

Corporate Governance Principles



Spain

Endorsement of the Spanish Good Governance Code

We endorse the principles and specific recommendations of the new Spanish Good Governance Code of Listed Companies (the Code), approved by the resolution of the National Securities Market Commission (CNMV) Board in February 2015. The CNMV is the Spanish government agency responsible for regulating national financial securities markets and ensuring their compliance with applicable regulations.

The Code sets out principles and provisions of best practice in relation to board leadership and effectiveness, remuneration, accountability and relations with shareholders. The format of the Code identifies some good governance principles, which in turn provide for a set of specific recommendations. It operates on a comply-or-explain premise, which under Spanish law requires companies to specify their degree of compliance with corporate governance recommendations, justifying any failure to comply.

The Code, was preceded by a broad reform of the Spanish Company Law (Ley de Sociedades de Capital or LSC) in 2014, which made mandatory many of the rules that in the previous 2006 Unified Code were considered to be merely voluntary recommendations. The Law 31/2014 includes binding votes on remuneration policy, stricter regulations on director classification and committee independence, as well as the implementation of new ownership thresholds for shareholder rights. The law also requires companies to disclose an annual corporate governance report. Accordingly, the corporate governance framework for Spain's listed companies comprises two different segments:

- 1) The binding provisions contained in the Spanish Company Law and other applicable laws (Securities Market Law – Ley del Mercado de Valores or LMV, Sustainable Economy Law – Ley de Economía Sostenible or LES) provide the legislative framework for regulation and basic principles of corporate governance.
- 2) The corporate governance recommendations contained in the new Code, which are strictly voluntary in nature, backed by the principles of comply-or-explain.

We encourage companies to fully comply with the Code, while recognising that good governance cannot be guaranteed merely by adherence to the principles and recommendations of the Code. We therefore urge companies to consider carefully how best to apply the principles and the spirit of the Code to their own circumstances and clearly communicate to shareholders the rationale behind their chosen approach. We will enter into discussions with companies where their explanations for non-compliance are unsatisfactory. In our Spanish Corporate Governance Principles, we set out in more detail the key elements of corporate governance that guide our approach to stewardship in Spain.

Board of directors

Spanish companies are usually governed by a unitary board consisting of executive directors (consejeros ejecutivos) and non-executive directors, the latter subdivided into proprietary directors or shareholder representatives (consejeros dominicales) and independent directors (consejeros independientes).

Board composition

The board should comprise members with an appropriate and diverse range of competencies, knowledge and experience to enable it to effectively discharge its duties and responsibilities. This includes leadership skills to move the company forward, appropriate group dynamics, technical expertise to make informed decisions, international experience to reflect the company's footprint and sufficient independence and strength of character to challenge executive management and hold it to account.

As mentioned in the Code, companies should provide a biography of all directors, including their background and area of expertise. The biography should also state to which director class they belong (executive, proprietary, independent) and which, if any, directorships they hold in other companies. We are not supportive of cross-directorships, where they conflict with the long-term interests of minority shareholders. A director needs to dedicate time to the company to appropriately fulfil his duties. Proprietary directors should disclose the shareholder they represent or have links with.

Independence

While representation of significant shareholders on the board can be justified and useful, we expect there to be a strong core of independent directors to ensure that the interests of minority shareholders are protected, to exercise objective judgment and, if necessary, to act as agents for change. We support the Code's recommendation that for large firms – IBEX 35 companies – independent directors should make up at least half of all board members. In circumstances where the board composition does not meet this recommendation, we want to see a carefully considered explanation. Where 50% or more of the members are executive directors and/or the board does not include a sufficient number of independent members, we typically recommend voting against some of the inside and/or affiliated directors. Shareholder representation on the board can be beneficial to all shareholders but should be roughly proportional to economic interest. The composition of the board should mirror the company's share capital structure, with minority shareholders continuing to have significant representation on the board. Where the relation between shareholder representatives and independent board members does not match the proportion between the economic interest represented by shareholder representatives and the free float, we may recommend voting against some of the shareholder representatives to ensure a better ratio.

Size

While no one size fits all, boards need to be large enough to allow for a variety of perspectives and to manage required board processes, including the efficient functioning of board committees. At the same time they should be as small as practicable to facilitate open dialogue among directors and good decision-making. The board of directors should ideally be composed of no fewer than five and no more than 15 members.

