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Catherine Woods
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By email to successionplanning@frc.org.uk

4th February 2016

Dear Catherine,

Consultation Paper on UK Board Succession Planning

Hermes EOS welcomes the opportunity to provide our comments on this consultation on the UK Board Succession Planning. By way of background, Hermes is one of the largest asset managers in the City of London, and is wholly owned by the BT Pension Scheme, the UK's largest corporate pension scheme. As part of our Equity Ownership Service (Hermes EOS), we also respond to consultations on behalf of many clients from around Europe and the rest of the world, including The British Coal Staff Superannuation Scheme, The BT Pension Scheme, Lothian Pension Fund, The Mineworkers Pension Scheme and The Public Sector Pension Investment Board. In all, Hermes EOS advises over 40 clients with regard to assets worth a total of over £155 billion (as at 31 December 2015).

General comments on succession planning

We agree with the premise of the FRC's discussion paper that planning for succession of board members and particularly the CEO and chair is of crucial importance to a company's long-term success. These engagements are commonly long standing conversations as we look to gain reassurance that adequate plans are in place to safeguard the long-term success and interests of the company.

Attached is a set of more detailed comments responding to those raised within the discussion paper. However, we would like to highlight the following main points:

- It is important to distinguish between three types of succession planning that are required across three time-horizons as follows: 1) contingency planning for the sudden departure of key personnel; 2) medium-term planning for the anticipated orderly replacement of current personnel; 3) longer-term planning for the future shape of the organisation, in line with the strategy.
- We agree that board succession planning is an important priority for all boards, but that it is often somewhat overlooked or appears to be managed in an informal way. The work of the nominations committee can seem to be of lower importance to that of the remuneration or audit committees and this should be addressed.
- We support the development of further guidelines on what good succession planning looks like. This could include suggested questions and potential activities for chairs of

nomination committees to refer to and, where relevant, report against. However, it should be emphasised that succession planning is far from being a compliance-driven process against a checklist of requirements.

- Similarly we also support the development of more detailed guidelines on the appropriate level of reporting on the work done by boards and the wider company on succession planning, given the lack of consistency of reporting in this area.
- A key outcome of improved succession planning is the development of a longer term pipeline of potential future board leaders. This will require boards to consider issues over a longer time horizon than the typical planning cycle and influence activity several levels below the board itself. If successful, this could help improve diversity and reduce hiring and remuneration costs.
- Institutional investors will continue to have a significant role to play in holding companies to account. The nature of succession planning is such that it is not easy to prescribe a single methodology. It is often an important yet non-urgent task and so not a top priority for conversation for investors with short time horizons. It is therefore likely to remain a topic on which long term investors need to hold companies to account through a direct dialogue at board level, and not to rely only on formal reporting channels.

If you would like to discuss any of these comments further, then please feel free to contact me at 020 7680 2110 or bruce.duguid@hermes-investment.com.

Yours sincerely,

Bruce Duguid

Bruce Duguid
Associate Director, Hermes EOS

Appendix: Further comments on succession planning

The following additional comments use the heading structure provided by the FRC in its consultation response.

Business strategy and culture

- Business strategy should identify the long term goals of the organisation and the priority of effort across different products, markets and geographies. This should lead to a reasonably clear identification of the types of skills, expertise and character attributes required on the board and at senior levels, both now and in the future.
- We believe succession planning needs to distinguish between three different but related types of challenge with different time horizons:
    - Contingency planning for the sudden and unanticipated departure of key personnel.
    - Medium-term planning for the orderly replacement of current personnel for example due to retirement or the anticipated end of their indicated period of service.
    - Long-term planning for the shape of the future board of the company potentially beyond the service periods of some of today's directors.
- We think that succession planning will benefit from development of a clear understanding of what the ideal characteristics of the board might look like, both now and in the future.
- The company should be encouraged to report on the types of skill and expertise it believes it needs and will need and the extent to which the current directors meet these requirements, together with training needs and plans.
- We note that a number of boards have developed a 'matrix' that breaks down the board's composition by factors such as gender, skills, and geographical experience, mapped against the time when current board members will rotate off. This may use the '9 year rule' as a guide, and we agree that this should not be seen as a limit to continued service on a board.
- It is important to note that family or founder-owned companies will have different cultures and may also have different approaches to succession planning. A difficult question to address is whether it is legitimate for majority or even minority-owned companies to seek to secure succession though a family line. Whilst this is increasingly rare in a UK context, it is more frequently the case in developing markets. Whilst strictly applicable to the UK, the FRC's guidance is likely to be keenly followed in other jurisdictions and it would be useful if it could reflect on this challenge. Our initial view is that any such appointment must achieve the approval of a majority of investors based on one shareholder, one vote and that it should be merit based. However, this does not preclude family members achieving succession in certain circumstances.
- Good reporting can prove informative and reassuring for investors and need not reveal information that is commercially sensitive. As investors, we wish to understand the nature of the skills and experience that would ideally be present on a future board and what plans it has to transition towards this. This could be based on the matrix approach described above, although other forms of reporting could also work and are likely to be needed concerning longer term planning.

