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30 April 2019

Dear FCA and FRC,

Response to DP19/1: *Building a regulatory framework for effective stewardship*

Hermes welcomes the opportunity to provide our comments to this discussion paper. Hermes Investment Management is an asset manager with a difference. With £33.51 billion[1] 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 billion[2] 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 framework in the UK. We believe this is a timely and necessary intervention to continue to raise awareness and performance on stewardship.

In our view the current proposed definition of stewardship is the minimum wording that can be used. Given a key objective of the EU Shareholder Rights Directive (SRDII) and revised UK Stewardship Code is to greater align the investment chain with the end beneficiaries it owes a fiduciary duty to, and over the long-term, it is essential that the wording of 'delivering sustainable value to beneficiaries but also society and the economy' is retained.

Noticeably absent from the draft Code is a mechanism for effective oversight and monitoring. Over the history of the Code to date this has been a key factor in its failure to achieve its potential and objective. An effective mechanism is essential under a future regulatory framework for achieving the opportunity and benefits of an active stewardship market.

The current work on the UK Stewardship Code and SRDII transposition must also be part of a broader alignment of the regulatory and guidance framework. It is our belief a shift toward more active stewardship across the industry needs to be complemented by a shift toward long-term holistic return client mandates/fund offerings – which will require changes to how fund objectives are articulated; fees charged; outcomes reported; and staff remunerated; and firms/fund governance.

Below we set out our response to the discussion paper. 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,

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

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

Q1: Do you agree with the definition of stewardship set out here? If not, what alternative definition would you suggest?

The definition we prefer to use is as follows.

"*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."*

That said, we understand most of the market has not been thinking about these issues for as long as Hermes has. On that basis we support the current definition and strongly believe it important that the current definition, with its mention of delivering sustainable value to beneficiaries but also the society and the economy, is retained as a minimum.

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 good fiduciary.

As such we welcome the clarity that the proposed definition of stewardship will bring to the purpose of undertaking these functions. We support the selection of language that makes it clear investors and other actors within the investment community should take note both of the potential impact of environmental, social and governance (ESG) factors on investments but also the potential impact of those investments on society and the environment.

Comfort could be provided to market participants if it is also noted in the definition that different factors are financially material over different timelines but that over a long enough timeframe they are all reconcilable.

Q2: Are there any particular areas which you consider that investors' effective stewardship should focus on to help improve outcomes for the benefit of beneficiaries, the economy and society (eg ESG outcomes, innovative R&D, sustainability in operations, executive pay)?

It should be up to individual investment firms to develop their own philosophy and approach to prioritising stewardship activities. Effective stewardship can't happen without this – so it should not be something regulators try to prescribe. However, given that many investors may be embarking for the first time on stewardship, it would be helpful to give guidance on the range of issues that would typically be included for focus under stewardship outcomes, including reference to good corporate governance, including ensuring adherence to the UK Corporate Governance Code or understanding the reasons for non-compliance, long-term strategy and business purpose, risk management processes and environmental and social risk management, including major societal issues such as the challenge of climate change and workers' rights and fair pay. Many of these issues are referred to the in draft stewardship code itself and its guidance notes and it is helpful to cross refer to these.

Q3: To what extent do the proposed key attributes capture what constitutes effective stewardship? Which attributes do you consider to be most important? Are there other attributes that we should consider? If so, please describe.

We agree the key attributes have been identified. If investment firms are to deliver Stewardship, it must become fundamental to how investment firms think about allocating capital as it is a device to move the focus purely from share price (or value of other financial instrument) toward understanding the company and its drivers of value and risk.

In the UK regulatory landscape, disclosure has been an important means to drive behaviour change. So it should also be with the Stewardship Code.

High quality Activities and Outcomes Reports, in fulfilment of the disclosure and transparency requirements, will be key to the regulator and market participants being able to identify effective stewardship. While prescriptive guidance on how to prepare such reports risks signatories adopting a tick box approach, which must be avoided, we think it would be useful to set out a principles-based view of what best practice is likely to look like.

From our perspective we think the Activities and Outcomes Report should be in three parts (reflecting a clear engagement rationale and 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.

Q4: What do you think is the appropriate institutional, geographical and asset class scope of stewardship? How can challenges associated with issues such as the coordination of stewardship activities across asset classes, or the exercise of effective stewardship across borders, be overcome?

We think the new Stewardship Code should apply to invested assets within and outside the UK, whether they are managed directly or on a delegated basis by UK-based asset managers. Given few firms potentially covered by the Code will only invest in the UK, to have impact the Code should apply to investments in non-UK jurisdictions in the same way they do in the UK. For example, of the £7.7 trillion managed by Investment Association member asset managers, £1.7 trillion is invested in the UK economy leaving ~ £6 trillion invested in non-UK assets[2]).

