

Catherine Horton
Financial Reporting Council
8th Floor, 125 London Wall
London EC2Y 5AS

26 February 2018

By Email: codereview@frc.org.uk

Dear Catherine,

Consultation on Proposed Revisions to the UK Corporate Governance Code and initial consultation on the future direction of the UK Stewardship Code

We welcome the opportunity to provide our comments on the proposed revisions of the UK Corporate Governance Code and the future direction of the UK Stewardship Code. Hermes Investment Management (Hermes) is an asset manager with a difference. With £33.0 billion in assets under management, we focus on holistic returns and consider the impact our decisions have on society, the environment and the wider world – outcomes for our clients that go far beyond the financial. Our stewardship team, Hermes EOS, is one of the world's leading engagement resources, advising on £336.2¹ billion on behalf of over 40 international institutional investors. The views expressed in this communication are those of Hermes and do not necessarily represent the views of all clients. Our response is explicitly supported by BBC Pension Trust (UK), BT Pension Scheme (UK), Environment Agency Pension Fund (UK), PNO Media (the Netherlands) and VicSuper (Australia).

Executive summary

Broadly speaking, we believe that the UK governance framework is operating well and is an asset to the UK that should be protected. Meanwhile, opportunities for improvements should be continually assessed in order to ensure that the framework is fit for future business models. To that end, we are pleased with this latest comprehensive review and many of the Financial Reporting Council's (FRC) recommendations.

We welcome the proposed revisions to the UK Corporate Governance Code (the Code) as they address the elements of governance most important to board effectiveness and corporate purpose. The extra focus on stakeholders, integrity, corporate culture and diversity is positive, as is the emphasis on how the overall governance of a company contributes to its long-term success. We believe that the new Code will help encourage boards to discuss in a more holistic fashion how their businesses seek to generate sustainable value for shareholders, and for wider stakeholders.

However, while we like the much clearer focus on principles, we are cautious about the Code becoming too prescriptive in some areas. Examples include the provisions which stipulate a hard nine-year limit for independence of a non-executive director and the twelve-month experience requirement for the remuneration committee chair.

¹ As at 31st December 2017

We support the shift in focus from provisions to principles, which allows for more thoughtful variation and explanation of different governance arrangements. While the intent of the Code has always been flexibility, it is now often applied in a formulaic manner both by companies and by shareholders and their advisers. As mentioned in the Introduction of the Revised UK Corporate Governance Code, the Code does not set out a rigid set of rules – it offers flexibility through ‘comply or explain’ provisions and associated guidance. It rightly encourages companies not to adopt a ‘tick-box approach’ but to move towards thoughtful discussion with investors about their unique challenges and corresponding governance arrangements.

We are encouraged by the strengthening of the employee and wider stakeholder voice within this revised governance framework. These are considerations that successful companies are already aware of. We are particularly sympathetic to strengthening the role of employees within governance arrangements and specifically giving the workforce a greater voice in boardrooms. We believe that elected employee directors could be beneficial in many circumstances. Employees are the providers of human capital on which companies depend. Fostering a closer partnership between management and the workforce is desirable and should support greater employee engagement and morale, which should lead to higher productivity. For this reason, we also welcome the inclusion of diversity considerations, particularly among senior management and the board in the revised Code.

Remuneration practices are an important factor in aligning the activities of management with a company’s purpose, strategy and performance. While not a panacea, we do believe that the signals sent through well-structured remuneration packages can be an important ingredient to aligning the interests of management with shareholders and other stakeholders. As mentioned in our response to the Corporate Governance Reform Green Paper², public companies – as their name suggests – ultimately need a social licence to operate. It is appropriate that the views of wider society are reflected within them. In this context, we suggest that company chairs should write annually to their workforce to explain and justify remuneration arrangements. Furthermore, we agree with widening the remit of the remuneration committee. The Hermes remuneration principles³, which are attached as an appendix, discuss how pay practice should cascade down the organisation and should help to inculcate the desired culture. The remuneration committee is best placed to oversee congruity in the whole organisation’s pay philosophy and practices.

The UK Stewardship Code, when introduced, was pioneering, and the FRC should be proud to note that it has been the catalyst for the proliferation of Stewardship Codes globally. However, we should recognise that the Stewardship Code has not fully fulfilled its purpose. Investment firms, whom are committed to and have invested substantial resource into acting as engaged stewards of their investee companies, are not rewarded in the market. The aspiration therefore that market forces will drive behavioural change remains a hope rather than a reality. For that reason, we believe that it is time to overhaul the UK Stewardship Code more broadly, and the implementation of the Shareholder Rights Directive of the European Union provides a good opportunity to renew and expand the scope of application of the Stewardship Code.

There are many lessons that can be learned from the success and continued evolution of the Corporate Governance Code when considering the future direction of the Stewardship Code. In particular, the recent recognition of the importance of a company defining and articulating its purpose has particular resonance for the actors in the investment chain. It is important to acknowledge that institutional investors owe a duty to deliver holistic returns to their clients, and ultimately to their underlying beneficiaries, as opposed to investee companies. It is, however, only through acting as stewards of the companies and assets in which they have invested clients’ monies that they can properly fulfil this duty.

If you would like to discuss any of these comments further, then please feel free to contact Roland Bosch at roland.bosch@hermes-investment.com

² Hermes response to Corporate Governance Reform Green Paper, February 2017, attached to this consultation as Appendix I.

³ Hermes Remuneration Principles: clarifying expectations, November 2016, attached to this consultation as Appendix II.

Yours sincerely,



Roland Bosch
Associate Director, Hermes EOS



Leon Kamhi
Head of Responsibility, Hermes Investment Management

UK Corporate Governance Code and Guidance on Board Effectiveness Questions

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

The proposed Code will apply to accounting periods beginning on or after 1 January 2019. This means that companies will not be required to report against the new Code until the second quarter of 2020. This should give companies sufficient time to respond to the proposed changes to the Code.

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

The Code is supported by the Guidance on Board Effectiveness (the Guidance), which assists boards when applying the Principles. As mentioned in the introduction to the Code, it does not set out the 'right way' to apply the Code, but it is intended to stimulate thinking on how boards can carry out their role most effectively. We have no specific comments on elements of the revised Guidance, beyond those made in subsequent responses (see Q3 and Q13).

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

In order to succeed in the long-run, companies need to effectively manage relationships with key stakeholders and have regard for the environment and society as a whole. Successful companies not only create sustainable value for their shareholders, but also benefit stakeholders, the wider economy and the society in which they participate.

For most, if not all companies, employees are not only a critical stakeholder but also a vital partner in value creation. We think it is worth noting that this special status of employees was recognised in the 1985 Companies Act, wherein s309 of the Act specified explicitly that directors of a company were to have regard to the interests of a company's employees, as well as the interests of shareholders. We therefore welcome the introduction of Provision 3, which will give the workforce a greater voice in the UK governance arrangements.

Employee representatives are likely to bring first-hand experience of the company and its business model and have a real stake in its long-term success. In addition, it is our view that the success of a company is very commonly predicated on a strong ethical culture, particularly a motivated workforce. The additional insights that an employee-director can bring to board discussions, not least in his or her perspectives on the cultural norms, could result in better discussions and decisions in the interests of the company's long-term success.

Our preference would be for the Code to recommend that boards include employee representation. Under 'comply or explain' companies have the ability to explain why employee representation may not be appropriate for them and describe how instead they ensure that the employee voice is heard and given appropriate weight within board discussions on a full-range of matters.

We would encourage the FRC to include some specific guidance within its Board Effectiveness Guidance which addresses the matter of non-independent board directors – this could encompass, among other matters, shareholder nominated directors as well as employee-elected directors. Illustrating existing best practice would help dispel some of the concerns, and re-emphasising the desire for collective responsibility would help clarify that the duties of all directors remain uniform – that is that they owe a fiduciary duty to the success of the company, in the interest of its members.

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 expect companies to assess the relevance of each Sustainable Development Goal (SDG) to their business and to consider how best to incorporate those which may be material or salient into their business models and strategies. We encourage companies to report on how they support the SDGs and encourage them to engage with civil society on how best to respond to them. However, we do

not believe that the UK Corporate Governance Code is the appropriate place to include an explicit reference to the SDGs. Instead, it may be appropriate to consider a reporting requirement against the SDGs in the Strategic Report.

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

We support the new provision in the Code that asks companies to respond – within six months – to significant votes against a resolution. This response should include an update on further engagement with shareholders and follows upon the original acknowledgement of dissent in the AGM results announcement.

This update should also apply to resolutions, which have been withdrawn prior to the shareholder vote and/or requisitioned resolutions, which do not have board support. The new provision recognises the GC100's and Investor Group Guidelines' definition of 20% as a significant percentage of votes against.

Although 'votes withheld' (abstentions) are not votes in law, some investors consciously withhold their vote to indicate their lack of support for a resolution. Companies should therefore consider viewing votes withheld (in combination with votes against) exceeding 20% as also indicating a low level of support from investors to be addressed in the same fashion.

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 general, we are supportive of the removal of all of the exemptions for those companies below the FTSE 350 in the current Code, as we believe the Code sets good practice, provides protection for minority investors in listed companies and that even smaller companies should strive for the highest standards of corporate governance. However, the removal of these exemptions should be seen in the context of 'comply or explain' to account for the changes required of these smaller companies. Some boards of certain type of smaller companies may consider these provisions – in particular where there would be a need to recruit additional non-executive directors – to be an unnecessary cost. There may be merit in emphasising, perhaps through the guidance, that small companies should consider setting out indicative timeframes as to when they expect to comply with certain provisions. Such an approach may encourage engagement and more meaningful explanations for non-compliance. Importantly, the removal of the exemptions will place a responsibility on investors and proxy-advisers to assess differing company approaches thoughtfully, while avoiding a rigid box-ticking approach – this may be an area that the FRC wishes to monitor closely.

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 are strong supporters of the 'comply or explain' principle. However, this requires companies to provide good quality explanations when they describe deviance from provisions of the Code. It also requires shareholders and their advisers to take proper account of these explanations.

Unfortunately, the proxy voting agencies have often interpreted the nine-year provision as a hard rule, with their standard policies often leading to automatic votes against the re-election of directors who have served more than nine years, no matter how good the explanation. Many investors, as a result of needing to systematise voting at many hundreds of company meetings, vote in line with their advisers' standard, making it difficult for companies who wish to explain their decision to consider the director independent, as such a director will typically receive a large vote against his or her re-election. However, companies often do not help themselves by using boilerplate language in their governance statements, which fails to provide a cogent explanation. We believe that companies should endeavour to improve their explanations and investors and their service providers should also be more willing to accept them when they are more convincing than the boilerplate that is often written.

The current nine-year provision is an arbitrary period and we would have no objection to it being extended at least for one or two directors, particularly because, as we have noted above, 'comply or explain' is not working very well in this area. Having one or two directors with greater than nine-years' tenure, particularly at complex companies, can strengthen a board, as their knowledge of corporate history through the business cycle can be very valuable. The intention of the nine-year provision was, at least in part, to reduce the number of boards at which there was a cohort of long-tenured directors that raised significant questions about the board's independence and willingness to evolve. This seems much less of a problem to us than when the Code was first introduced, and we are in danger of creating a problem of insufficient experience on boards through too rigid an application of the nine-year provision. Average tenure does not solve the problem, as a board of a number of long-tenured directors together with a group of new directors may indicate power and influence is concentrated in a small number of directors.

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

We believe that the 'comply or explain' principle has served governance in the UK well and introducing hard rules alongside 'comply or explain' may exacerbate the problems described in our response to Q7 – that too many investors, often because of their advisers, are currently interpreting the provision as a hard stop, regardless of the quality of the explanations or the composition of the board as a whole. Imposing a maximum period may undermine the 'comply or explain' philosophy and all parties should seek to make 'comply or explain' work better.

Q9. Do you agree that the overall changes proposed in Section 3 of the 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 believe that diversity of views, ways of thinking, background and experience leads to better decision making. We therefore welcome the proposed changes to Section 3 of the revised Code. The wide criteria used to describe aspects of diversity are important. We believe that such diversity should enhance boards and senior management. We recommend that the Code extends the definition of senior management to include the direct reports of the executive committee, which provides a wider cadre of management to report on, giving investors and others a better insight into the company's diversity. The Code should help to encourage even those companies that are at the forefront of trying to increase the diversity of their senior ranks. It should also act as a spur for greater effort among those that are less advanced. We therefore welcome the changes.

