Hermes Investment
Management Limited
1 Portsoken Street
London E1 8HZ
United Kingdom

Tel: +44 (0)20 7702 0888
Fax: +44 (0)20 7680 9452

www.hermes-investment.com

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,

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 snap shot, 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 Effective 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:

<u>Expectations for company boards:</u>

- 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.

<u>The following options may warrant further promotion</u>:

- 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).

<u>Transparency</u>

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.