A failure to actively steward those assets held overseas could affect business integrity – albeit limited to the financial services sector - back in the UK. Thus we believe a global focus is in keeping with the current FRC mandate, which is to promote transparency and integrity in business overall and also with the FCA mandate, which is to make financial markets work in the interests of a fair deal for consumers.

There is a legitimate concern that because corporate governance and reporting standards may not be as robust in other countries as they are in the UK, it may be more difficult – in extra-UK jurisdictions - to obtain meaningful publicly available data on potential material environmental or social factors. However, this can be overcome through undertaking proprietary research through deploying sufficiently experienced and skilled team to engage

[2] See p13-14 https://www.theinvestmentassociation.org/assets/files/research/2018/20180913-fullsummary.pdf.pdf

directly with companies of concern, which is – in our opinion – exactly the type of impactful engagement the updated Stewardship Code should foresee.

Finally, the FRC has stated that a key driver of the proposal to extend the Code to be open to investors across all asset classes is the ongoing shrinkage of listed securities market. While this is a strong reason it should not be the main reason behind this change. Enhanced stewardship efforts across all asset classes are a key means to promote the long-term success of companies and generate financially, economically and socially sustainable wealth for investors and the economy and society in which they live. Against the backdrop of wider regulatory changes afoot, this seems a completely reasonable and desirable rationale.

In addition, with respect to engagement, we have found that there is no barrier to bondholders and shareholders engaging corporate boards and management teams to encourage long-term value creation and sustainable growth and that except in very specific limited circumstances, long-term interests are aligned[3]. Undertaking the exercise across all asset classes will also assist firms in unearthing any strategic misalignments across the products they offer that will not be in their overall clients-best interests. This therefore argues for reporting against the Code's requirements to happen both at fund and firm level.

Q5: We welcome examples of how firms with different objectives and investment strategies approach stewardship. In particular, we welcome input on how stewardship practices differ across active and index tracker funds, in the following areas: i: how firms prioritise and conduct stewardship engagements ii: what investments firms have made in stewardship resources iii: how stewardship activity is integrated with investment decisions.

On points (i) and (ii) there should be no difference in the approaches of active and index funds. Attention should be paid, however, to the ratio of stewards employed to steward what are usually very large funds with very large numbers of securities to ensure they are proportionate to the task at hand. On point (iii), active managers are at liberty to adjust portfolios in a way traditional index funds are not. However, passive managers are increasingly now developing tilted funds that mimic an index fund but underweight or even remove companies from the index due to major ESG risks, notably climate change, thus moving to a more hands-on approach.

In terms of Hermes, we have 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

[3] Two exception can be poison pills and cash outflows from a company. See https://www.hermes-investment.com/uki/stewardship/we-can-all-get-along/

- 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.
- 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 statistics[4].

Q6: To what extent do you agree with the key barriers to achieving effective stewardship identified in this DP? What do you believe are the most significant challenges in achieving effective stewardship? We would particularly welcome views on the investment required to embed effective stewardship in investment decision-making.

There is undoubtedly an issue with cost in an environment where index funds pride themselves on being low or no cost options and where undertaking effective stewardship requires a significant investment in suitable and experienced staff and resources to support and record the impact of their work. However, we have found this cost is not unmanageable.

Moreover, looking at the issue from the public good perspective, as the discussion paper notes, good stewardship benefits many investment managers – whether they engage themselves or not – and benefits society as a whole. On that basis, we believe that in due course, the current free-riding that exists should be addressed through an expectation that all investment managers engage in stewardship as part of their fiduciary duty.

The issue of misaligned incentives and the flow of information are more complex and can in part be addressed through having all members of the investment community sign up to a strengthened Stewardship Code – we set out further ideas below. However, it’s not a silver bullet. It is our belief a shift toward more active stewardship across the industry needs to be complemented by a shift toward long-term holistic return client mandates/fund offerings – which will require changes to how fund objectives are articulated; fees charged; outcomes reported; staff remunerated; and firm/fund governance.

On how misaligned incentives and information flows could be addressed through getting service providers involved in stewardship activities, we have the following proposals.

- 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.
- Stewardship service providers should have an exemplar asset owner/manager approach.
- For investment consultants signing up to the Code, they should set out how they view the role of stewardship in delivering enhanced investment and also societal and 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

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

their approach 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 work both for investors and companies, care should be taken to ensure that the conflict of interest policies adopted by proxy advisers are fit for purpose i.e focused on ensuring there is a robust process in place to manage confidential information obtained from companies when providing voting advice to investors in those companies.

- 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 ensure that fund marketing materials/key documentation notes whether the firm/fund has signed up to the Stewardship Code and whether stewardship is applied within a particular fund, providing links to any relevant reports.
- 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.
- Credit ratings agencies should fall under similar obligations.

Q7: To what extent do you consider that the proposed balance between regulatory rules and the Stewardship Code will raise stewardship standards and encourage a market for effective stewardship?