We agree with the inclusion of specific reasons why a director should be re-elected in Provision 18. Companies should honestly and fairly address any concerns regarding the suitability of directors, including when directors have prima facie concerns over their own independence for any reason. This should be done without the use of boilerplate language that provides no insight to investors – who often decide on how to vote solely based on this disclosure.

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 the extension of the reporting provisions as described in the revised Code. We believe that what gets measured gets managed, and that British society – and so British business – needs to address the frequent lack of gender and other diversity at senior management level. If companies outside the FTSE 350 do not have to report on this, the FRC will send a very poor message that will further increase mistrust of business among sections of society, threatening the social licence to operate of business as a whole.

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.

From the available data, lack of sufficient opportunity for some ethnic minorities, not only in senior levels but in all levels, within many organisations may be an even worse problem than that based on gender, with employment rates far lower among some ethnic groups than others and a virtual absence from senior management and board positions for some ethnic groups.

We believe that companies should be tackling this issue. What gets measured gets managed and companies should therefore report on ethnic diversity. While we understand that there may be legal complexities and that data on ethnicity may have to be self-reported, this should not present a problem for the Code which is underpinned by a 'comply or explain' approach rather than hard law. We strongly believe that the Code should require, on a 'comply or explain' basis, the ethnic composition of companies' boards and senior management.

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?

Yes

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.

Similarly to all other board committees (including nomination and remuneration), we agree that the terms of reference should be referred to in the Guidance. Moving this provision helps to simplify the Code and shift the focus to applying the main Principles.

In contrast, we would like to see the current Code Provision C.3.5. related to financial whistleblowing to be maintained in the Revised UK Corporate Governance Code. Although a general mechanism for workforce whistle-blowing is included in Provision 3 of Section 1, audit committees of UK financial services companies have been given an extended role to oversee whistleblowing arrangements.

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 refer the FRC to the response in the Corporate Governance Reform Green Paper⁴, that we submitted in February 2017, that provided our views on remuneration and therefore on this and the following two questions in some detail. We agree with the wider remit of the remuneration committee in the provision. The Hermes remuneration principles⁵ discuss how pay practice should cascade down the organisation and should help to inculcate the desired culture. The remuneration committee is best placed to oversee congruity in the whole organisation's pay philosophy and practices. While some have expressed fears that remuneration committees will become executive in nature, we believe that good remuneration committees should already be taking these factors into account. We are happy for other committees of the board, provided that they are majority independent, to oversee some or all of this work, liaising with the remuneration committee as appropriate.

⁴ Hermes response to Corporate Governance Reform Paper, February 2017, attached to this consultation as Appendix I.

⁵ Hermes Remuneration Principles: clarifying expectations, November 2016, attached to this consultation as Appendix II.

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

To further increase alignment with long-term business success and stakeholder value, we proposed some solutions in our Hermes remuneration principles⁶. Executives should be incentivised to deliver strategic goals and be mindful of the company's impact on key stakeholders. This means strategic performance metrics to replace or complement total shareholder return (TSR) within incentive schemes alongside relevant metrics focused towards impact on stakeholders.

Above all, we believe that long-term ownership of shares in the company is the best way to achieve alignment with long-term sustainable performance. These shares should be held post-employment, with the shares being sold down no more quickly than a third on each anniversary of termination of employment. This would help engender greater long-term thinking.

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

We believe that the provisions should help. Boards and remuneration committees should not hide behind formulae when the results of pay schemes do not reflect the circumstances of the company. Remuneration committees sometimes score CEOs very highly on the non-financial aspects of their work even if the financial results are disappointing. Remuneration committees have to better explain their decisions when using qualitative assessments and not formulae. Boards should use the Code as a guide to action and seek views from shareholders through engagement, explaining their decisions in their disclosures.

UK Stewardship Code

The UK Stewardship Code, when introduced, was pioneering, and the FRC should be proud to note that it has been the catalyst for the proliferation of Stewardship Codes globally. However, we should recognise that the Stewardship Code has not fully fulfilled its purpose. Investment firms which are committed to, and have invested substantial resource in, acting as engaged stewards of their investee companies are not rewarded in the market. The aspiration therefore that market forces will drive behavioural change remains a hope rather than a reality. For that reason, we believe that it is time to overhaul the UK Stewardship Code more broadly, and the implementation of the Shareholder Rights Directive of the European Union provides a good opportunity to renew and expand the scope of application of the Stewardship Code.

We believe that our responsibilities as an investor do not stop with a decision to buy or sell a stock. Investors must act as engaged owners of the companies in which we are invested and the assets that we manage. This means acting as a steward – rather than simply a trader – of investments through constructive dialogue and taking action where necessary.

Independent academic research on our activity has shown that stewardship can have substantial effects on the financial results of engaged companies. An analysis of Hermes EOS' proprietary engagement data over the 2005 to 2014 period⁷ reveals that stewardship has the potential to decrease the downside risks of engaged companies.

Another study of Hermes EOS' engagement data⁸ has shown that successful and meaningful engagement with companies requires investor representatives to engage and interact with senior company executives and the board of directors. The research shows that personal, board-level

⁶ Hermes Remuneration Principles: clarifying expectations, November 2016, attached to this consultation as Appendix II.

⁷ Research Report: ESG Shareholder Engagement and Downside Risk – Hoepner, Oikonomou, Sautner, Starks, Zhou – January 2018 https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2874252

⁸ Research Report: Talk is not cheap – The role of interpersonal communication as a success factor of engagements on ESG matters – Wolff, Jacobey, Coskun–Sept.2017 - <https://www.hermes-investment.com/ukw/wp-content/uploads/sites/80/2017/09/Hermes-EOS-Research-Report-Sep-17.pdf>

interactions with the company substantially increase the chances of effective engagement success. We therefore think that the amendments to the Stewardship Code should encourage active engagement and not box-ticking.

Format

We believe that there should be a single Stewardship Code, which applies to the length and breadth of the investment chain and appropriately articulates the varying responsibilities of each constituent – in particular asset managers (AM), asset owners (AO) and investment consultants. A single Stewardship Code would have the benefit of drawing out how each agent, through their approach and activities, is aligned with the interests of the ultimate beneficiaries on whose behalf they are acting. A focus therefore, in the first instance, on developing principles which are applicable to all investment chain participants is important. We would suggest that these broadly applicable principles are in turn supplemented by tailored provisions which speak specifically to individual actors and are further supported by guidance in order to elaborate on what best practice can and should look like.

A new Stewardship Code should have the ambition to activate all participants in the investment chain to be best practice stewards in their areas of responsibility, thus the fostering of an active market for high quality stewardship. In recognition therefore of the very disaggregated asset owner base in the UK, we would emphasise the importance of considering and articulating the responsibilities of investment consultants as vital intermediaries, whose fiduciary duties should make them well positioned to support these aims.

Content

There are many lessons that can be learned from the success and continued evolution of the Corporate Governance Code when considering the future direction of the Stewardship Code. In particular, the recent recognition of the importance of a company defining and articulating its purpose has particular resonance for the actors in the investment chain.

Focus on purpose

We strongly encourage the FRC to translate this new emphasis within the Corporate Governance Code across to the Stewardship Code. If the Stewardship Code were to require every entity in the investment chain to clearly define its purpose, this would go a long way to addressing many of its criticisms. The disclosure of purpose should in turn be accompanied by an elaboration of an entity's governance – and, for non-asset owners, economic model, remuneration, incentives and fee structures. The economic model, in particular the entity's remuneration system, should support the entity's purpose and align its interests with those of its clients and beneficiaries. With respect to governance, it might be worthwhile for the new Stewardship Code to take into account some of the features of the UK Corporate Governance Code – the new aspects around stakeholder consideration should have particular resonance for agents in the investment chain.

Extend to fund level disclosure

Building on this logic, we suggest that individual investment funds should also be expected to set out within their fund documentation their non-financial objectives, ie their objectives beyond the narrow investment return objectives. Furthermore, they should explain how they view, intend to resource, carry out and report on their stewardship of investee companies and/or other assets. It is worth noting that it is individual funds, not fund houses, which are selected by investors. Therefore this additional fund-level focus is important in order to support the development of the market with stewardship considerations informing purchasing decisions. Similarly, for companies, it is often the managers of individual funds with whom they interact, and it is not uncommon for these interactions not to reflect the practices described within a parent firm's Stewardship Code statement.

Avoiding judgements on investment strategies

The focus of the Stewardship Code should remain on encouraging the constructive, long-term value orientated dialogue between investors and their investee companies. The Stewardship Code should avoid implicitly judging individual investment strategies – this judgement should be made by individual clients. There is scope for much greater clarity around each individual investment fund's approach to responsible investment in order to support a more competitive market. These are issues, however, that have been recognised by the European Commission and, to a lesser extent, by the FCA, and should sit outside the purview of the Stewardship Code. The Stewardship Code should remain principally focused on the ex-post investor-company relationship as opposed to the ex-ante investment process itself. Bodies such as the PRI and others are already addressing the latter.

Avoid a check-list of engagement topics

We strongly believe that the Stewardship Code should avoid developing a check-list of issues, be it on ESG or strategic issues, that investors should be expected to engage upon. Instead, agents in the investment chain should explain their approach to strategic, ESG and other issues rather than be limited by a check list.

The Stewardship Code should emphasise that investors should commit to engaging with companies in a substantive manner on those issues that are material to a company's long-term business model and its value creation. The materiality of issues are clearly dependent on the investee company itself, and the sector and geography it is operating in. Also, the materiality of these issues will be a judgement call for the individual fund managers, dependent upon their investment horizon, and this assessment should be informed by and be consistent with the investment objectives and purpose which they should be expected to set out within fund documentation. Overly prescriptive expectations regarding engagement topics could be detrimental to the overall effectiveness of constructive dialogue with investee companies and reduce the credibility of investors.

Focus on substance and outcomes

We believe it is important that the Stewardship Code recognises that it is not sufficient for investors just to report their stewardship activities. Rather, investors should report explicitly on how they undertake their stewardship responsibilities. This includes reporting about the type of interaction (eg meeting/email/call), the seniority levels, the specific issues, how the investor has collaborated with other investors and stakeholders, and, under certain circumstances, how it has escalated the engagement.

This is consistent with our view that stewardship needs to be undertaken in an evidence-based fashion – that is it must be informed by evidence on what makes stewardship effective and successful (see the academic evidence referred to previously).

Overall, we think that the Stewardship Code should explicitly expect signatories to explain (1) how stewardship activities help their organisation and specific funds to deliver on their purpose and (2) the experience and resources assigned towards stewardship and how this resource is integrated into the fund management proposition. That way stakeholders can determine whether, in their view, sufficient and appropriate resources are spent on stewardship, and that, for example, the mere attendance at a quarterly earnings call with an investee company is not counted as a substantive stewardship activity.

In our view, it will be important that the new Stewardship Code specifically requires investors to explain how they conduct stewardship. We suggest that the relevant entities responsible for carrying out company engagements set clear and measurable objectives when they initiate an engagement with a company. These objectives should be also specific and time-bound so that clients and beneficiaries can assess the progress made relative to those pre-defined objectives.

Investors should also report their engagement efforts through meaningful statistics and case studies on particular company engagements to underpin their premise to be good stewards.

Increase the expectations

While investment strategies may vary, we believe that stewardship is a responsibility of all authorised investment firms. As a result, we contend that it would be rational for the regulator (and government) to impose a clearer expectation on the investment chain to support corporate activities which are in its and the wider economy's long-term interests. To that end, we think that the Stewardship Code should move from its current 'comply or explain' model towards an 'apply and explain' model. The FRC should also give thought to the concept of a 'comply or delegate' model. If further attempts to foster a market for stewardship fail to result in meaningful behavioural change, then regulators may wish to intervene. We have previously suggested⁹ that, recognising that genuinely understanding and getting to know companies is difficult and costly, and one that few firms have been willing to shoulder, a market failure exists, and it may be right for government to correct this via the imposition of a levy on the investment industry to more adequately resource effective engagement.

