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# CORPORATE GOVERNANCE PRINCIPLES

Canada

Hermes EOS  
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For professional investors only

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**HERMES**  
INVESTMENT MANAGEMENT

## INTRODUCTION

Hermes EOS believes, as a representative of responsible long-term shareholders, that the interests of its clients should be aligned with those of company management and boards. All parties should look to increase returns to shareholders sustainably over the long run. To this end, we strive to foster a collaborative and constructive dialogue with the companies in which our clients own shares.

Pressure from investors and regulatory reforms have helped to secure significant additional rights to enable shareholders to hold boards of directors to account. We support these developments as we firmly believe that additional shareholder rights can enhance the dialogue between companies and shareholders. Moreover, we engage with companies to ensure their commitment to sustainable long-term performance and success.

These principles are intended to help boards of Canadian companies to address the longer-term issues they should consider when performing their oversight role.

## BOARD INDEPENDENCE AND OTHER ATTRIBUTES

We believe a board of directors should comprise a majority of independent directors with an appropriate balance of relevant experience and expertise. These should have the demonstrable character and ability to represent the interests of all shareholders to provide challenge to management and oversight of the company. An independent director should have no direct or indirect material relationship with the company or its executives, should not be a representative of a significant shareholder nor have sat on the board for such a time as to compromise his or her independence of mind. In addition, the individual should have the character and ability to hold management to account on behalf of shareholders.

When planning for succession or refreshment, a board should be mindful of the company's strategy, the diverse nature of its activities, plans, employees, customers, other stakeholders and its own dynamics. We believe that most boards lack sufficient diversity to reflect the markets and communities in which they operate. They should address this by acknowledging the issue and taking positive action to resolve it. Boards should therefore consider the skill sets, experience, age, gender, background, ethnicity, nationality, as well as the other characteristics of possible candidates. We will not be able to support the re-election of the governance committee chair where there seems to be limited acknowledgement of the importance of diversity.

We engage with board members on strategy, business and reputational risk, as well as on environmental, social and governance issues that could affect sustainable performance and long-term value. Through our engagements we seek to understand, and where necessary challenge, the tone that boards set to foster appropriate behaviour and culture as entrusted stewards of the assets of our clients.

## COMBINED CHAIR/CEO ROLES

Although most Canadian companies have separate chairs and CEOs, at some, the two roles are held by the same individual. Having an independent chair is likely to be a better arrangement at most

companies than combining the roles. We believe that the chair should manage the board, while the CEO is responsible for managing the business. Combining the roles can confuse these responsibilities and overly concentrate power in one person, thus creating not only problems with oversight but also with accountability.

We therefore urge companies that continue to have a combined chair and CEO to appoint an independent chair to improve the effectiveness of board debate and accountability to shareholders. While we recognise that it may appear difficult to make changes in this respect, our expectation is that, no later than upon the succession of the CEO, the board should split the roles and appoint an independent chair for approval by shareholders at the subsequent AGM.

We may, on a case-by-case basis, support boards where one individual holds both roles, providing a permanent lead independent director is appointed and that individual has clearly defined authority and responsibilities including:

- A significant role in establishing board meeting agendas and information to the board
- Ensuring that the independent directors are satisfied with the performance of the CEO and provide their feedback and advice to him or her regularly
- Leading the process for board evaluation and succession
- Having the ability to call meetings of the independent directors and, if necessary, the full board.

From time to time, we request meetings with company chairs or lead independent directors. Meeting shareholders is a key part of the role of these individuals. Where this access is unreasonably denied, we may not support the re-election of these board members.

## MAJORITY VOTING

As required under Canadian and provincial corporate statutes, directors are elected by plurality vote. In 2012, the Toronto Stock Exchange (TSX) adopted rules requiring listed companies to ensure that their shareholders are able to elect directors individually and to provide full disclosure of the voting results for each director. In 2014, another listing requirement followed, which mandates all companies without a controlling shareholder to adopt majority voting in the form of a director resignation policy. Instead of a director resignation policy, we, however, urge companies to adopt a binding majority vote standard, to the extent allowed by law. We believe that electing directors is a fundamental shareholder right and thus prefer to have the opportunity to vote either for or against directors to the more cumbersome process by which the right to determine who is elected to the board is passed to the other directors, which tends to occur under director resignation policies.

## ACCESS TO THE PROXY

Federal and some provincial corporation acts permit shareholders holding 5% of outstanding shares to call a shareholder meeting to elect directors. The rules do not explicitly allow access to management's proxy, which inevitably leaves shareholders who want to nominate directors with no alternative but to initiate costly, distracting and divisive proxy contests.

While the right of access to the proxy should be exercised prudently, and within appropriate limits, it is important that shareholders have the ability to nominate candidates for election to the board. This right, together with majority voting, would ensure that the election outcomes are in line with the views of shareholders.

We encourage companies to voluntarily implement the necessary amendments to their by-laws and governance guidelines to facilitate the right of shareholder access to the proxy. In the absence of such provisions, we generally support shareholder proposals seeking this right where they advocate reasonable minimum levels of ownership. We believe that 3% of the outstanding shares, as opposed to the 5% suggested in some corporation acts, is the appropriate threshold to gain access to the proxy. We oppose management proposals that implement by-laws or shareholder rights plans that could interfere with the ability of shareholders to nominate directors to the proxy or elect new directors.