Diversity

We believe that boards should seek diversity in the broadest sense, taking into account a company's long-term strategic direction, business model, suppliers, employees, customers and geographic footprint. We support the long-term aspiration that boards, together with all levels of management, should broadly reflect the diversity of society, including across dimensions such as age, race and gender. As members of the 30% Club of Investors, we believe that boards should achieve a minimum of 30% female representation and, if not, set out plans to reach that target by 2020. The Code recommends that boards should have adequate diversity of knowledge, gender and experience to perform their tasks efficiently, objectively and in an independent manner. Specifically, the Code recommends that the director selection policy should pursue the goal of having at least 30% of total board places occupied by female directors before the year 2020. We may recommend voting against the chair of the nominating committee if insufficient progress has been made with respect to female representation on the board.

Appointment period

We strongly believe that directors should be elected or re-elected on a regular basis to ensure that they feel appropriately accountable to shareholders. We therefore welcomed the reduction of the maximum term of mandate from six to four years in the Spanish Company Law, although this does not apply to directors appointed prior to 2014. We will oppose any director up for election with a mandate greater than four years.

Combined chair/CEO roles

Under Spanish Law, the role of chair may be held by an executive director, however, company legislation now stipulates that a qualified majority of two thirds must vote for the chair's appointment in such cases. The Code also states that when the roles of chair and CEO are combined, an independent lead director (*consejero coordinador*) should be appointed. A significant number of Spanish companies have an executive chair. We prefer a structure of an independent chair and a separate CEO, as this is likely to be more effective at most companies than a combination of the roles. We believe there should be a clear division of responsibilities at the head of the company between the running of the board and executive responsibility for management of the company's business. Combining the roles can confuse these responsibilities and overly concentrate power in one person, leading to problems of oversight and accountability. Companies that continue to have a combined chair and CEO, should at least appoint a lead independent director – with well-defined responsibilities (see below) – to improve board decision-making, oversight and accountability to shareholders.

Lead independent director

On a case-by-case basis, we may support boards where one individual holds both roles providing a permanent lead independent director is in place with clearly defined responsibilities, including a significant role in establishing board meeting agendas, in board evaluation and succession planning. This helps to ensure that the independent directors are satisfied with the performance of the CEO. The role and prerogatives of the lead independent director are relatively new under Spanish legislation. The lead independent director's powers ought to include:

- the ability to call a special meeting of the board of directors or the independent directors at any time, at any place and for any purpose, including the removal of the chair/CEO from one or both positions
- consulting with the chair of the board, CEO and committee topics and schedules of the meetings of the board and committees and approve such schedules to ensure sufficient time for discussion of all agenda items
- presiding over meetings when the CEO is conflicted, not just when the CEO is absent
- guiding full board consideration of CEO and board appointment, evaluation and succession
- meeting one-to-one with the CEO after every regularly scheduled board meeting
- guiding the annual self-assessment of the full board
- engaging with long-term shareholders at their request
- a statement that the powers and role of the lead independent director are equivalent to that of an independent chair and that explains why the person holding the position is the best candidate for the role

From time to time, we request meetings with company chairs or lead independent directors. Meeting shareholders is a key part of the roles of these individuals. Where this access is unreasonably denied, we find it difficult to support the re-election of those board members.

Succession planning

We believe that good succession planning at the board and senior management level is an important safeguard of long-term value for any organisation. It should involve contingency planning for the sudden loss of key personnel, as well as planning for foreseeable change, for example impending retirement or with increasingly long tenure. Good succession planning should also include building a pipeline of suitable candidates for the board or senior management from within the organisation. We encourage companies to make their senior management and executive directors available, where appropriate, to serve as non-executive directors at other companies as part of their development. This helps to develop a deep pool of suitable talent for companies to draw from when selecting candidates for board positions.

Board evaluation and education

We expect companies to continually assess the effectiveness of their boards to ensure they are operating optimally, with the right governance structures. We welcome the obligation of the Spanish Company Law that the board should undertake an annual appraisal of its performance and that of its committees. Ideally this should be accompanied by an independent, externally facilitated evaluation at least every three years, as recommended by the Code. Boards should demonstrate their commitment to their own effectiveness by reporting transparently and honestly on the main topics of discussion in the evaluation process and the steps that have been taken and will need to be taken to address any issues. We consider engagement with boards where we do not see evidence of good quality evaluation or have concerns about their effectiveness.

Committees

The new Spanish Company Law requires listed companies to have a nomination and remuneration committee. Setting up an audit committee was already obligatory, although the law now requires all of its members to be non-executive directors. In Spain, we generally encourage companies to ensure that all the members of the audit and at least a majority of the nomination and remuneration committee are independent non-executive directors. For the audit committee, we pay close attention to the financial skills and experience of the members – the Code recommends knowledge and experience in accounting, auditing and risk management matters – and their potential conflicts of interest. In addition, in accordance with Spanish law, all committees should be chaired by an independent director.