The current shift towards low cost and passive investing makes the delivery of effective stewardship both more difficult but also more important. Effective stewardship is often the only means by which passive investment funds can express their discontent with a company's performance and ESG practices. Investment funds often do not have the option to exit large positions due to liquidity constraints in the market and, if they are passive index-trackers, some funds have the obligation to hold certain stocks. These trade-offs make an important argument for more effective and genuine stewardship for this particular type of investor and emphasises the need for tailored provisions for every constituent in the investment chain.

However, we are aware that exiting certain stock positions due to concerns about a company's future prospects is not necessarily a reflection of the failure of acting as a steward. Rather, exiting companies where engagement has been unsuccessful might simply be the inevitable action for investors to fulfil their fiduciary duties towards their clients and beneficiaries, given the resulting investment risk. This may be especially true when there is a long history of unsuccessful engagement with particular companies.

⁹ Hermes response to BIS Committee corporate governance inquiry, October 2016, attached to this consultation as Appendix III.

Appendix I

Hermes response to Corporate Governance Reform Green Paper, February 2017

Corporate Governance Reform Team
Department for Business, Energy & Industrial Strategy
3rd Floor Spur 1
1 Victoria Street
London
SW1H 0ET
Via email - corporategovernance@beis.gov.uk

17 February 2017

Dear Sirs,

Corporate Governance Reform Green Paper

Hermes Investment Management provides active investment strategies and stewardship. Our goal is to help people invest better, retire better and create a better society for all. We have been doing this since 1983, initially to manage the assets of our owner, the BT Pension Scheme, and more recently for a growing range of external clients, from institutions to advised private investors, comprising £28.6 billion of assets under management and £261.3 billion of assets under advice (relating to our stewardship service)

As an investment firm entirely owned by ordinary pensioners and focused on improving the lives of the millions of beneficiaries we serve we welcome the government's review of UK corporate governance. We would be delighted to discuss any of our points further should that prove useful as the government deliberates.

Executive summary

We believe that while there has been tangible progress over the last two decades in UK corporate governance, there remains room for improvement in order to ensure that governance structures are supporting long-term sustainable business success in the interests of both shareholders and wider society.

Remuneration practices are an important factor in aligning the activities of management with a company's purpose, strategy and performance. While not a panacea, we do believe that the signals sent through well-structured remuneration packages can be an important ingredient to aligning the interests of management with shareholders and other stakeholders. We believe that the prevailing model of executive pay has significant problems, not least an excess of complexity and an undue focus on short-term share price management. We suggest that pay structures need to be much simpler and less leveraged than they are at present.

The issue of high pay and indeed low pay within organisations and society cannot and should not be ignored. The question as to what is an acceptable and fair level of pay is a difficult one for shareholders to arbitrate but one that does need consideration and it is right for government to address it. Public companies, as their

name suggests, ultimately need a social licence to operate. It is appropriate that the views of wider society are reflected. To that end we support the proposal for disclosure of pay ratios but also suggest that this should be accompanied by additional insight into a company's human capital management practices. These might include a company's: workforce composition, level of employee turnover, investment in training and development, pay distribution and policy towards low pay. We suggest that a company chair should, making use of this context, write annually to their workforce to explain and justify remuneration arrangements.

We are encouraged by the discussion around strengthening the employee, customer and wider stakeholder voice within governance arrangements. These are considerations that successful companies are already very aware of. Equally however, in many cases we have seen these wider interests side-lined in the pursuit of short-term profits, ultimately to the detriment of the company's longer-term interests. We are particularly sympathetic to strengthening the employee's role within governance arrangements and specifically giving workers a greater voice in boardrooms. We believe that elected employee directors could be beneficial in many circumstances. Workers are the providers of human capital on which companies depend and fostering a closer partnership between management and the workforce is desirable and should support levels of productivity.

As investors in both public and private companies, we are very conscious that the ideals of good governance are not the preserve of public companies alone. We argue that for private companies, in particular those private infrastructure businesses providing an essential public service, the development of a clear best-practice code can only be beneficial.

Our aim is a sustainable economy which provides pension saving beneficiaries with not only a financial return but also a quality of life they deserve. While the duties of both investors and company directors are reasonably well-established in law, the time horizons of both parties are too often shortened and their vision narrowed. Policy changes which encourage companies and investors to consider their purpose and engage constructively with each other on important longer-term issues are to be welcomed.

We hope that in our response we have set out a number of ideas to support sustainably successfully companies as well as delivering savers with the holistic returns they need. We look forward to discussing these further over the coming months.

Yours sincerely,

A handwritten signature in black ink, appearing to read 'Saker Nusseibeh', with a long horizontal flourish extending to the right.

Saker Nusseibeh

CEO, Hermes Investment Management

Executive pay

1. Do shareholders need stronger powers to improve their ability to hold companies to account on executive pay and performance? If so, which of the options mentioned in the Green Paper would you support? Are there other options that should be considered?

- While it is incumbent upon us as investors to utilise our existing rights more effectively, we do see merit in toughening the existing voting regime.
- Care should be taken to not unintentionally usurp the role and responsibility of directors.
- We favour: a) an escalation mechanism whereby if a remuneration report fails to receive majority support then a further General Meeting would need to be called at which both a new pay policy and the re-election of the remuneration committee chair would be considered; b) an ex-ante approved cap on total receivable pay.

It is important to begin by acknowledging that the UK already has, arguably, the most extensive rights available to shareholders with respect to executive remuneration. Therefore, irrespective of whether investors should be granted additional rights, it is incumbent upon us as investors to utilise our existing rights effectively and in certain cases more forcefully than is common practice at present.

At Hermes we engage with investee companies globally and our experience is that the UK's system of a binding prospective policy vote and subsequent retrospective advisory vote has resulted in greater quantity and quality of engagement between companies and investors. The triennial policy vote has provided a safety valve against annual tinkering, an exercise which commonly results in pay inflation.

We recognise however, that the 2016 AGM season demonstrated that discontent remains and there remains scope for improvement, in particular with respect to the small number of companies who received majority votes against their remuneration reports with, to the outside view at least, no obvious repercussions. As a result we do see merit in toughening the existing regime.

In considering the potential options it is important to ensure that it remains clear that it is directors who are responsible for setting pay policies and for approving the subsequent outcomes. Shareholders have a responsibility in this area but care should be taken to not unintentionally usurp the role of directors.

As alluded to we are cautious about the potential inflationary impact of more regular policy votes and suggest therefore that the focus of any reform should be directed towards the existing advisory vote on the remuneration report. We think that this opens up two questions: 1) should there be explicit repercussions for a failed advisory vote, and 2) should this vote remain advisory.

The idea that discretionary incentive pay awards simply pay out irrespective of the outcome of a shareholder vote seems too lenient and at odds with public perception. In the first instance therefore, we suggest that there is merit in creating through regulation an escalation repercussion in those circumstances whereby if a remuneration report fails to receive majority support then a further General Meeting would need to be called within six months. This subsequent EGM could be expected

to consider approving a revised remuneration policy, and also could be expected to re-approve the re-election of the remuneration committee chair. We believe that this toughened escalation mechanism would focus the collective mind of the remuneration committee and provide a greater incentive for it to consult ahead of the AGM ensuring that any discontent is resolved ahead of time. The presenting of the two resolutions at the EGM has the added benefit of allowing shareholders to clearly convey whether it is a faulty policy or its implementation and the poor judgement of the remuneration committee that is the cause of discontent.

The above proffered solution we believe has the attraction of being an evolution of the existing regulations and retaining accountability with the directors. We recognise however, that the simplest solution may be to make the existing annual vote on the remuneration report binding. Such a change would sharpen even further the focus of both shareholders and boards on the real cause of discontent – the take home pay received. Constraining such a vote to discretionary variable pay outcomes would also avoid running into any contractual issues. In this scenario a company, if it were to lose the vote on its remuneration report, could be required to call a further General Meeting in relatively quick order with a suggested remedy. While the simplicity of this solution is attractive, we would be concerned that the result would be to transfer responsibility for executive pay away from a company's board of directors and towards its shareholders.

While we consider that strengthening the existing regime may be beneficial, evidence from Switzerland suggests that it may make little significant difference to pay practices. In order to tackle those minority of instances where total resultant pay from an approved policy for an individual has been significantly higher than foreseen by either the remuneration committee or shareholders, our recent pay paper (Remuneration Principles: Clarifying Expectations, Nov 2016) suggested that there is merit in introducing an ex-ante shareholder approved total cap on pay. We believe that requiring such a cap to be included within pay policies would go some way towards ensuring unforeseen circumstances are avoided and promote a shift towards simpler pay structures. As we set out in our paper, a radical simplification of existing incentive pay structures could we believe resolve many of the issues of concern.

In general, we caution against the creation of an ever extending list of votes on pay as this risks diluting accountability with the likelihood being that shareholder votes will be split between resolutions. We encourage companies (and indeed shareholders and commentators) to accept and become more comfortable with the reality that management may not receive 98-100% votes in favour of pay resolutions in future. Disparate views should be welcome and it is the job of the remuneration committee to use their judgement and be willing to be accountable for doing so. While this is not to suggest that boards should not be concerned by circumstances whereby a resolution is passed but receives a significant level of dissent, we do believe that arguably one of the causes of the current predicament is group think amongst investors which has in effect imposed a one-size fits all pay structure on companies.

- 2. Does more need to be done to encourage institutional and retail investors to make full use of their existing and any new voting powers on pay? Do you support any of the options mentioned? Are there other ideas that should be considered?**

- We support mandatory disclosure of voting records if accompanied by guidance to enable more consistency of format.
- Care needs to be taken to ensure that undue emphasis is not given to the vote at the expense of focusing attention on investors' stewardship efforts more broadly.

We agree that there should be mandatory disclosure of investment managers' voting records. While most large asset managers do already provide voting disclosures there is inconsistency of format and timing and therefore guidance may be beneficial in enabling clients and the public to more easily navigate and compare these records.

Asset managers have an implicit fiduciary duty to exercise these rights and should be accountable for doing so to their clients. For most firms, public disclosure is inexpensive and enables transparency to underlying savers, indeed the disclosures suggested are included as provisions within the UK Stewardship Code. In terms of enhancing the levels of investor accountability, we suggest that thought should also be given to encouraging investors to explain their voting records with reference to their voting policies and outcomes.

Care does need to be taken to ensure that undue emphasis is not given to the vote at the expense of focusing attention on investors' stewardship efforts more broadly. While the vote is an important right which should be exercised, it should be exercised intelligently. Often, a decision to vote against management is a last resort and arises after engagement with the company has failed. Public policy should be directed towards the fostering of more constructively engaged relationships between shareholders and boards. To that end, consideration of new disclosures in this area should also encourage more clarity around an investor's approach to and resources allocated to company engagement.

3. Do steps need to be taken to improve the effectiveness of remuneration committees, and their advisers, in particular to encourage them to engage more effectively with shareholder and employee views before developing pay policies? Do you support any of the options set out in the Green Paper? Are there any other options you want to suggest?

- We strongly caution against requiring remuneration committees to consult shareholders.
- We suggest that a company's chair should write an annual letter to their workforces to justify the CEO's pay in the context of wider pay practices and company performance.

It is right to identify the need for both companies and investors to be willing to engage in open and constructive dialogue on important governance matters, including on remuneration. In practice, it would be a rare instance that a remuneration committee chair did not seek to engage with their top 10 or 20 shareholders in advance of seeking approval at an AGM for substantive changes to their remuneration policy – those who do not engage in such a fashion commonly face the repercussion of a sizable vote against. As such, we strongly caution against the proposal to require remuneration committees to consult shareholders, such a requirement would likely

result in needless, meaningless and resource draining consultations on non-substantive matters.

We do believe that boards should think further as to how they can best incorporate wider company pay practices within their deliberations. While it is likely impractical to require a remuneration committee to consult the wider company workforce when preparing a pay policy for their executive management, we do suggest that a company's chair should write an annual letter to their workforces to justify the CEO's pay in the context of wider pay practices and company performance. We believe that the practice of writing such a letter could have a positive behavioural impact and bring the issue of fairness into sharper focus. This letter to the workforce could be expected to cover:

- An explanation and justification for how the pay structure and the resultant pay outcomes for the CEO are warranted given: a) the company's performance, and b) differing outcomes across the wider organisation;
- An explanation of the company's policy and practice towards paying living wages in the territories in which it operates;
- Statutory disclosures on Gender Pay;
- An explanation of the approach taken by the company towards gathering employee views;
- A graphical or tabular illustration of: a) the total pay awarded to the CEO and median pay for the wider workforce over a five plus year period; b) the pay distribution appropriately stratified across the workforce.

