HERMES
INVESTMENT MANAGEMENT

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

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 will 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.

<u>Full board membership for employees</u>

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.

<u>Stakeholder advisory committees</u>

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 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 data 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,

Saker Nusseibeh

CEO, Hermes Investment Management