Looking at the issue from the public good perspective good stewardship benefits many investment managers – whether they engage themselves or not – and benefits society. On that basis, we believe that in due course, the current free-riding that exists should be addressed through an expectation that all investment managers engage in stewardship as part of their fiduciary duty.

However, we are not there yet, and so we support the current approach wherein the Shareholder Rights Directive 2, is used to introduce minimum standards, while the updated Stewardship Code sets a new gold standard. This should be reviewed in the next 3-5 years and a consideration given to whether it should be made mandatory across the board – especially in light of new EU Investor ESG disclosure requirements, which have recently been agreed[5].

In addition, to help promote market clarity on what constitutes high quality stewardship, we strongly believe that the Code should have a binary status – with signatories either meeting it or not (i.e. no tiering)[6].

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[5] http://europa.eu/rapid/press-release_IP-19-1571_en.htm

[6] 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.

Effective oversight and monitoring of the Code are an area that needs to be addressed, as it is notably absent from the draft Code. We suggest 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.

It would seem to make sense for such monitoring and enforcement to be undertaken by a bolstered FRC team. However, this will require a change in the mandate of the FRC (as it evolves to become ARGA), which can only be endowed by the Government.

Q8: To what extent are there are issues with proxy advisers that are not adequately addressed by SRD II and proposed revisions to the Stewardship Code?

The requirements are currently too light. 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 approach 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 work for both investors and companies, care should be taken to ensure that the conflict of interest policies adopted by proxy advisers are fit for purpose with a robust process in place to manage confidential information obtained from companies when providing voting advice to investors in those companies.

Q9: We welcome feedback on other specific aspects of the regulatory framework described above. In particular, we are interested in views on:

i: Whether and to what extent the FCA's proposed rules for asset owners should be extended to SIPP operators?

They should. This is a vast source of empty votes that needs to be addressed. We suggest SIPP operators should be encouraged to sign up to the Stewardship Code and 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. These obligations should also be extended to self-select broking platforms.

ii: The case for regulatory rules to expand the reach of stewardship beyond listed equity

We think the Code should apply to invested assets within and outside the UK. Given few firms potentially covered by the Code will only invest in the UK, to have impact the Code should apply to investments in non-UK jurisdictions in the same way they do in the UK. For example, in 2017, £91 billion flowed out of the UK in foreign direct investment[7]. A failure to actively steward those assets held overseas could affect business integrity – albeit limited to the financial services sector - back in the UK. Thus, we believe a global focus is in keeping with

[7] Latest ONS data published Q4 2018.

the current FRC mandate, which is to promote transparency and integrity in business overall and also with the FCA mandate, which is to make financial markets work in the interests of a fair deal for consumers.

In addition, enhanced stewardship efforts across all asset classes are a key means to promote the long-term success of companies and generate financially, economically and socially sustainable value for investors and the economy and society in which they live. Undertaking the exercise across all asset classes will also assist firms in unearthing any strategic misalignments across the products they offer that will not be in their overall clients-best interests. This therefore argues for reporting against the Code's requirements to happen both at fund and firm level.

iii: Whether there is a role for UK regulators in encouraging overseas investors to engage in stewardship for their asset holdings in the UK

We agree the regulator should encourage this. It is a key means to help uphold the Corporate Governance Code in the UK.

iv: The extent to which additional rules might be necessary either to improve stewardship quality or prevent behaviours that might not be conducive to effective stewardship

There could be clearer guidance on expectations with respect to 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 to 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 meeting contains one or more significant matters.

In addition, given the Stewardship Code explicitly states the purpose of 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.

v: For differences between active and index-tracker strategies in the practice of stewardship, whether there are particular regulatory actions we should consider to address any perceived harms.

Consideration could be given to whether regulatory change is needed to enforce the above.

vi: Whether the FCA's proposed rules to implement certain provisions of SRD II should apply on a mandatory, rather than 'comply or explain', basis.

We believe this is part of the fiduciary responsibility of investment managers, and so yes this is a sensible approach. Though a comply or explain basis will only be effectively with monitoring of adequate compliance and reasonable explanation (see also response to Q7).

Q10: We welcome feedback on whether, to support effective stewardship, we should consider amendments to other aspects of the regulatory framework that affect how investors and issuers interact (such as the LRs, PRs and DTRs)?

We think this is an important question that deserves proper consideration and suggest the FCA conducts a separate review as to how these regulations could be amended to facilitate high-quality Stewardship before coming to a final view. The review could cover all regulations that require companies to deploy mechanisms that could make good Stewardship easier. Such an ‘omnibus proposal’’ could include a review of the merits of Shareholder Committees, one share one vote, requiring facilities to enable small shareholders to vote and voice concerns, and enhanced disclosures and any other innovations that would make good Stewardship easier, thus lowering system costs.