While we agree that it is good practice for the remuneration committee chair to have served at least 12 months in advance of succeeding as chair of the committee, this is a matter for best practice rather than regulation as some flexibility will be necessary.

4. Should a new pay ratio reporting requirement be introduced? If so, what form of reporting would be most useful? How can misleading interpretations and inappropriate comparisons (for example, between companies in different sectors) be avoided? Would other measures be more effective? Please give reasons for your answer.

- We support the publication of pay ratios as a 'hook' for wider workforce communications and ideally accompanied by a pay distribution curve.
- Companies should be expected to provide much more granular information around their human capital management practices including their annual workforce turnover, accident and fatality rates and results of employee surveys.

We support the publication of a pay ratio and suggest that the relationship between the CEO and median offers a sensible comparison, although there is also merit in a comparison with the national living wage in the territories in which it operates. A pay ratio will in of itself only provide limited information about pay practices and the treatment of employees across the wider company. We suggest therefore that a pay ratio should be used as a 'hook' for wider workforce communications – see our

answer to the question above – and that there may also be merit in the publication of a pay distribution curve – i.e. number of employees in bands by reference to total remuneration.

More importantly still, we would argue that the workforce remains opaque to the outside world. Although human capital is both a very significant cost for companies and a hugely critical asset it is very difficult for an investor to form a view as to how any individual company treats this asset and it is therefore absent from most company valuations. We believe that there should be an expectation that companies provide much more granular information around the composition of their workforce alongside, for larger companies, metrics disclosing the annual workforce turnover, accident and fatality rates and results of employee surveys.

We believe that over time these could provide interesting company specific insights. Investors are very used to looking at individual data points in a company and industry specific context and therefore the understandable concerns around mis-interpretation by investors are unwarranted – although undoubtedly companies will want to manage the external communication of this information to mitigate any reputational risk.

5. Should the existing, qualified requirements to disclose the performance targets that trigger annual bonus payments be strengthened? How could this be done without compromising commercial confidentiality? Do you support any of the options outlined in the Green Paper? Do you have any other suggestions?

- The excessive use of ‘commercial sensitivity’ should be discouraged.

We agree that existing Reporting Regulations should be tightened in order that ‘commercial sensitivity’ ceases to inhibit the disclosure of bonus targets after the reporting period. It can be (though not always) understandable that companies do not want to release targets at the start of the period. Frequent opacity in this area remains a frustration for investors and prevents an adequate assessment of whether an executive is being paid for performance.

6. How could long-term incentive plans be better aligned with the long-term interests of quoted companies and shareholders? Should holding periods be increased from a minimum of three to a minimum of five years for share options awarded to executives? Please give reasons for your answers.

- Our November 2016 paper, Remuneration Principles: Clarifying Expectations, advocated much simpler, more transparent and less-leveraged pay packages. It would be appropriate for the provisions within the Corporate Governance Code relating to executive pay to be toughened.

We do not believe it would be appropriate for the government or an individual regulator to intervene to dictate remuneration structures, this is a matter best resolved by company boards primarily with involvement by shareholders. Government should be mindful to avoid unintentionally driving or forcing particular structures upon companies which may have unintended consequences. That said,

we do believe that the prevailing model of executive pay amongst UK public companies has significant problems. In November 2016 we published a paper entitled: Remuneration Principles: Clarifying Expectations, in which we advocated that executive pay structures need to be much simpler and less leveraged than they are at present.

In our paper we identified five problems with the prevailing model of executive pay:

1. Excessive quantum and perceived unfairness: Research increasingly questions the marginal motivational gain from the award of additional pay. It is also doubtful that remuneration committees are always aware of the total potential value of the reward packages offered or able to justify the sums to the wider workforce or the public, the majority of whom regard the levels of pay awards as unfair.
2. Misalignment to long-term value: Pay structures are often highly leveraged and yet too predictably deliver a consistently high level of pay, with the average FTSE 100 bonus payout amounting to 75% of maximum and four out of five companies paying target levels of bonus every year. This suggests that target calibration is difficult and 'variable' or 'performance-linked' pay are misnomers. Additionally, the most common performance measures, relative total shareholder return (TSR) and earnings per share (EPS), can be volatile over the short term and achieved in ways inconsistent with the creation of long-term value.
3. Excessive complexity: Incentive schemes are too often overly complex, diminishing their ability to motivate and resulting in participants viewing them as little more than lottery tickets – although with some elements almost guaranteed to pay out. This, together with uncertainty of outcome, leads to a discounting of the value of possible awards by approximately 50% compared to fixed pay (see PwC's Making executive pay work: The psychology of incentives).
4. Weak accountability: The system of a binding vote on policy accompanied by an advisory vote on its implementation has not prevented a disconnection between pay and performance, particularly if the policy has not been scenario-tested in advance, is badly implemented or is not subject to discretionary adjustment. Moreover, remuneration-related disclosures are too often boilerplate in nature to reveal genuine insight or create board accountability.
5. Low levels of trust: Trust in general between remuneration committees and investors is low and among the public is lower still. While effective stewardship and accountability is needed along the ownership chain, this lack of trust is discouraging remuneration committees from exercising their judgement and discretion. Investors meanwhile too often fail to engage meaningfully and consistently or hold boards sufficiently accountable.

Hermes has long held the view that the best means of aligning the interests of executives and shareholders is through significant executive shareholdings maintained over long periods of time. This solution is however, not without its issues. The focus of management in some cases has become too heavily directed towards managing the company's share price at the expense of creating real economic value.

Similarly, this alignment with shareholders risks potentially eroding management's responsibility towards their workforce, with employees seen as commodities rather than partners in value creation; or towards society, with environmental impacts, if they come without a direct cost to the company, considered outside of the company's purview.

We therefore advocate a fundamental shift in the structure of executive remuneration packages towards much simpler, more transparent and less-leveraged structures. The combination of simplicity with increased certainty of outcome should result in lower average pay-outs without changing the value of the award in the minds of individual executives. Importantly, we believe that pay packages should avoid incentivising unintended behaviour and encourage the creation of sustainable value for all stakeholders - a shift away from a heavy reliance on performance related pay should assist with this.

Importantly, our Remuneration Principles have deliberately sought to avoid prescribing any specific pay structure and instead we encourage companies to come forward with proposals which are reflective of their strategies and business models. The shift in companies of all shapes and sizes to the current identikit pay structure is we believe associated with the problems identified and is something we should avoid.

Recognising the limitations of legislation in this area we believe it would be appropriate for the provisions within the Corporate Governance Code relating to executive pay to be toughened. In particular there should be more explicit expectations included around levels of shareholding, post-departure tail-risk and accountability.

Strengthening the employee, customer and wider stakeholder voice

7. How can the way in which the interests of employees, customers and wider stakeholders are taken into account at board level in large UK companies be strengthened? Are there any existing examples of good practice that you would like to draw to our attention? Which, if any, of the options (or combination of options) described in the Green Paper would you support? Please explain your reasons.

- For most, if not all companies, employees are not only a critical stakeholder but also a vital partner in value creation.
- We believe there are lessons that the UK can learn from other jurisdictions while maintaining our unitary board structure.
- We encourage a change to the Corporate Governance Code in order that employee board representation becomes a comply-or-explain requirement.
- We support the voluntary creation of stakeholder advisory committees, the composition of which should be determined by company boards.
- We encourage the FRC to revisit its Strategic Report guidance in order that reporting better communicates how directors have fulfilled their duties as set out in s172 of the Companies Act.

- We encourage further consideration to be given to the benefits of cascading an ownership culture throughout an organisation.

In order to succeed in the long-run, companies need to effectively manage relationships with key stakeholders and have regard for the environment and society as a whole. Successful companies not only create sustainable value for their shareholders, but also benefit stakeholders, the wider economy and the society in which they participate.

For most, if not all companies, employees are not only a critical stakeholder but also a vital partner in value creation. We think it is worth noting that this special status of employees was recognised in the 1985 Companies Act wherein s309 of the Act specified explicitly that directors of a company were to have regard to the interests of a company's employees, as well as the interests of shareholders. We encourage the government therefore to stay committed to its originally communicated objective of giving employees a greater voice in UK governance arrangements.

Getting behaviours right in a company and supporting and developing the potential of individual employees is crucial to improvements in productivity – something on which UK companies have performed poorly for some years. A motivated and more aligned workforce typically leads to a more successful company in the eyes of its customers, suppliers, employees, society and ultimately for its shareowners (see: The Materiality of Human Capital to Corporate Financial Performance, IIRC, April 2015; Edmans et al, 2011, "Does the Stock Market Fully Value Intangibles? Employee Satisfaction and Equity Prices", Journal of Financial Economics). Employee board representation could help with this but also should not be seen in isolation.

As a matter of good practice, boards should be composed of a diverse mix of individuals who collectively are more than sum of their individual parts. Board composition should be viewed through the lens of what expertise is needed on the board in order that today's and tomorrow's challenges are able to be appropriately debated and understood. Recognising this, we believe that an employee's views may be as valuable to this discussion as a capital markets or marketing expert.

Board members should regularly visit their operations, and where necessary the different geographies in which they operate, in order to gain insights into the day-to-day running of the business. Such visits however, typically only ever provide a snapshot, and likely sanitised, view of a company's day to day operations and as such is no substitute for genuine open communication channels, something which may be most impactfully achieved through board representation itself.

The representation of employees on company boards is common practice throughout much of Europe as well as in other international countries and we believe that there are undoubtedly lessons that the UK can learn from these jurisdictions while maintaining our unitary board structure. From our experience engaging with companies we have noted good, and bad, practices irrespective of the governance system. We have heard much positive anecdotal feedback from those directors who sit on boards which include employee representation, with many citing the different perspective as a positive contribution to a more holistic board discussion. Of course we have also heard critiques although these most notably stem from circumstances, as in Germany, when the employee representation becomes too dominant an element on the board and results in a confrontational board discussion as opposed to

a culture of collective responsibility – this is something which would need to be guarded against.

We encourage a change to the Corporate Governance Code in order that company boards are expected to include employee representation, ideally elected by the workforce globally. Importantly, elected employee directors (ultimately elected by shareholders alongside their fellow directors) should not be delegates of the workforce but instead introduce an employee's perspective to board discussions and help provide a bridge between workers and management. Employee directors would not be considered independent, would be a minority element of the total board, and critically would have the same fiduciary duty as their fellow directors to act in the interests of the company and not any one specific stakeholder.

We consider that the above would be far more desirable than the situation whereby an existing NED is designated with being the conduit to stakeholders. This recommendation risks absolving all directors of their existing responsibilities under s172 while failing to change the dynamics of board discussions and is one therefore that we encourage the government not to proceed with.

While for all companies employees are a critical stakeholder, we recognise that there are other important stakeholders whose interests should be considered by companies but for whom commercial realities would make board representation wholly inappropriate. We also recognise that, despite s172, it is difficult for those outside of a company at present to gain reassurance that boards are appropriately considering the interests of these parties when making decisions. To that end, we support the voluntary creation of stakeholder advisory committees, the composition of which should be determined by company boards. It would be important that the committee is able to request information from management, be adequately resourced by the company and be invited to discuss their agenda with the full board at least annually. The advisory committee could be expected to provide a public report of their activity annually, published alongside a company's Report & Accounts, and be invited to present this at the annual general meeting at which the committee's chair could be available to respond to questions.

More generally, we would encourage the FRC to revisit its Strategic Report guidance in order that associated reporting makes an explicit link to those provisions set out in s172. While the existing regulations (s414C) require companies, through the strategic report, to inform members of the company and help them assess how the directors have performed their duty under s172, there is no specific requirement to report specifically on how these issues have, or have not, been considered. As a result, the quality of reporting on these matters is variable. There are a number of opportunities within existing reporting structures to provide this content including the governance report, strategic report and the Chair's statement. We expect to see a company identify who its key stakeholders are, explain why these constituencies are important, and convey how consideration of their interests have informed board and management decisions and are aligned with supporting the company's long-term success.

