsibilities, such as activity metrics (e.g. engagements delivered) and case studies.

We also suggest amending provision 6 to “Signatories should establish a code of conduct *and disclose how it has been applied*”. This would align the provision with Provision 5 and the requirement on proxy advisors of the amended Shareholder Rights Directive.

However, guidance provided to these different providers should be adapted as appropriate to their daily business. We provide some examples below.

- For investment consultants signing up to the Code, they should set out how they view the role stewardship in delivering enhanced investment and also societal, environmental outcomes. and how they assess and advise clients on the value and quality of stewardship services as part of the investment advice they provide.
- For proxy voting services those signing up to the Code need to have beliefs that guide their advice that go beyond governance issues. To that end they should set out their beliefs on key thematic areas e.g. remuneration, climate change, modern slavery, plastic pollution etc and expectations on how they are addressed. They should also have a statement on how they apply this to their voting recommendations and services. Finally, given they are close to both investors and companies, a clear conflict of interest policy and process to resolve conflicts arising is needed.
- Distribution Platforms signing up to the Stewardship Code need to set out how they are actively facilitating the ability of clients to act as effective stewards, including through voting. This could include, for clients using the platforms to purchase shares, providing technological solutions as well as offering voting advice as part of their financial advice. In addition, for clients purchasing funds, they could update fund marketing materials to – in addition to financial performance – note whether the firm/fund has signed up to the Stewardship Code.
- For sell side analysts signing up to the Code, their commitment should be reflected by their adopting an approach to drafting brokers notes that includes a long-term focus on performance beyond just financial. In addition, financial outlooks need to go beyond 3m to take a 3,5,7-year view. The aim should be for them to move from quarterly to strategic research – helping shift the market away from advice that drive short-term trading behaviours. Actioning this could include their commenting on alignment of company strategy with the Paris Agreement on Climate Change;

reporting the proportion of women on boards; including data on gender pay gaps and so on.

Annex 1

To really drive effective engagement and be able to monitor that this is being achieved, the Guidance should be clear on information to be reported as part of the Annual Activities and Outcomes Report. From our experience, regular public reporting, or at least reporting to clients/beneficiaries, on engagement should generally include the following information:

On investee companies:

- Voting behaviour at all shareholder meetings:
 - o votes in favour of, against and abstaining on the management recommendation;
 - o votes against management by issue;
 - o support for shareholder resolutions;
 - o rationale for the most significant vote decisions;
 - o engagement around the votes; and
 - o differences with the recommendation of the chosen proxy research provider, if any;

With regard to companies engaged:

- the process for selection of companies for engagement;
- the number of companies engaged;
- seniority of company representatives typically engaged (e.g. investor relations, subject specialists, CEO/CFO, chair, board member);
- issues addressed through engagement;
- progress made against predefined engagement objectives; and
- resource that is dedicated to engagement (and, if separate, its interaction with fund managers).

On the most significant engagements:

- objectives of the engagements that are most material to the company or industry in which it operates and according to the geography;
- interaction type (e.g. meeting/call/statement at annual general meeting), seniority levels engaged and issues addressed;
- engagement and collaboration with other investors and stakeholders;
- under certain circumstances, how the engagement has been escalated;
- the outcomes and progress against objectives; and
- monitoring of the company and its response.