## CAPITAL STRUCTURES WITH UNEQUAL VOTING RIGHTS

Share structures with unequal voting rights disenfranchise minority shareholders by increasing the voting power of one class of shareholders with a disproportionately small equity stake. We encourage companies with multiple-class share structures to adopt the concept of one-share one-vote and only support initial public offerings of companies with single class structures that provide a level playing field for investors.

## EXECUTIVE COMPENSATION

We developed the Remuneration Principles for Building and Reinforcing Long-Term Business Success<sup>1</sup> with a number of pension funds to provide high-level guidance to companies regarding our expectations of their pay structures and practices. We have also developed our thinking on what this might mean in practice. These can be outlined as follows:

- Compensation committees should expect executive management to make a material long-term investment in shares of the businesses they manage.
- Pay should be aligned to long-term success and the desired corporate culture throughout the organisation.
- Pay schemes should be clear and understandable for investors and executives and ensure that executive rewards reflect long-term returns to shareholders.
- Compensation committees should use the discretion afforded to them by shareholders to ensure that awards properly reflect business performance.
- Companies and investors should have regular discussions on strategy and long-term performance.
- Total pay is often too high and pay schemes often seem to pay out significant sums despite a less good experience of shareholders and other stakeholders.
- Pay structures should be much simpler and less leveraged than they are at present, for example through the use of a single incentive scheme and lower variable and total possible pay.

- Executives should be incentivised to deliver strategic goals, as opposed to total shareholder return or stock price appreciation and to take account of the company's impact on key stakeholders.
- Pay awards should reflect the outcomes for long-term investors and take account of any erosion of the company's value.
- Pay packages should aim to make executives ongoing owners to support the company's longer-term success.
- Pay schemes should recognise that the timeframes of executive tenure are commonly shorter than the timeframes of accountability for their decisions. Accordingly, minimum shareholding requirements for directors should remain in place for a period of time following departure.
- Compensation committees should take a more robust view on pay, using their judgement and being accountable for their decisions and should avoid paying more than is necessary.
- The potential outcomes of a pay policy should be rigorously scenario-tested with a cap on the total possible pay published in advance.
- Boards should be able to justify to the workforce and the public the rationale for pay awards to management and, if they are not able to do so convincingly, use their discretion to make adjustments.

Oversight of executive compensation should be handled by a committee of truly independent directors with the relevant expertise. We expect transparency from the board on the compensation report in the annual proxy statement. This extends to the format in which pay disclosures are made, which ought to be readily understandable and user-friendly. Oversight of non-employee director remuneration should ensure that director independence from management is not compromised.

In the event that the compensation committee determines the disclosure in advance of company-specific hurdle rates for annual bonus and long-term incentive schemes to be unfeasible, companies should disclose these retrospectively. This enables shareholders to evaluate how prudently the compensation committee has applied the company's resources and gives some indication of what it is likely to do in future. Such disclosures also give shareholders some insight into the quality of the debate at the compensation committee. We are unlikely to support compensation plans involving awards which are not linked to performance criteria but are instead determined based on the discretion of the compensation committee without accompanying robust justification, including with regard to the metrics used to inform the decision and results.

We note that our interest is not limited to director and executive-level compensation. Especially at organisations where staff pay makes up a high portion of overall costs, we have concerns that levels of pay and performance criteria for variable remuneration may create perverse and short-term incentives for employees. We therefore encourage companies to improve their disclosure about how incentives for individuals with the ability to materially impact the performance of the business are linked to the interests of long-term shareholders, including the effective management of risk.

<sup>1</sup> <https://www.hermes-investment.com/wp-content/uploads/2017/09/Remuneration-Principles.pdf>

## **ADVISORY VOTE ON COMPENSATION**

We believe that engagement by investors coupled with and reinforced by voting is likely to be the most effective means of bringing about positive change.

Furthermore, investors should demonstrate that their policies can be evidenced through their voting. They should not be supportive of payouts which do not support the company's long-term success and should hold individual directors accountable for questionable pay policies or approving inappropriate outcomes. We believe that holding the compensation committee regularly to account through a shareholder say-on-pay vote and a vote on proposed pay plans leads to improved dialogue between compensation committees and investors. Companies that regularly consult shareholders on remuneration practices are, we believe, in a better position to reflect the views of their owners on compensation. Where we recommend voting against these resolutions, we are also likely to oppose the election of the compensation committee chair. Where companies do not address shareholder concerns following a significant level of shareholder opposition, we may register our concerns about pay by recommending voting against all of the compensation committee members.

## **SHAREHOLDER PROPOSALS**

We encourage boards to engage with serious, committed long-term investors, including ourselves on behalf of our clients, to reduce the need for shareholder resolutions to be tabled at AGMs. Where boards interact with their shareholders in an engaged way on issues affecting the long-term value of the company, we see less need to file or support shareholder resolutions.