Additionally, we encourage further consideration to be given to the benefits of cascading an ownership culture throughout an organisation in order to promote a positive unified culture and an alignment of interests between shareowners, management and the company. It is right that if the company succeeds then all

parties should be rewarded. Evidence suggests that when employees have a stake in the business they work for this contributes significantly to higher levels of commitment and productivity, results in more innovation and in turn better business performance (see *The Effectiveness of Employee Share Ownership: A Case Study of Siemens AG*, Wolff, M, 2015). Similar evidence finds similar relationships for employee engagement. As such, we would encourage the government to give further consideration as to how it might further incentivise employee share ownership.

8. Which type of company do you think should be the focus for any steps to strengthen the stakeholder voice? Should there be an employee number or other size threshold?

- It is not only public companies which have a responsibility towards wider stakeholders.

We agree with the premise of this question which is to say that it is not only public companies which have a responsibility towards wider stakeholders. We do not have a particular view as to whether an appropriate criterion should be an employee number or size thresholds as in either case it is easy to think of companies to whom such a requirement would be relevant but whom would not be covered. For example, it is possible that infrastructure businesses providing critical public services may neither be listed, nor large (by virtue of turnover or number of employees) enough to fall within the proposed regime. As such, it may be most appropriate to in the first instance pursue changes through voluntary codes.

9. How should reform be taken forward? Should a legislative, code-based or voluntary approach be used to drive change? Please explain your reasons, including any evidence on likely costs and benefits.

- We favour a code-based approach.

For the reasons described above we favour a code-based approach as this provides sufficient flexibility to cover a greater breadth of companies, can be tailored in such a fashion that additional or super-equivalent expectations are set out for particular constituencies of companies and can be reviewed and refined more regularly than legislation.

Corporate governance in large, privately-held businesses

10. What is your view of the case for strengthening the corporate governance framework for the UK's largest, privately-held businesses? What do you see as the benefits for doing so? What are the risks to be considered? Are there any existing examples of good practice in privately-held businesses that you would like to draw to our attention?

11. If you think that the corporate governance framework should be strengthened for the largest privately-held businesses, which businesses should be in scope? Where should any size threshold be set?

12. If you think that strengthening is needed how should this be achieved? Should legislation be used or would a voluntary approach be preferable? How could compliance be monitored?

- We support the introduction of a corporate governance code adapted for private companies.
- It is important to recognise that a one-size-fits all approach will rarely work, and indeed, the diversity of corporate forms and issues which would need to be catered for is large.

Society has a legitimate expectation that companies, irrespective of their form or financing structure, will be run responsibly in return for the privilege of limited liability.

At Hermes we invest in both public and private companies. In the case of private companies we may invest directly, at times taking significant stakes and often having board positions, or we may invest indirectly through other funds. Irrespective of our investment approach we have a consistent expectation that those companies in which we are invested have high standards of governance and operate in such a way that they are mindful of their impact on wider society.

In general, all companies, whether public or private, should be working on behalf of the beneficiaries who are invested in them, and so we support the introduction of a corporate governance code adapted for private companies.

It is worth acknowledging that there are already governance reference points for private investments – such as the Walker Guidelines for Disclosure and Transparency in Private Equity and the Institute of Director's Corporate Governance Guidance and Principles for Unlisted Companies in the UK; the former however, do not comprehensively cover the full range of governance best practice matters and the latter are not widely referred to or adopted. Similarly, specific governance principles already apply to certain regulated utilities, for example Ofwat's governance principles for water companies and Ofgem's requirements for gas and electricity companies. However, these principles self-evidently only apply to certain regulated sectors and clearly there are a much wider range of private businesses which have an impact on society because of either their size, economic contribution or function.

A large portion of the existing Corporate Governance Code is directed towards governance structures which aim to ensure that minority interests are protected. Many of these principal-agent issues will differ for private companies, however, equally certain expectations are translatable, in particular those around board leadership, effectiveness and transparency.

Hermes itself is a relatively small private company, however, as a strong public advocate of good governance we are mindful of the need to walk the talk. As a result we have adopted many of the expectations that we demand of investee companies and will be expanding further on the public disclosures we provide within our report and accounts this year.

In February 2017 we published a paper entitled *Corporate Governance of Public Service Infrastructure Assets*, which made the case for an enhanced corporate governance code for private infrastructure assets. Such a code we believe would help close the governance gap and ensure consistent and optimal outcomes for investors, employees and other stakeholders.

In terms of developing a new Code for private companies it is important to recognise that a one-size-fits all approach will rarely work, and indeed, the diversity of corporate forms and issues which would need to be catered for is large. For that reason, we believe that it may be desirable to develop and endorse, potentially through the guise of the FRC, a high level Code which would be applicable to all private companies of a certain size and which can be supplemented by tailored guidance for particular constituencies – for example smaller companies, larger complex private companies and infrastructure businesses providing an essential public service. Provisions of such a Code should we believe include:

Expectations for company boards:

- To have responsibility for agreeing strategy and risk oversight and ultimately the success of company;
- Have a clear division of responsibilities between day-to-day management and the board;
- Be led by an independent chair;
- The board's composition to include a significant independent element and an appropriate diversity of skills, backgrounds and perspectives;
- Have no singularly dominant individual with unfettered powers.
- Be subject to periodic board effectiveness review.

Additionally for those companies in which there is a legitimate public interest, there may be benefit in ensuring that the interests of key stakeholders, including end users, communities and employees take due prominence at board meetings.

The following options may warrant further promotion:

- An advisory committee including company management, shareholder directors/independent directors and involving a company's key stakeholders;
- Expecting such companies to set out their purpose, perhaps by defining within their articles their view of success (with an emphasis on long-term outcomes) or their essential service purpose;
- An expectation that remuneration is linked to matters other than financial returns (such as metrics related to environmental and social performance).

Transparency

Hermes encourages clear and transparent disclosure from the businesses in which we invest, both for the purposes of our own risk management and opportunity analysis and also because of the thought processes that such disclosure requirements prompt in executive management. We contend that:

- Making public reporting of key non-financial information a requirement for significant private businesses could reinforce accountability and good practice;
- Such reporting could include, for example, the key focus areas of any stakeholder committee.

13. Should non-financial reporting requirements in the future be applied on the basis of a size threshold rather than based on the legal form of a business?

In many cases we think it is appropriate that non-financial disclosure reporting requirements extend beyond large listed companies.

Other issues

14. Is the current corporate governance framework in the UK providing the right combination of high standards and low burdens? Apart from the issues addressed specifically in this Green Paper can you suggest any other improvements to the framework?

Broadly speaking we believe that the UK governance framework is operating well and is an asset to the UK that should be protected while opportunities for improvements continually assessed in order to ensure that the framework remains fit for future business models. To that end, we welcome this latest consultative exercise.

Appendix II

Hermes Remuneration Principles: clarifying expectations, November 2016

OUTCOMES
BEYOND
PERFORMANCE

REMUNERATION PRINCIPLES: CLARIFYING EXPECTATIONS

Hermes Investment Management
November 2016

For professional investors only

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HERMES
INVESTMENT MANAGEMENT

Remuneration practices are seen as key to aligning the activities of management with a company's purpose, strategy and performance. While not a panacea, we do believe that well-structured remuneration can be an important ingredient to delivering long-term business success and aligning the interests of management and other stakeholders.

Within this paper, directed primarily towards large publicly listed companies, we set out some proposals, which seek to practically improve existing executive director pay practices in the context of the current reality in order to better achieve their intended objectives.

SETTING THE SCENE

Much evidence suggests a relatively weak link between executive pay and company performance. The Executive Remuneration Working Group formed by the UK's Investment Association notes within its interim report, that while the FTSE is trading at broadly the same levels as 18 years ago, executive pay over the same period has more than trebled! Meanwhile, a growing number of studies suggest only a loose correlation, at best, between higher pay and performance.²

This divergence has been accompanied by shifts in the distributions of profits and thus a resultant increase in income inequality both within companies and across society more broadly. This is epitomised by the trend in the ratio of CEO pay to the average worker. While calculations vary and source data is not directly comparable, analysis has suggested that in the UK the ratio has doubled in a little over a decade from 70x in 2002 to 140x in 2015.³ This ratio is higher in the UK than it is in Germany or France,⁴ with the US the only major economy with a higher pay ratio which is in excess of 300x and rising.⁵

The phenomenon of rapidly rising rewards for top talent, while not limited to corporate executive pay,⁶ is beginning to threaten the public company's licence to operate and thus potential long-term value. Edelman's annual Trust Barometer indicates that the biggest "trust gap" of all institutions in the UK is between British business and its customers. This is reinforced by survey evidence⁷ suggesting that two thirds of the population believe executive pay is too high and 72% are angry as a result – it is no wonder that the UK's Prime Minister has indicated a clear intention to respond.

Significant regulatory change has enhanced the level of transparency and introduced triennial ex-ante binding shareholder votes alongside annual advisory ex-post votes. The level of shareholder dissent expressed on remuneration resolutions in 2016 illustrates, however, that investor dissatisfaction with existing remuneration arrangements persists. This dissatisfaction can be split into two categories: one, a lack of connection between pay and performance; and secondly a question over fundamental fairness and a company's social licence to operate.

With the triennial review of remuneration policy taking place at many UK companies in 2017 and further political action being considered in the UK and elsewhere, we believe there is a window of opportunity to encourage fresh thinking.

Based on recent experience, we believe the prevailing model of executive pay has significant problems, which include:

- 1 Excessive quantum and unfairness:** Research⁸ increasingly questions the marginal motivational gain from the award of additional pay. It is also doubtful that remuneration committees are always aware of the total potential value of the reward packages offered or able to justify the sums to the wider workforce or the public, the majority of whom regard the levels of pay awards as unfair.
- 2 Misalignment to long-term value:** Pay structures are often highly leveraged and yet too predictably deliver a consistently high level of pay, with the average FTSE 100 bonus payout amounting to 75% of maximum and four out of five companies paying target levels of bonus every year.⁹ This suggests that target calibration is difficult and 'variable' or 'performance-linked' pay are misnomers. Additionally, the most common performance measures, relative total shareholder return (TSR) and earnings per share (EPS), can be volatile over the short term and achieved in ways inconsistent with the creation of long-term value.
- 3 Excessive complexity:** Incentive schemes are too often overly complex, diminishing their ability to motivate and resulting in participants viewing them as little more than lottery tickets – although with some elements almost guaranteed to pay out. This, together with uncertainty of outcome, leads to a discounting of the value of possible awards by approximately 50% compared to fixed pay.
- 4 Weak accountability:** The system of a binding vote on policy accompanied by an advisory vote on its implementation has not prevented a disconnection between pay and performance, particularly if the policy has not been scenario-tested in advance, is badly implemented or is not subject to discretionary adjustment. Moreover, remuneration-related disclosures are too often boilerplate in nature to reveal genuine insight or create board accountability.
- 5 Low levels of trust:** Trust between remuneration committees and investors is at a low ebb and among the public is lower still. While effective stewardship and accountability is needed along the ownership chain, too often remuneration committees fail to exercise their judgement and discretion. Investors meanwhile too often fail to engage meaningfully or hold boards sufficiently accountable.

At the centre of the conundrum of how to tackle executive pay lies the fundamental question of why CEOs of public and private companies are paid so differently from the rest of their workforce and to those at the top of other professions. In most walks of life, employees receive an annual salary in monthly cash instalments and for some perhaps also a modest bonus.

¹ Executive Remuneration Working Group, Interim Report, April 2016.

² Are CEOs paid for performance? MSCI, July 2016; Executive remuneration in the FTSE 350 – a focus on performance-related pay, A report for the High Pay Centre from Income Data Services, October 2014.

³ Just Do It, High Pay Centre, 2015.

⁴ Remuneration: pay ratios, The good, the bad and the ugly, Kepler Cheuvreux, October 2014.

⁵ AFL-CIO Paywatch, 2015.