Remuneration

The Code offers best practice recommendations on remuneration, while the Securities Market Law LMV and Sustainable Economy Law LES provide the legislative framework for the structure and content of the remuneration policies of publicly listed companies.

Say on pay

Spanish companies must prepare and submit an annual remuneration report for advisory shareholder approval and submit their remuneration policy to a binding vote at least once every three years. Any material change to the remuneration policy must be submitted to a vote at a shareholders meeting in order to take effect. Should a company fail to gain shareholder approval for its remuneration report, it must submit its remuneration policy to shareholders for approval at the next annual general meeting.

Remuneration principles

Executive remuneration continues to be an area of concern for Hermes EOS. While the legal requirements for specific features and disclosure have led to improved transparency regarding the link between pay and performance, experience shows that, in many cases, remuneration still fails to align the interests of executives with those of long-term shareholders. In particular it often fails to safeguard against excessive risk-taking or be sufficiently reflective of long-term performance. This concern is exacerbated by the level of homogeneity in incentive structures across companies and industries, in spite of their clear differences. For this reason, we developed with several large pension funds the Remuneration Principles for Building and Reinforcing Long-Term Business Success:

1. Remuneration committees should expect executive management to make a material long-term investment in shares of the businesses they manage.
2. Pay should be aligned to long-term success and the desired corporate culture throughout the organisation.
3. Pay schemes should be clear, understandable for both investors and executives, and ensure that executive rewards reflect long-term returns to shareholders.
4. Remuneration committees should use the discretion afforded them by shareholders to ensure that awards properly reflect business performance.

5. Companies and investors should have regular discussions on strategy and long-term performance.

We incorporate these principles into our discussions on remuneration with companies and will support those remuneration committees looking to innovate in how they structure their incentive schemes for which they are responsible to position them best for future success.

Shareholder rights

Under the new Spanish Company Law, the ownership threshold for adding proposals to the meeting agenda was lowered from 5% to 3% of the share capital, while the ownership threshold to legally challenge corporate resolutions has been set at 0.1% for listed companies. Under certain circumstances, a shareholder or group of shareholders holding at least 3% of a company's share capital, and shareholder associations holding at least 1% of a company's share capital, are entitled to request ownership information for any shareholder.

Capital management

In Spain, the new Company Law provides the legal framework for authorities involving share capital increases and decreases, share repurchases and the issuance of shares or convertible/non-convertible debt instruments.

Pre-emption rights

Pre-emption rights are an important safeguard for shareholders and their interests as part-owners of companies and we will carefully consider whether to waive them on a case-by-case basis. For the Spanish market, we generally endorse the recommendation of the Code, that authorisations to issue shares without pre-emptive rights should be limited to 20% of a company's issued share capital.

Related party transactions

We expect enhanced disclosure on the nature of related party transactions, especially when the auditor report on related party transactions does not provide the level of information necessary to understand their motivation and scope. Significant transactions should be approved by a separate shareholder resolution.

Reporting

We believe that the quality of reporting reflects how well the board thinks about its strategy and has line of sight of operations and indicates how able it is to manage the company. Good quality reporting that is fair, balanced and reasonable supports engagement between shareowners and boards. For this to be most effective, boards must report openly and transparently on the performance of the company and their stewardship of it over the year, acknowledging the challenges, as well as the achievements, the state of the market and the competitive landscape. It is also fundamental that risk is reported on in a way that allows investors to understand the main risks that the board has identified for the business and how the company manages and mitigates those.

Environmental and social responsibility

Companies should manage effectively environmental and social factors that are relevant to their business, with a view to enhancing their sustainability. They also ought to regularly disclose to shareholders how they identify and manage these material risks and provide evidence that the processes to do so are effective. Furthermore, companies should clearly define board and senior management responsibilities for environmental and social issues. Directors of companies should be 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. We seek to enter dialogue where we judge the management of, or reporting on, environmental and social issues to be insufficient. We support the development of enhanced reporting in this area, such as the frameworks of the International Integrated Reporting Council and the Carbon Disclosure Standards Board, with particular emphasis on the integration of material environmental, social and governance issues into discussions on corporate strategy and risk management.

In Spain, we are encouraged by the new set of recommendations in the Code dealing with Corporate Social Responsibility. As a non-delegable board power, Spanish companies should deploy an appropriate corporate social responsibility policy and report transparently and in sufficient detail on its development, application and results.

Climate change and human rights

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 the increase in global temperature as a result of climate change to below 2°C. This 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 publicly support the ambition of the Paris agreement and to have this commitment embedded as a central tenet of their public policy and sustainability activity. 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.

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 reporting framework for the Guiding Principles to disclose how they manage human rights issues that are salient to their business.

Hermes Investment Management

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