Hermes Equity
Ownership Services Limited
1 Portsoken Street
London E1 8HZ
United Kingdom

Tel: +44 (0)20 7702 0888
Fax: +44 (0)20 7702 9452

www.hermes-investment.com

April 2015

Mr Elias Koufou
DWP Consultation Coordinator
2nd Floor Caxton House
Tothill Street
London
SW1H 9NA

By e-mail, to: elias.koufou@dwp.gsi.gov.uk

Changes to the Investment Regulations following the Law Commission's report 'Fiduciary Duties of Investment Intermediaries'

Dear Mr Koufou:

Hermes EOS welcomes the opportunity to respond to DWP's consultation on changes to the Investment Regulations following the Law Commission's report 'Fiduciary Duties of Investment Intermediaries'.

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 substantial institutional investment clients from around Europe and the world, including the Environment Agency Pension Fund, The Univest Company, VicSuper of Australia Canada's Public Sector Pension Investment Board (PSP), and PNO Media (Netherlands). (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 £134 billion (as at 31 December 2014).

We believe the definition of fiduciary duty is clearly understood: acting in the best shared interests of scheme beneficiaries. Understanding what is in the best shared interests of scheme beneficiaries requires consideration of a wide-range of both short and long-term factors, including environmental, social and governance (ESG). We consider ESG factors in so far as they are relevant to the risk-adjusted returns of an investment and do not invest solely on the basis of ESG factors.

We answer the specific questions raised in the consultation below and would welcome a further conversation with the DWP as its thinking develops in this area.

Yours sincerely,

Darren Brady
Hermes Equity Ownership Services

Question 1 - How could regulation 2(3)(b) of the Investment Regulations be amended so that it more clearly reflects the distinction between financial and non-financial factors?

We think that clarifying the distinction between financial and non-financial factors is an important element of strengthening trustees' ability to confidently and fully execute their duties to pursue sustainable risk management and value creation.

Clarity is best achieved not through the strict labelling of certain "types" of factors as "financial" and others as "non-financial" but rather through evaluating the motivation behind why a particular factor is considered in reaching an investment decision.

We do not believe that environmental, social, or governance ("ESG") factors are in fact "non-financial". While these factors may not be estimated precisely in a quantitative fashion and over a specific time frame, they can be material either as a risk to financial value or as an opportunity.

While trustees might find it difficult to assess ESG factors and then make the right decisions taking these factors into account, there is an increasing body of evidence to demonstrate not only that they have a bearing on financial performance but that some activities, including active stewardship, can positively influence long-term risk adjusted returns. In our view this is best implemented by a combination of integration of ESG factors as part of the investment process and through active stewardship of portfolio companies and assets.

"Non-financial" factors should be viewed as those whose primary motivation for consideration is based on the desire to protect and enhance their fund's reputation in line with beneficiaries' beliefs. For a factor to be considered "non-financial" its sole reason for consideration must be motivated by such reasons that are independent of any anticipated influence, over any time period, on investment returns potential. The distinction is ultimately one of "value" vs. "values" when determining whether a factor should be viewed as "financial" or "non-financial".

We welcome the fact that the Law Commission wishes to remove any remaining misconception between "financial" and "non-financial" factors. We are of the view that trustees should take these issues into account where material rather than, as the consultation suggests, being able to decide whether to take them into account or not.

The Law Commission should therefore make sure that there is no misconception: if ESG factors can influence long-term value and if engagement with companies can help to reduce long-term risk and increase value, then trustees overall have a fiduciary obligation to take ESG factors into account and disclose how they are doing so.

Question 2 - Do you agree that amending the Investment Regulations to require trustees to comply with the current requirements in the Stewardship Code or explain why they have not done so, is the most appropriate way to implement the Law Commission's recommendation? If not, what approach would be more appropriate to encourage trustees to consider their approach to stewardship?

We do think there is a case for clarifying and in some cases strengthening the duty of investment intermediaries to their clients, but sympathise with the previously stated position of the Law Commission that "any attempt to change fiduciary duty through legislation would result in new uncertainties and could have unintended consequences".