⁶ There is evidence that CEO pay in listed companies has not risen any faster than pay for others in the top 0.1% of earners in the UK and US, e.g. top sports people, entertainers, surgeons and lawyers, as referenced by PWC in their paper: Time to Listen, 2016, quoting work by Professor Martin Conyon, University of Lancaster and Wharton Business School.

⁷ Opinion research for PWC, June 2016, as reported in PWC paper: Time to Listen, June 2016.

⁸ The power and pitfalls of executive reward: A behavioural perspective, CIPD, December 2015.

⁹ PWC, Time to Listen, June 2016.

Running a public company brings with it the challenge of trust and alignment between the principal (the shareholders) and agent (the executives). Pay structures have evolved to help achieve the necessary alignment. Despite, or because of efforts to control this tension, pay has become complex and excessive while arguably failing to align or motivate. Despite the issues we have outlined it is striking that it is the US and UK pay model which is the precedent much of the rest of the world has or is moving towards.

Hermes has long held the view that the best means of aligning the interests of executives and shareholders is through significant executive shareholdings maintained over long periods of time. This solution is also however, not without its issues. The focus of management in some cases has become too heavily directed towards managing the share price at the expense of creating real economic value. Similarly, this alignment with shareholders risks potentially eroding management's responsibility towards their workforce with employees seen as commodities rather than partners in value creation; or towards society, with environmental impacts, if they come without a direct cost to the company, considered outside of the company's purview. While there are imperfections with the theory that all relevant matters will eventually be reflected within a company's share price it remains in our view the least worst measure of value creation, but one that necessitates company boards being mindful of what is not captured and communicated by the share price.

We believe it is also necessary to challenge the level of overall pay paid to some executives. Public companies, as their name suggests, ultimately need a social licence to operate. Given the responsibility that the CEO role entails it is appropriate that the individual should be paid commensurately. It is also the case however, that the role of CEO of a public company is a privileged one and an incumbent is often the recipient of many highly valued non-monetary benefits. Arguably these additional benefits have been increasingly monetised in recent years and anecdotal evidence suggests that the potential scale of monetary incentives now available may be crowding out more purpose-driven and desirable motivations.

We are therefore proposing a fundamental shift in the structure of executive remuneration packages towards much simpler, more transparent and less-leveraged pay packages. The combination of simplicity with increased certainty of outcome should result in lower average pay-outs without changing the value of the award in the minds of individual executives. Importantly, we believe that pay packages should avoid incentivising unintended behaviour and encourage the creation of sustainable value for all stakeholders, a shift away from heavy reliance on performance related pay should assist with this.

We also recognise that another conclusion might be to suggest that pay practices should be reversed and resort to the simpler models of the 1970s or 80s before commonly discredited ideas associated with classical economic theory influenced practice. This could mean a move to an even more radical option of paying senior executives an entirely fixed salary, based primarily on shareholdings together with a cash salary similar to today's levels. This would provide the ultimate in simplicity and transparency and should achieve long-term alignment. It would also recognise that no set of metrics fully reflects the complexity of managing an organisation, leaving the executives and board free to design and then pursue their strategy of choice. In our discussions with executives to date, this model is often seen as a breath of fresh air. The greater challenge to its more widespread adoption may be in dissuading those in the US and UK who can appear irrevocably wedded to high-leverage remuneration packages.

Importantly, the debate around societal fairness cannot and should not be ignored. It is appropriate that the issue is given due consideration by both companies and investors and that the views of wider society are reflected.

OUR REMUNERATION PRINCIPLES

During 2012, in conjunction with our owner the BT Pension Scheme, and along with the Pension and Lifetime Savings Association (formerly the NAPF), Railpen Investments and the Universities Superannuation Scheme, we published a set of Remuneration Principles for Building and Reinforcing Long-Term Business Success. Our proposition was that pay should direct management to behave more as engaged owners rather than short-term custodians of a business. The resulting success will ultimately be reflected in the long-term share price to the benefit of investors, management and the company.

Our Remuneration Principles deliberately sought to avoid prescribing any particular pay structure and instead encouraged companies to come forward with proposals which were reflective of their strategies and business models. Therefore, the shift in companies of all shapes and sizes to the standardised identikit pay structure described above, which is associated with the problems already identified, has been disappointing.

EFFECTIVE STEWARDSHIP

Given the deep concerns of stakeholders over executive pay in many jurisdictions, it is in the interests of companies and investors to resolve the tensions. To do so requires all parties to engage constructively and be willing to make demonstrable change. To date, public policy has put responsibility firmly on investors to regulate and control executive remuneration and this looks set to continue, following proposals to introduce a binding say-on-pay for annual pay awards. We, within the investment management industry, therefore must recognise our responsibility to engage with companies effectively as interested owners and, where necessary, use our shareholder rights collectively and consistently.

We believe our 2013 Principles have enduring value and relevance across markets. Through this paper we want to reassert the Principles and clarify more explicitly how we believe companies may implement them. Importantly, we stress that pay structures, no matter how well devised, cannot substitute for the leadership by the board and management.

OUR REMUNERATION PRINCIPLES

- 1 **Shareholding:** Executive management should make a material long-term investment in the company's shares
- 2 **Alignment:** Pay should be aligned to long-term success and the desired corporate culture
- 3 **Simplicity:** Pay schemes should be clear and understandable for both investors and executives
- 4 **Accountability:** Remuneration committees should use discretion to ensure that awards properly reflect business performance
- 5 **Stewardship:** Companies and investors should regularly discuss strategy, long-term performance and the link to executive remuneration

CLARIFYING EXPECTATIONS

Our Remuneration Principles are intended to guide remuneration committees towards better designed pay arrangements. In addition, we hope that investors and their investee companies will recognise that they each have stewardship responsibilities which necessitate a greater level of constructive engagement and recognition of the wider impact of decisions.

Below we emphasise a few points for particular consideration which are directed towards resolving the causes of dissatisfaction we identified. In addition, in order to provide greater colour to the type of pay structure these principles describe we have set out in more detail what a model pay structure could look like.

Alignment with long-term business success and stakeholder value:

- 1 Pay structures should be much simpler and less leveraged than at present, for example higher fixed pay and a single incentive scheme
- 2 Executives should be incentivised to deliver strategic goals (as opposed to TSR) and be mindful of the company's impact on key stakeholders
- 3 Pay awards should reflect the outcomes for long-term investors and not be blind to erosion in company value
- 4 Pay packages should be aimed at enabling executives to accrue wealth generation achieved as ongoing owners and in support of the company's longer-term success
- 5 Pay schemes should recognise that the timeframes of executive tenure are commonly shorter than the timeframes of accountability for their decisions, which are much longer

Fairness:

- 1 Remuneration committees, guided by the UK Corporate Governance Code's guidance to "avoid paying more than is necessary" should take a more robust view on pay, utilising and being accountable for exercising their judgement
- 2 The potential outcomes of a pay policy should be rigorously scenario-tested with a published cap on total pay opportunity agreed in advance
- 3 Boards should be able to justify to the workforce and the public the rationale for pay awards to management, if they are not able to do so convincingly then directors should use their discretion to make adjustments
- 4 Engagement by investors coupled with and reinforced by voting is likely to be the most effective means of bringing about positive change
- 5 Investors should demonstrate that their policies can be evidenced through their voting. They should not be supportive of capital distributions which do not support the company's long-term success and should hold individual directors accountable for questionable pay policies or approving inappropriate outcomes

Existing problem	Our Principle	Proposed solutions
Excessive quantum	Shareholding	<ul style="list-style-type: none"> ■ Less leveraged pay packages composed of higher levels of fixed pay which include a significant proportion of salary paid in shares (together with individual personal share purchases) ■ An approved ex-ante total cap on overall pay as well as for individual components
Misalignment to long-term value creation	Alignment	<ul style="list-style-type: none"> ■ Strategic performance metrics to replace TSR within incentive schemes alongside relevant metrics focused towards impact on stakeholders ■ Remuneration committees to adjust pay outcomes in light of both relative and absolute TSR performance. Incorporating one or both as an underpin may be appropriate ■ Tail-risk built into pay structures, for example sales of shares restricted to a third per year post departure
Excessive complexity	Simplicity	<ul style="list-style-type: none"> ■ Single incentive scheme structure reflecting primarily strategic goals, together with operational and personal objectives
Weak accountability and unfairness	Accountability	<ul style="list-style-type: none"> ■ More ownership of and accountability for pay outcomes, including greater use of discretion ■ Publication of a pay ratio and associated policy illustrating CEO to wider workforce pay ■ Chair to write annually to the workforce explaining the CEO's pay award in the context of company performance and pay practices at the company and elsewhere
Low levels of trust	Stewardship	<ul style="list-style-type: none"> ■ Greater quality engagement along the entirety of the ownership chain with consideration of fairness

Time for change

We strongly believe the time is right for companies and investors to fundamentally rethink their approach to executive remuneration.

We are encouraged that many of the ideas we suggested in 2013 are re-emerging and are confident that there is now a significant appetite for change among many to consider how they may more closely align pay

with the interests of their long-term owners, as well as broader society, in order to restore trust and position themselves best for future success.

We stand ready to work with companies to support efforts which we believe are in the interests of the company and their long-term shareholders.

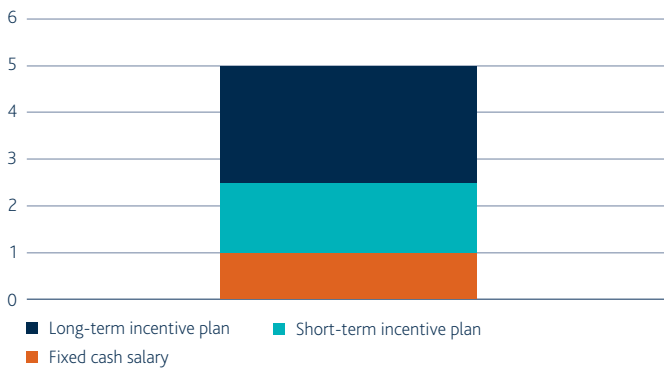
Hermes Remuneration Principles in practice: promoting the long-term success of the company while avoiding paying more than is necessary

Below is an illustration of the type of structure which we encourage companies to consider.

Illustration of a new structure	
Component	Features and rationale
Fixed pay	<p>An increase in fixed pay with the portion of variable pay typically "always paid" transferred into a fixed alignment share award:</p> <ul style="list-style-type: none"> ■ That portion of the incentive pay opportunity should in turn be significantly discounted (~50%) in acknowledgment of the increased certainty of the award. This will result in executives receiving an annual cash salary plus an annual share award ■ The alignment shares to be held for the longer of either: a) until minimum shareholding requirements have been achieved (500% of salary for a larger company) or b) 5 years
Variable pay	<p>A shift to a simplified single incentive scheme which combines today's existing short-term and long-term incentive schemes and which has genuinely variable outcomes:</p> <ul style="list-style-type: none"> ■ Awards based on a review of performance (looking back over at least a 12-month period) against a transparent scorecard dominated by strategic goals relevant to the business and sector (>50%) and not including absolute or relative total shareholder return together with stretching operational and personal targets aligned to the fulfilment of the company's communicated strategy and its long-term sustainable success ■ Awards predominantly made in the form of shares although it may be appropriate to have a modest cash element (<25%) ■ The awarded shares to be held for the longer of either: a) until minimum shareholding requirements have been achieved or b) 5 years <p>An underpin included to align pay outcomes with outcomes for shareholders:</p> <ul style="list-style-type: none"> ■ An absolute TSR underpin to be included and relative TSR performance to inform the remuneration committee's decisions – both measures to operate on a three-year period with the remuneration committee adjusting awards as appropriate ■ Stretching goals and targets, with the genuine possibility of achieving zero or close to zero award
Overarching	<p>A significant shareholding requirement:</p> <ul style="list-style-type: none"> ■ Shareholding guidelines to increase with seniority – for executive directors shareholding guidelines to be a minimum of 500% of salary (for a FTSE 100 company), 300% for a FTSE 250 company and 200% minimum for all other companies and share ownership provisions to ideally be cascaded through the organisation ■ In addition to fixed and variable pay awards, executive directors should be expected to buy, out of their own funds, some shares annually to build up to the minimum shareholding requirement over a reasonable time horizon <p>Post-departure alignment through tail risk element built into the policy:</p> <ul style="list-style-type: none"> ■ Restrictions on the sale of shares below the minimum shareholding requirement post-departure (e.g. at a minimum 33% per annum over a three-year period) ■ Malus and clawback provisions with the remuneration committee given wide discretion over their enforcement <p>Benefits should not be used as a means to boost salary:</p> <ul style="list-style-type: none"> ■ Benefits arrangements such as those for pensions should be in line with the wider workforce (e.g. the same pension contribution as a percentage of basic salary)