We make voting recommendations on a pragmatic basis, reviewing each proposal in its company-specific context and considering the extent to which the issue in question has been managed, often following dialogue with the company on these issues. In our experience, shareholder proposals can be a natural catalyst for related dialogue with companies, and we thus avail ourselves of these opportunities, where appropriate, regardless of whether we have supported the resolution.

We expect boards to address issues raised by shareholder proposals that receive significant support or where the issues are material to the company. In addition, we view any failure to implement a shareholder proposal that has received majority support as a clear indication of a board of directors not fulfilling its obligations to the owners of the company.

## **ENVIRONMENTAL AND SOCIAL RISK MANAGEMENT**

Companies should manage environmental and social factors that are relevant to their business effectively, with a view to enhancing their sustainability. They should also disclose to shareholders on a regular basis how they identify and manage the relevant risks and provide evidence that these structures are effective. Companies should clearly define board and senior management responsibilities for environmental and social issues. We believe that directors of companies are accountable to shareholders for the management of material

environmental and social risks, as over the long term these will affect the value and ability of companies to do business. Therefore, we will seek to enter dialogue where we judge the effective management of, or reporting on, environmental and social issues to be insufficient. Climate change and human rights risk management in particular are of increasing importance to our clients.

## **CLIMATE CHANGE**

Uncontrollable climate change is a systemic risk to the value of the portfolios of our clients because of its economic and geopolitical consequences. We therefore support the ambition of the 2015 Paris agreement of 195 countries to limit global warming as a result of climate change to below 2°C.

The historic commitment was helped by the intervention of companies globally, which publicly encouraged political action in the run-up to and during the UN climate change conference.

Because of the systemic risk to the global economy, we encourage all companies to support publicly the ambition of the Paris agreement and to have this commitment embedded as a central tenet of their public policy and sustainability activities. To support this, boards should ensure that they have climate change on their board meeting schedules at least annually and that they expose themselves and senior management to experts who can challenge them on the strategic risks and opportunities that climate change represents.

We acknowledge that climate change is more important for some companies than others. However, it is relevant to all businesses, which is why we expect to see companies thoroughly prepare for a low-carbon economy and to mitigate the likely risks of climate change in their business model and operations, as well as seek opportunities from this transition. With this long-term perspective in mind, we expect companies to voluntarily encourage and embrace public policy initiatives required to make the transition to a low-carbon economy.

## **TASK FORCE ON CLIMATE-RELATED FINANCIAL DISCLOSURES**

We welcome the recommendations of the Financial Stability Board's Task Force on Climate-related Financial Disclosures. As a representative of long-term shareholders, we expect companies to assess and report on possible future climate change risks, not just those that have already emerged. Therefore, we expect companies to respond positively to the recommendations and to report against them. For companies in sectors where climate risks are most material, this should include identifying potential material issues by testing the performance of their strategies against a range of low-carbon scenarios and demonstrating that these are effectively monitored and managed.

## **HUMAN RIGHTS**

Licences to operate are increasingly affected by the reputation of companies, including their performance on human rights. We support the UN Guiding Principles on Business and Human Rights and the UN Global Compact. We expect companies to use the UN Guiding Principles Reporting Framework to disclose how they manage human rights issues that are salient to their business.

## **SUSTAINABLE DEVELOPMENT GOALS**

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 into their business models and strategies. We encourage companies to report on how they support the SDGs and to engage with civil society to find out how best to respond to them.

## **VALUES, ETHICS AND ANTI-BRIBERY AND CORRUPTION**

We expect companies to have best practice anti-corruption and anti-bribery policies and processes in place and robust compliance mechanisms to enforce them. However, on their own these are not enough. We expect boards to oversee the anti-bribery and corruption controls and – as importantly – to set the tone from the top, as well as to outline the highest ethical standards and expectations and the values of the organisation. This is to ensure that the culture does not allow corruption to thrive and has the necessary organisational measures in place to provide the best possible defence against corruption. We seek to enter dialogue where we judge the culture and values of a company to be lacking or the effective oversight, management of, or reporting on, bribery and corruption, company values and ethics to be insufficient.

## **TAX**

We expect companies to:

- Comply with all tax laws and regulations in all countries of operation
- Recognise the importance of taxation to the funding of good public services on which they and their stakeholders rely, and their commitment to pay their fair contribution
- Ensure that their tax policies and practices do not damage their social licence to operate in all jurisdictions in which they have a presence
- Disclose the taxes paid by or collected by them in each country.

## 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:

#### Private markets

Infrastructure, Private Debt, Private Equity, Commercial and residential real estate

#### High active share equities

Asia, global emerging markets, Europe, US, global, and small and mid cap

#### Credit

Absolute return, global high yield, multi strategy, global investment grade, real estate debt and direct lending

#### Multi asset

Multi asset inflation

#### Stewardship

Active engagement, advocacy, intelligent voting and sustainable development

### Offices

London | New York | Singapore

### Why Hermes EOS?

Hermes EOS enables institutional shareholders around the world to meet their fiduciary responsibilities and become active owners of public companies. Hermes EOS is based on the premise that companies with informed and involved shareholders are more likely to achieve superior long-term performance than those without.

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