

July 13th 2012

FRC consultation on revisions to the Stewardship Code

We welcome the opportunity to comment on this consultation. We recognise the Stewardship Code as the first such regulatory instrument in the world, and support the FRC's aim of seeking to enhance it over time.

By way of background, Hermes is a leading asset manager in the City of London. As part of our Equity Ownership Service (Hermes EOS), we also respond to consultations on behalf of many clients from the UK and around the world, including VicSuper of Australia, PNO Media (Netherlands), Lothian Pension Fund, Canada's Public Sector Pension Investment Board, La Caisse de dépôt et Placement du Québec, British Coal Staff Superannuation Scheme and the Mineworkers Pension Scheme (only those clients which have expressly given their support to this response are listed here). In all, EOS advises clients with regard to assets worth a total of £89 billion.

We ourselves are a signatory to the Code and seek to deliver services to our clients which live up to its spirit as well as adhering to its principles and guidance.

We support the bulk of the changes proposed to the Stewardship Code, which seem significant enhancements to the standards and expectations under it. We believe that the introductory text is helpful and welcome the increased focus on conflicts of interest. We strongly support the intention to encompass asset classes other than equity in the Stewardship Code, and to encourage an international application of the principles of the Code, as well as encouraging the application of the Code by overseas investors in the UK.

As well as these general comments, we make some brief specific suggestions below under a series of headings. We discuss these in order of significance.

Voting holdings within pooled funds

We welcome the discussion of the different roles of different parties in the investment chain, and the emphasis on the need for all institutional investors to be responsive to the needs and wishes of their clients and beneficiaries. We believe that this needs to be reflected in a further addition to the Code – a piece of unfinished business from the original



version. At that time, the FRC noted an intention to address a number of issues at the next review; most of these have been considered and reflected in the text (most notably stocklending), but one has not. This is the issue of beneficial owners having the right to vote the shares attributable to their investment in pooled funds. This can be delivered technically but requires the goodwill of fund managers to respond to the wishes of their underlying clients. We call on the FRC to deal with this piece of unfinished business and to establish an expectation - against which fund managers would be open to explain if they chose not to apply - that fund managers should allow clients to vote the shares attributable to them within pooled funds. This requirement is necessary to give the underlying beneficial owners a basis for moving this debate forward - even some of the largest asset owners have failed thus far to persuade their fund managers to enable them to do this.

Assurance standards

We note the increase in the expectation that investors will apply the AAF 01/06 or SSAE 16 standards to their Stewardship Code disclosures. We apply this standard and make the conclusions available to clients on request, however we believe that there are problems with the standard which the FRC will probably over time need to address. The problems arise from the view of the auditing profession, including those who write the AAF 01/06 or SSAE 16 requirements, that they can only provide an assurance report on matters that are objectively verifiable. This narrows the scope of the Principles and the Guidance which is encompassed by the AAF 01/06 and SSAE 16 approaches, and means that often the most difficult and judgemental elements are not covered. We believe that this risks reducing the value of the AAF 01/06 and SSAE 16 as overall assessments of delivery under the Stewardship Code.

Perhaps more fundamentally, we note that in essence the AAF 01/06 and SSAE 16 assurance simply assesses whether in practice the investing institution carries out the processes which it has laid out - it does not assess the scope or ambition of these nor whether they are fully capable of delivering the intent of the Stewardship Code. This means that there will often be fewer issues raised by an AAF 01/06 or SSAE 16 assessment of a simple process which may deliver little of practical value to clients and beneficiaries than for an approach which seeks to deliver real value but fails to achieve the high standards it sets for itself on some occasions. It is hugely unfortunate if the assessment process which the Code requires were to act as a constraint on the standards which investment institutions set for themselves in relation to the Code.

We support the use of the AAF 01/06 or SSAE 16 on an interim basis (and willingly make our own AAF 01/06 freely available to clients on request) but we do believe that these issues mean that over time the FRC will need to consider an alternative assurance standard in relation to the Code.

Overall drafting changes and further proposals

We welcome the proposed changes to the Code and welcome the FRC's diligence in responding to earlier comments on how the text could be enhanced. We believe that the introductory text (including the 'application' and 'comply or explain' wording) is a marked improvement on what went before, and that the added expectations with regards to conflicts of interest and collective engagement are extremely welcome. On conflicts, we

would welcome it becoming standard practice for fund managers to disclose at least annually to their clients their conflicts of interest with respect to stewardship matters (which naturally will be different from their conflicts in their wider operations). We also support the proposed distinction drawn between asset owners and asset managers, as well as the clearer delineation made between voting and engagement activities.

We have one minor suggestion as to a further enhancement of the guidance text to Principle 4. Currently, the third bullet point on escalation suggests that concerned investors might meet "all independent directors". On occasions it may be appropriate for investors to meet all independent directors collectively, but it is also appropriate, and normal practice, for investors to meet independent directors other than the chair or SID, and we believe it would be unhelpful if the Code indicated that individual meetings were inappropriate. We note that under Principle 3 the guidance suggests meeting the chair and "other board members" and we would recommend the adoption of the same language under Principle 4.

On Principle 7 we wonder whether "report" is a sufficiently demanding standard to set. A phrase which builds in greater substantive expectations would be "make themselves accountable", meaning that the whole principle might read "make themselves accountable periodically for the delivery of their stewardship and voting activities".