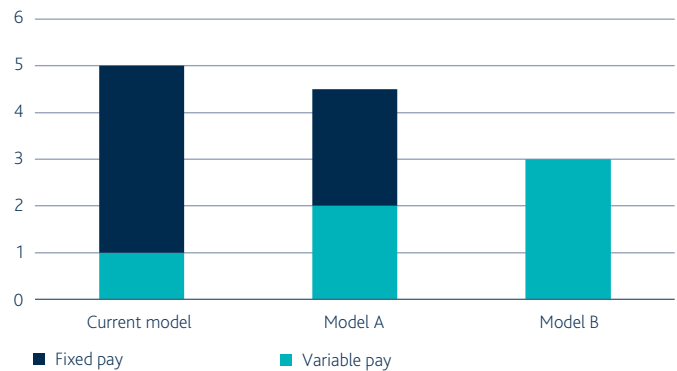
Additional new expectations	
Component	Features and rationale
Accountability	<p>Remuneration committees should own the policy and the outcomes:</p> <ul style="list-style-type: none"> Remuneration committees should use their discretion to adjust the formulaic outcome of remuneration policies. The committee chair should explain within their annual statement whether they have used discretion and if so, how and why Remuneration committee should retain overall discretion for decisions regarding good and bad leavers, with the default position that the awards lapse
Link to workforce	<p>Boards should not be blind to the implications of pay disparities between the CEO and other members of the executive team nor between the CEO and the wider workforce:</p> <ul style="list-style-type: none"> The chair of the remuneration committee should write annually to employees to explain the basis for the CEO's awarded pay for the current year vis-à-vis corporate and individual performance and wider pay changes throughout the company The chair of the remuneration committee should meet employees and take on board their views through appropriate representative fora and summarise this process within the remuneration report The company should publish and comment upon the ratio of CEO to median worker pay – comparing internally or externally

Figure 1: Current model – fixed: variable



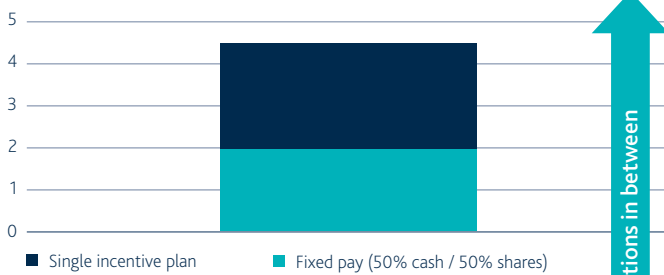
For illustrative purposes only.

Figure 3: The lower leveraged the package the lower the total quantum

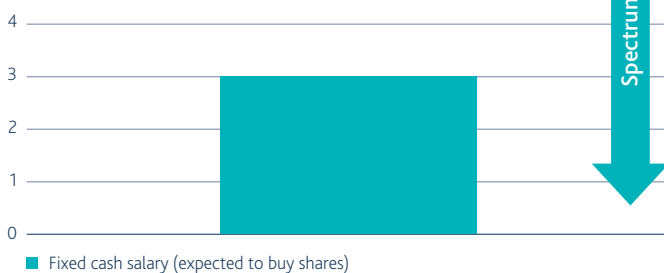


For illustrative purposes only.

Figure 2: Proposed model A – fixed: variable



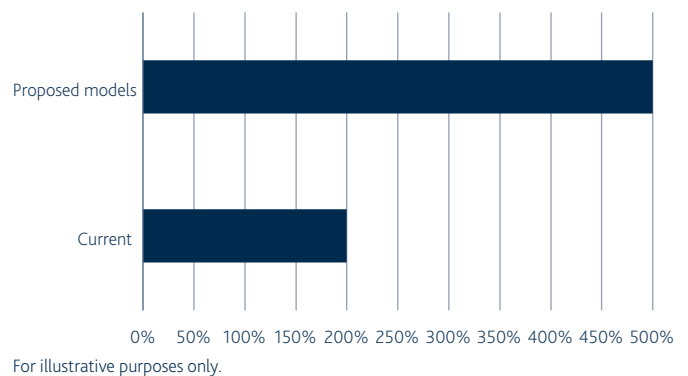
Proposed model B – all fixed



For illustrative purposes only.

Spectrum of options in between

Figure 4: Accompanied by extended shareholding guidelines



For illustrative purposes only.

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HERMES INVESTMENT MANAGEMENT

We are an asset manager with a difference. We believe that, while our primary purpose is to help savers and beneficiaries by providing world class active investment management and stewardship services, our role goes further. We believe we have a duty to deliver 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 goal is to help people invest better, retire better and create a better society for all.

Our investment solutions include:

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Appendix III

Hermes response to BIS Committee corporate governance inquiry, October 2016

Business, Energy and Industrial Strategy Committee

House of Commons

London

SW1A 0AA

26 October 2016

Re: BIS Committee corporate governance inquiry

Introduction

- By way of background, Hermes Investment Management is one of the largest asset managers in the City of London, and is wholly owned by the BTPS, one of the UK's largest corporate pension scheme.
- We manage assets on behalf of more than 330 clients across equities, fixed income, alternatives and real estate, with £28.6 billion of assets under management. Additionally, in Hermes EOS, we have the industry's leading stewardship service, advising on £237 billion of assets. As one of the world's largest stewardship service providers, Hermes EOS engages with around 500 of the world's largest companies across all major sectors and geographies on the full range of issues relevant to long term shareholder value. These include corporate governance, long-term strategy and key risks and opportunities, including those related to climate change.
- As an investment firm entirely owned by ordinary pensioners and focused on improving the lives of the millions of beneficiaries we serve we welcome the Committee's inquiry into corporate governance as we do the vision outlined by the Prime Minister of a country that works not for the privileged few but for all.

1. Executive summary

- 1.1. We believe that while there has been tangible progress over the last two decades in UK corporate governance, there remains much to do to ensure that companies are working in the long-term interests of the beneficiaries who own them.
- 1.2. Remuneration practices are an important factor in aligning the activities of management with a company's purpose, strategy and performance. While not a panacea, we do believe that the signals sent through well-structured remuneration packages can be an important ingredient to delivering long-term business success and importantly aligning the interests of management with other stakeholders. We believe however, that the prevailing model of executive pay has significant problems and as such we suggest that pay structures need to be much simpler and less leveraged than at present.
- 1.3. We also believe that the issue of quantum and the question as to what is an acceptable and fair level of pay cannot and should not be ignored. Public companies, as their name suggests, ultimately need a social licence to operate. It is appropriate that the question of

fairness is given due consideration and that the views of wider society are reflected. We suggest that a company's chair should write annually to their workforce to explain and justify their CEO's pay award in the context of company performance and pay practices at the company and elsewhere. Boards should after all be confident in justifying the rationale for pay awards to management to interested parties.

- 1.4. We are also encouraged by the discussion around employee representation in the UK corporate governance framework and support mechanisms to give employees and other key stakeholders a greater voice within boardrooms. Workers are the providers of human capital on which companies depend as well as ultimately the providers of financial capital through their savings and pension schemes. Presently however, too often the interests of employees are side-lined in the pursuit of short-term targets. We believe that at the very least the Corporate Governance Code should be revised in order that it communicates a clear expectation that greater stakeholder, and in particular employee, voice and representation is provided for within board decision making processes.
- 1.5. Our aim is a sustainable economy which provides beneficiaries with not only a financial return but also a quality of life they deserve. While the duties of both investors and company directors are reasonably well-established in law, the time horizons of both parties are too often shortened and their vision narrowed.
- 1.6. We set out a number of ideas to bring greater visibility and accountability to a director's fulfilment of their responsibilities towards wider stakeholders. We also recognise however, the responsibility of us in the investment industry to consider and engage constructively with companies on these important longer-term issues.
- 1.7. While things are moving in the right direction, global capital is still not managed in a way that takes responsibility for shaping society seriously. We must think of the holistic nature of the investment returns we are generating and how the non-financial and real world impacts, as well as the financial aspects, are aligned with the objectives we are tasked with delivering.
- 1.8. It is right to acknowledge that genuinely understanding and getting to know companies is difficult: it involves a cost, and one that few firms have been willing to shoulder. We contend that a market failure exists and we believe it would be right for government to intervene to correct this via the imposition of a levy on the investment industry to more adequately resource effective engagement with UK companies.

2. Directors Duties

- 2.1. In the UK there is no distinction in law between the duties of a non-executive and an executive director. This is because the UK has a unitary board structure within which the board makes collective decisions with due reference to their duties. For public companies, the directors, acting as agents of the enterprise, and therefore of shareholders, protect the interests of the shareholders, as the owners of the company. In turn, shareholders are afforded many rights within law including the ability to elect individual directors and ultimately to remove the Directors by ordinary resolution and elect a new Board if they believe that the Board is not protecting or enhancing their interests sufficiently,
- 2.2. A directors' duty, as set out in the Companies Act is clear, it is towards the success of the company. While this duty, defined in section 172 of the Companies Act is understood to mean the long-term success of the company the day-to-day operation of capital markets too often shortens the time-horizons of company directors.
- 2.3. Despite the legal clarity, anecdotal evidence suggests that not all Directors are fully aware of their duties. This is reflected in the decision-making processes of boards, with short-term share price management too often prioritised over sustainable longer-term

success. This raises the question as to whether these duties are being appropriately implemented.

- 2.4. In order to succeed in the long-run, companies need to effectively manage relationships with key stakeholders and have regard for the environment and society as a whole. Successful companies not only create sustainable value for their shareholders, but also benefit stakeholders, the wider economy and society in which they participate.
- 2.5. We believe that doing well economically in the long-term and behaving ethically and responsibly are not mutually exclusive and indeed is not discouraged by an accurate reading of the law as it stands.
- 2.6. As a minimum we suggest that it is appropriate that companies are open about and prepared to discuss the impact of their activities. While the quality of corporate reporting on environmental, social and governance matters has moved on significantly in recent years, it remains variable. There remains particular opaqueness with respect of the level of disclosure given to a company's interactions with key stakeholders such as its employees. Furthermore there is commonly little connection made between these disclosures when provided and a director's duty to consider the long-term consequences nor have regard to these wider interests. We suggest that the Financial Reporting Council (FRC) adjust its Strategic Report guidance to encourage better practice in this area, in particular, making the link with the considerations outlined in section 172 of the Companies Act. Improvements in corporate reporting would help join the dots more explicitly between a company's operations and strategy and the duties of its directors to consider the interests of wider stakeholders.
- 2.7. The system of corporate governance that operates in the UK is reliant upon a chain of accountability. Executives should be overseen and challenged by non-executives. Directors should be open to engagement with their shareholders and in turn shareholders should hold directors and ultimately the chair accountable. Satisfactory engagement between company boards and investors is crucial to the health of the UK's corporate governance regime. Engagement and dialogue offers shareholders the opportunity to assess the quality of and gain insight into the effectiveness of a board member in order to determine whether they bring the requisite expertise or experience to appropriately challenge management. Alongside this, the annual election of directors is important in providing accountability to shareholders.
- 2.8. In our experience the UK's governance system works well, however, there is always scope for improvement. We believe that improved communication may enable shareholders to better understand how a board considers wider stakeholder interests.

3. Board composition

- 3.1. We strongly believe that boards need to be more diverse. Boards should be comprised of individuals with a diverse range of skills, knowledge and experience including the leadership skills to move the company forward, appropriate group dynamics, technical expertise to make informed decisions and sufficient independence and strength of character to challenge executive management. We support the long-term aspiration that boards, together with all levels of management, should broadly reflect the diversity of society, including across dimensions such as age, nationality, race and gender.
- 3.2. A genuinely diverse board with individuals regularly visiting operations in the different geographies in which the company operates should, in theory, be able to ensure that the full gamut of stakeholder's views are presented and discussed – including those of consumers and employees.
- 3.3. It is too often forgotten that it is ordinary workers who in addition to being the providers of human capital to a company also own the financial capital through their pension schemes. It is these individuals who work in the companies they own, they are the

citizens who live in the society shaped by the financial industry with their capital and the ultimate tax payers who bail out the system when it goes wrong. Recognising this context and acknowledging that the owners of capital have in recent years become increasingly disconnected, due to intermediation, from how their savings are invested we believe it is appropriate that employees be given a greater voice in UK governance arrangements.