The nomination committee

- In our view the quality of nominations committee reporting can appear somewhat less sophisticated than remuneration and audit committee reporting.
- We believe there is merit in the FRC considering the development of additional guidance for the role of Nominations Committees and its reporting. While, as with many aspects of corporate governance, no single approach would be appropriate for all companies, we do believe that Committees should be encouraged to deepen and broaden their activities and associated reporting. Guideline reporting could follow the above framework of the three horizons of succession planning and refer to the activity of the nominations committee in relation to each of: 1) contingency planning for the sudden departure of key board personnel; 2) medium-term planning for the anticipated orderly replacement of current board personnel; 3) long-term planning for the shape of the future board.

- We have found it informative to hear first hand from directors about the lessons they have learned during their induction period, such as issues that have surprised them and their immediate impressions of opportunities for improvement. We would encourage any guidance on reporting by the Nominations Committee to include such insights from new directors.
- We believe that the nominations committee and the remuneration committee should work closely together, particularly in agreeing remuneration for executive appointees to the board. It is also important that remuneration structures incentivise today's executive directors to deliver long term performance beyond their own tenure, for example through holding periods of shares, which would help ensure a focus on succession planning.

<u>Board evaluation</u>

- Board evaluation and succession planning are linked, but distinct, activities. Independent and rigorous Board evaluations will play an important role in informing boards of where they may need to retain or enhance key skills and expertise, as well as where there may be room for improvement among current members.
- It is important that board evaluation does not only focus on the effectiveness of today's board in dealing with today's challenges, but also gives insight to the needs of the future board in the context of the company's strategy. Developing this additional angle may go beyond the scope of some board evaluation exercises and should be included within the evaluation or within a separate periodic exercise.
- While the quality of disclosures around board evaluations is often improving, as investors we would value more disclosure around the outcomes of the evaluation, rather than merely a focus on its process.

<u>Pipeline</u>

- A key driver of improved succession planning is the development of a longer term pipeline of potential future board leaders. This will require boards to consider issues over a longer time horizon than the typical planning cycle and influence activity several levels below the board itself.
- If successful, this would not only improve the number of internal candidates, but also offer potential co-benefits in terms of improved diversity and reduced hiring and remuneration costs. In well performing companies, internal hires can often be preferable given their deeper understanding of the challenges and culture of the organisation. It would also help add to the wider pool of board-level talent for the UK as a whole.
- Presently, there is limited disclosure about a companies' approach to nurturing and developing the talent below board level and greater disclosure would be illuminating. Areas of interest include:
    - The extent to which prospective candidates rotate role around the business;
    - The extent to which senior executives are given access to board members, either through presenting to the board, shadowing board activities or mentoring (which we strongly encourage);
    - How senior executives are being supported to take up external board positions to build non-executive experience.

<u>Diversity</u>

- Investors want the best possible candidates to be chosen for the Board. However, any judgement about the qualities desired should include an assessment of the diversity of perspective on a board.
- The appropriate diversity of the board will include a range of dimensions including, but not limited to: gender, race, geographical or sector experience and potentially years of experience.
- We view the issue of diversity as primarily a pipeline challenge. Commonly diversity is better achieved at the top and bottom of an organisational hierarchy, but can be poorer in the middle. This implies an asymmetric system for promotion which may reveal short-comings in nurturing diversity for the long-term.

<u>Role of institutional investors</u>

- Long term investors will tend to focus on succession planning as a regular topic of engagement with companies, recognising its importance to long term value.
- In our experience, many chairs will consult with investors on the skills or qualities they would want in a new board appointee. If engagement is working smoothly, these conversations should be regular and help reduce the need for last minute confidential and sensitive discussions.
- Our experience is that investors generally learn more about succession planning from companies in private discussions rather than through formal reporting. Whilst improved reporting will help, we doubt that it can replace entirely the need for direct dialogue, given the nuanced nature of the topic. As noted above under strategy & planning, good succession planning is intimately linked to long term strategy which is also often a topic of longer term investor engagement.
- As far as possible, investors value order changes in board personnel. It is therefore good practice for companies to signal publicly in advance the intended retirement of board members, especially in the case of senior members such as chairs of committees or the senior independent director.