Hermes Equity Ownership Services

Hermes Equity
Ownership Services Limited
1 Portsoken Street
London E1 8HZ
United Kingdom

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

www.hermes.co.uk

Catherine Woods
Financial Reporting Council
Fifth Floor
Aldwych House
71-91 Aldwych
London WC2B 4HN

By email: remcon@frc.org.uk

6th December 2013

Dear Catherine,

Re: Directors' Remuneration Consultation Document

Thank you for the opportunity to provide input into the consultation on possible changes to the UK Corporate Governance Code regarding directors' remuneration. Below we provide our comments on the main sections of the consultation.

Extended Clawback Provisions

Clawback is a feature that we see increasingly being adopted by remuneration committees when considering the tools available to them to extend accountability in incentive schemes. However while the feature is becoming more common, there are very few examples of it being used in practice, making the assessment of its effectiveness challenging. Neither is clawback the only tool that remuneration committees have to achieve the desired outcome, and given the rarity of its use we wonder whether other tools may be more effective. Further such examples include extending performance periods to more accurately reflect the company's business or investment cycles, thereby more likely capturing the poor performance that would need to be considered in the event of incentive recovery, extended holding periods of awards after vesting, adding the option of malus, and remuneration committee discretion. As the FRC is looking to address the Government's concerns about payments for failure we believe it should look at a broader toolkit than just clawback for insertion into the Code.

That clawback is used so rarely suggests to us that there might well be practical or legal difficulties with its implementation. One such difficulty is that the parameters around when the remuneration committee can use clawback are often tightly defined, thereby significantly reducing its use as a tool to strengthen remuneration committees' hands and avoid payment for failure. Often the language is specific around material misstatement or misconduct, which we suspect has been directly influenced by the language in Schedule A of the Code as it stands, and which are instances that, we gladly note, rarely occur. However they are not the only occasions in which we would hope that a remuneration committee might wish to consider the use of clawback or another method of extending accountability. We would favour removing these words from the Code altogether or, if the FRC prefers to include circumstances under which payments could be recovered, inserting “for example” before their inclusion in the Code.

For the reasons above we do not support the inclusion of a “comply or explain” provision in the Code relating to clawback. We do however believe that the FRC could consider the inclusion of a broader provision relating to the inclusion of tools in incentive schemes that allow remuneration committees to be able to make adjustments to payouts in order for those payouts to best reflect the committee’s views on performance, notwithstanding the mechanical outcomes of the schemes. For example, executives might hit their incentive targets for the year yet the company could have been exposed to serious reputational issues. In this instance we would expect remuneration committees to want to reflect this in incentive outcomes, even if the company’s reputation itself did not factor directly into the scope of the incentive schemes. We also believe there is an opportunity to encourage timeframes in incentive schemes to better match a company’s particular investment cycles and periods over which the success or otherwise of those investments can be judged, rather than the standard three years which is currently alluded to in Schedule A.

Remuneration Committee Membership

When considering board and board committee composition, we look to ensure that the right individuals with the appropriate skills and background for the particular company and role are in place, rather than applying hard and fast rules about an individual’s previous or current employment. We are also very interested in seeing the talent pool for non-executive directors widen to promote greater diversity on boards, and encourage companies to allow their executives, both at and below board-level, to serve as non-executives at other companies. Executives are also able to bring contemporary knowledge from their day jobs which helps to bring a balance of views and ensures that boards to not become too distanced from the current environment.

Furthermore, the statistics that the FRC includes in the consultation show no substantive evidence to support the hypothesis that executive directors serving on other companies’ remuneration committees lead to greater investor dissent on the remuneration report. We are further concerned to note that the statistics also show a broad downward trend in executives serving on other companies’ remuneration committees. Unless there is stronger evidence of the conflict of interest that is described in the consultation, which we have not experienced in our engagements thus far, we believe that this proposal is neither necessary nor desirable.

Votes Against the Remuneration Report

Where companies receive significant votes against a resolution, we expect boards to react appropriately. If they do not make changes to satisfy the concerns expressed through the shareholder dissent, or do not communicate their approach in a way that alleviates shareholder concerns, the owners of those companies can hold their boards to account through engagement and, ultimately, vote against the re-election of directors. The key outcome therefore of disclosures of the steps taken following a significant vote against the remuneration report would therefore be to encourage more of this engagement, of which we, and we know the FRC, are supportive. In this light, we believe that if the FRC is to consider inserting a requirement to report to the market on the reasons for significant votes against resolutions and any action undertaken in response to the concerns, it would be more complete to make this requirement relevant to any type of resolution. We would propose that the usual methods of communicating to the market, i.e. RIS announcements and company websites, would be the appropriate vehicles.

However, there are challenges in setting a minimum threshold for votes against, particularly given the different compositions of a company's share register, both in the number and regional diversity of its members. It must also be recognised that some investors simply will not want to pursue dialogue, and companies will need to take a view as to who the most engaged members of their share registers are when undertaking engagement programmes. As the consultation recognises, the relevant sections in the Enterprise and Regulatory Reform Act 2013 specifically avoid defining "significant" in this context, in much part we understand due to the challenges just highlighted. We therefore do not believe that such a requirement would need to include reference to a specific percentage threshold, although welcome best practice initiatives, such as the GC100 and Investor Group's document, offering guidance in this area. Where companies receive substantial votes against but do not disclose to the market, we would presume that their largest shareholders will have a view on the significance of the dissent and would look to engage and hold the board to account as per the process described in the paragraph above if necessary.

I would be happy to discuss the content of this response in more detail with you should you wish: you can contact me on 0207 680 3789 or f.woolfe@hermes.co.uk.

Yours sincerely,

Freddie Woolfe

Freddie Woolfe
Head of UK Engagement