- 3.4. We recognise that the representation of employees on company boards is fairly common practice throughout much of Europe as well as in other international countries. There are undoubtedly lessons that the UK can learn from these jurisdictions, although equally it is important to be mindful of the different environments in which these various systems of governance operate. We note that there are multiple academic studies which attempt to assess the impact of employee representation, however, given the lack of any meaningful comparator or control group we consider it impossible to draw any meaningful conclusions. From our experience engaging with companies we have noted good and bad practices irrespective of the governance system and have heard much positive anecdotal feedback from those directors who sit on boards which include employee representation.
- 3.5. The recent spotlight on diversity highlights the significant talent pools, for example women, which are presently underutilised. Getting behaviours right in a company and supporting and developing the potential of individual employees is crucial to improvements in productivity. A happier and more aligned workforce typically leads to a more successful company in the eyes of its customers, suppliers, employees, society and ultimately for its shareowners
- 3.6. In the first instance we favour a non-legislative approach to promote the inclusion of employees in governance structures. We briefly set out below three options that we believe are worthy of further consideration and which are not mutually exclusive.

Full board membership for employees

- 3.7. UK law already permits employee directors, however, there is just the single FTSE company which features employee representation. In order to shift current practice, the UK Corporate Governance Code could be amended to provide an expectation that board composition includes employee representation and associated guidance included within the FRC's soon to be updated board effectiveness guidance. Whilst we would not class employee directors as independent they would have the same fiduciary duty as their fellow directors to act in the interests of the company and not any one specific stakeholder.
- 3.8. The Code's criterion for board independence may need to be adjusted as would the stipulations around board composition and the guidance should be clear that the inclusion of a sole employee director should be avoided.
- 3.9. We note that UK pension schemes trustees are already required to ensure that arrangements are in place, and implemented, that provide for at least one-third of trustees, or at least one-third of directors of the trustee company, to be member-nominated. This we suggest provides an instructive precedent to consider and demonstrates the feasibility of introducing employee election mechanisms – it should also be noted that, unless changes are made to the Companies Act, employee nominated directors would also need to be subject to election by the shareholders.

Stakeholder advisory committees

- 3.10. We believe there is merit in considering further developments to the traditional board committee structure of UK companies. A new provision of the Corporate Governance Code could be introduced to encourage boards to establish an independent advisory stakeholder committee to the board.

- 3.11. These advisory committees would be composed of a company's key stakeholders. For all companies this would include a significant proportion of employee representation along with, dependent upon the nature of the company, representatives of suppliers and consumers along with legal, ethical or environmental experts. The advisory committee would be expected to provide a report of their activity annually to the board and would be structured in line with section 172 of the Companies Act. This report would be published alongside a company's Report & Accounts and could be the subject of an advisory vote of the shareholders (or other stakeholders). This would provide the additional beneficial disclosures that we describe above.

Employee ownership

- 3.12. We recognise the monetary and non-monetary benefits of cascading an ownership culture throughout an organisation in order to promote a positive unified culture and an alignment of interests between shareowners, management and the company. It is right that if the company succeeds then all parties should be rewarded.
- 3.13. Evidence tends to suggest that when employees have a stake in the business they work for this contributes significantly to higher levels of commitment and productivity, results in more innovation and in turn better business performance. As such, we would encourage the consideration of further incentives to promote employee ownership and in turn proposals could be introduced to provide for board representation of employee shareowners once a certain threshold is reached.

4. Executive pay

- 4.1. Much evidence suggests at an aggregate level a relatively weak link between executive pay and company performance. At Hermes we are cognisant that the phenomenon of rapidly rising rewards for top talent, while not limited to corporate executive pay, is beginning to threaten the public company's licence to operate and thus potential long-term value.
- 4.2. Running a public company brings with it principal-agent issues, and current pay structures have evolved as an attempt to reconcile the resultant tensions. Strikingly, the predominant US and UK model of fixed pay, annual bonus and a long-term incentive plan is the precedent much of the rest of the world has or is moving towards. Despite, or because of efforts to control this tension, pay has become complex and excessive while arguably failing to align or motivate.
- 4.3. Based on recent experience, we believe the prevailing model of executive pay has significant problems, which include:
- A. Misalignment to long-term value: Pay structures are often highly leveraged and yet too predictably deliver a consistently high level of pay, with the average FTSE 100 bonus pay-out amounting to 75% of maximum and four out of five companies paying target levels of bonus every year. This suggests that target calibration is difficult and 'variable' or 'performance-linked' pay are misnomers. Additionally, the most common performance measures, relative total shareholder return (TSR) and earnings per share (EPS), can be volatile over the short term and achieved in ways inconsistent with the creation of long-term value.
 - B. Excessive complexity: Incentive schemes are too often overly complex, diminishing their ability to motivate and resulting in participants viewing them as little more than lottery tickets – although with some elements almost guaranteed to pay out.
 - C. Excessive quantum and unfairness: It is doubtful that remuneration committees are always aware of the total potential value of the reward packages offered or able to justify the sums to the wider workforce or the public, the majority of whom regard the levels of pay awards as unfair.

- D. Weak accountability: The system of a binding vote on policy accompanied by an advisory vote on its implementation has not prevented a disconnection between pay and performance, particularly if the policy has not been scenario-tested in advance, is badly implemented or is not subject to discretionary adjustment. Moreover, remuneration-related disclosures are too often boilerplate in nature and fail to reveal genuine insight or create board accountability.
- E. Low levels of trust: Trust in business is at a low ebb . Effective stewardship and accountability is needed along the ownership chain, too often at present remuneration committees fail to exercise their judgement and discretion. Investors meanwhile too often fail to engage meaningfully or hold boards sufficiently accountable.
- 4.4. The role of CEO of a public company is a privileged one with significant responsibilities, which is why an incumbent is often the recipient of many highly valued non-monetary benefits. Arguably these additional benefits have been increasingly monetised in recent years resulting in a more rational and transactional perspective to be applied. While most CEOs undoubtedly have sound motivations, anecdotal evidence suggests that the potential scale of monetary incentives now available may crowd out more purpose-driven and desirable motivations. In addition, arguably the focus of management in some cases has become too heavily directed towards managing the share price at the expense of creating real economic or stakeholder value.
- 4.5. We believe it is healthy to question some of the fundamental principles around which pay schemes are currently designed. Can pay structures ever fully reconcile the twin objectives of linking pay to performance and aligning the interests of management with those of their long-term investors? If they can, is it possible to do so while recognising responsibilities towards wider stakeholders? Similarly, the issues around quantum and acceptable and fair levels of pay cannot and should not be ignored. Public companies, as their name suggests, ultimately need a social licence to operate.
- 4.6. During 2012 we, in conjunction with our owner the BT Pension Scheme, and along with the Pension and Lifetime Savings Association, Railpen Investments and the Universities Superannuation Scheme, published a set of Remuneration Principles for Building and Reinforcing Long-Term Business Success. Next month we will publish a paper which clarifies how we believe companies should apply our principles in order that pay is aligned with long-term success and the creation of both shareholder and stakeholder value while also meeting a fairness test. We suggest that:
- 4.7. Alignment and simplicity
- i. Pay structures should be much simpler and less leveraged than at present. We suggest that pay packages should be composed of higher levels of fixed pay, which includes a significant proportion of salary paid in shares alongside a single incentive scheme which is focused on the delivery of strategic goals (as opposed to relative total shareholder return) and is mindful of the company's impact on key stakeholders.
 - ii. Pay packages should be aimed at enabling executives to accrue wealth generation achieved as ongoing owners and in support of the company's longer-term success.
 - iii. Pay schemes should recognise that the timeframes of executive tenure are commonly shorter than the timeframes of accountability for their decisions which are much longer. As such executives should be exposed to an element of tail-risk post-departure for example through restrictions on the sale of shares to a third per year.

Fairness and stewardship

- i. Remuneration committees, guided by the UK Corporate Governance Code's guidance to "avoid paying more than is necessary" should take a more robust view on pay, utilising and being accountable for exercising their judgement.

- ii. Boards should be able to justify to their workforce and the public the rationale for pay awards to management, if they are not able to do so convincingly then directors should use their discretion to make adjustments. To this end, we recommend the introduction of an ex-ante shareholder approved total cap on pay and support the publication of a pay ratio and associated policy illustrating CEO to wider workforce pay. In addition, we believe that a company's chair should write annually to the workforce explaining the CEO's pay award in the context of company performance and also pay practices across the company and elsewhere.
 - iii. Investors should demonstrate that their policies can be evidenced through their voting. They should not be supportive of capital distributions which do not support the company's long-term success and should hold individual directors accountable for questionable pay policies or approving inappropriate outcomes.
- 4.8. Engagement by investors coupled with and reinforced by voting is we believe the most effective means of bringing about positive change. Our experience to date has been that the UK's system of a binding policy vote and subsequent ex-post advisory vote has resulted in greater quantity and quality of engagement between companies and investors and has provided a safety valve against annual tinkering.
- 4.9. The recent AGM season has however, demonstrated that discontent remains and there remains scope for improvement. While recognising that at present only a very small proportion (approx. 3%) of companies lose the advisory vote or repeatedly receive significant dissent there are limitations with advisory votes as demonstrated this year and as a result we are supportive of the proposed granting to shareholders of an annual binding vote on pay. Even with the additional rights, it will be incumbent upon us as investors to utilise our rights effectively and in certain cases more forcefully than is common practice at present.

5. Stewardship

- 5.1. In recent years there has been a near universal cry for more "long-termism" and more "stewardship". This has been welcome. To date however, despite the best intentions of many parties, the obligations on investment firms has not been addressed head on. We contend that any consideration about the purpose and governance of UK companies and the responsibilities of their directors should equally consider the duties and responsibilities of the investors invested in these companies.
- 5.2. While there is a need for accountability along the ownership chain, investors presently too often fail to engage meaningfully or hold boards sufficiently accountable. There is more that can be done to bring greater accountability to the relationship between underlying beneficiaries and their asset manager agents. Ensuring effective stewardship and accountability along the full length of the ownership chain would result in more trust and bring us closer to delivering the idea of enlightened shareholder value.
- 5.3. It is right to acknowledge that genuinely understanding and getting to know companies is difficult, it involves a cost, and one that few firms have been willing to shoulder. Effective stewardship – that is, acting as engaged owners of companies with the objective of supporting their longer-term success – is costly with the benefits accruing to all investors.
- 5.4. Evidence demonstrates that engagement results in sustainable out-performance which would benefit the investment industry's clients and the companies and economies in which they invest. While, Professor Kay Review asserted that within his 2012 review that stewardship is a core function of equity markets, we go further and suggest that its delivery is a public good. It is however, one that is not able to be adequately delivered through existing market structures. Thus a market failure exists which warrants intervention.

5.5. To correct this market failure we suggest the introduction of an explicit positive duty on investment managers and other providers of tax advantaged savings vehicles to undertake or otherwise ensure the good stewardship of the entities in which they invest. Additionally, we suggest that there is merit in the introduction of a cross-industry levy to finance a vastly enhanced, pooled stewardship capability. In order to promote behavioural change within asset management companies this levy could be designed in such a way that those managers that fail to deploy sufficient resources towards stewardship, or whose business models are incompatible with such resourcing, would pay a higher charge.

6. Conclusion

6.1. We look forward to engaging further with the Committee as it progresses its inquiry. If you would like to discuss any of these comments further, then please feel free to contact my colleague Will Pomroy at 020 7680 8042 or will.pomroy@hermes-investment.com

Yours sincerely,

A handwritten signature in black ink, appearing to read 'Saker Nusseibeh', with a long horizontal flourish extending to the right.

Saker Nusseibeh

CEO, Hermes Investment Management