However, it is important to provide greater certainty on the interpretation of the general law of fiduciary duties such that these are consistent with the aim of promoting behaviours aligned to pension funds' long-term investment horizons and to limit the flexibility allowed within the scope of fiduciary duties that may unintentionally contribute to enabling the persistence of potentially harmful behaviours.

We note that in many ways the structure and wording of the current Stewardship Code is geared towards the specific activities and responsibilities of asset managers, which vary from those of pension fund trustees as asset owners.

As such we are reticent about supporting the current proposal as we feel asking asset owners to “comply or explain” with the Stewardship Code in its current form may risk a compliance approach resulting in undue confusion as to what their responsibilities are.

Asset owners are increasingly considering the value to be gained for long-term performance from behaving as active owners of the assets in which they are invested. In essence, stewardship is working with the underlying assets to ensure they focus on delivering risk-adjusted value over the time horizons that matter to long-term owners. Some asset owners hire specialist firms to do this work, but many expect this to be part of the process of fund management as defined in the current iteration of the Stewardship Code.

However, asset owners should be compelled to consider the Stewardship Code as part of determining their own responsible ownership approach. We would suggest a more open-ended requirement, for example, to set out “our policy, if any, with respect to the consideration of stewardship activities when selecting, appointing and reviewing investment manager’s performance.

The Law Commission previously recommended that trustees should be encouraged to consider whether and how to carry out their stewardship responsibilities – engagement with investee companies and exercising of voting rights - either directly or through their investment managers. The report recommended including a specific requirement for the fund’s Statement of Investment Principles (“SIP”) to contain a statement of the trustees’ policy (if any) on stewardship.

In the Government’s response to the Law Commission’s report it committed to consulting on changes to the Investment Regulations to require trustees to state their policy (if any) on stewardship in the SIP, suggesting this should mirror what is set out in the current principles and guidance requiring trustees to report against the Stewardship Code and we are broadly supportive of such an approach.

The effect of this it is suggested would be a requirement on trustees to state in their SIP:

- that they have signed up to the Stewardship Code, or explain why they considered this was not relevant to them in discharging their investment duties; and
- if they have signed up to the Code, how they comply with the principles of the Code, or explain to what extent, and on what grounds their approach departs from these principles.

To this question we are very supportive of updating the current language as suggested by requiring trustees include a statement within the SIP of their policy on: a) how they evaluate long-term risks, including from ESG and other factors which may be financially material to the performance over their investments; and b) determining whether and in what circumstances it would be appropriate to make investment decisions on the basis of non-financial factors similar to what is described above.

While adopting a strict “comply or explain” requirement for trustees to describe their efforts to comply with the explicit requirements of the Stewardship Code as recommended by the Law Commission may not currently be the most effective course- all asset owners should have flexibility to “explain” their approach to the key described above.

We also see scope for such an approach extending into a more formal “comply or explain” structure as the current Stewardship Code evolves to more directly address the circumstances of asset owners in addition to asset managers.

Question 3 - What steps would trustees need to take to comply with any amendments to the Investment Regulations, as set out in Chapter 2? What, if any, costs would be involved in meeting any new requirements?

This is a difficult question to answer precisely due to the large number of variables which may impact the ultimate cost to trustees and beneficiaries.

There is no inherent cost in trustee's considering what stewardship activities they may undertake or how ESG factors might be incorporated into their funds' decision making process. The cost is realized at the implementation stage, which will vary significantly from fund to fund based on the determinations made by the trustees.

In practice, this can take several different forms from developing a specialised in-house resource to deploy the fund's ESG integration and stewardship work, to outsourcing these responsibilities to third party service providers on a full time basis, to simply retaining the services of consultants on an ad-hoc basis. Some asset owners have found it is possible to implement a cost-effective approach to stewardship, particularly for passive equity portfolios, by pooling resources thereby giving them greater scale and influence with portfolio companies.

As such it is difficult to model the precise costs incurred by individual funds as these will be highly variable.