Thank you for inviting me to give oral evidence on behalf of Hermes Equity Ownership Services to inform the Committee’s inquiry into this important aspect of corporate governance.

At the evidence session on 16 October 2018, there were some questions which indicated an interest in specific ideas of how government, regulators or Parliament could intervene to ensure certain desired changes in executive remuneration.

We want to see executive remuneration schemes that effectively incentivise the delivery of long-term value for shareholders, other stakeholders and society, while paying no more than is necessary.

As explained in our evidence, we don’t believe that the typical UK executive remuneration scheme based on a combination of cash salary, an annual bonus and a three year long-term incentive plan (LTIP), best achieves this.

We want to see a move to much simpler schemes with lower variable pay opportunity and higher executive shareholdings. In general, our preferred structure is a restricted share scheme model, whereby a portion of fixed pay is awarded in shares and held for the long term, with some safeguards in place to prevent vesting in instances of failure. This would replace the LTIP.

Under conventional LTIPs, the pay outcome is perceived as highly uncertain by recipients, as it is contingent on achieving performance measures over a number of years and subject to variables, some of which are beyond management’s direct control. This uncertainty causes the perceived value of awards in later years to be irrationally discounted, driving up the maximum potential award offered at the outset to compensate. In our view, by reducing uncertainty of outcome, restricted share scheme structures should lead to lower pay over the long-term and better alignment between executive pay and shareholder outcomes. This fixed pay element could then be appropriately complemented by an annual bonus focused on achievement of a mix of strategic and financial targets, in-line with long-term strategy and targeted annually.

We believe that shifting to pay schemes based on this model should become the new common standard. However, we recognise that it is difficult to be prescriptive of any single approach in all circumstances as some variability in specific structures would remain necessary, and that requiring a single structure for remuneration through legislative or regulatory means could have unintended consequences. As such, a company’s board and its remuneration committee should retain responsibility for designing schemes it believes are most appropriate to incentivise performance, aligned to the long-term nature of the business and its strategy, and regulators and oversight bodies should give guidance on remuneration structures rather than be prescriptive.

However, a complementary approach could be to set parameters applicable to all types of scheme which should lead towards simpler schemes with higher shareholdings, as follows:

- **Letter to employees:** As explained in response to questions, we would like to see a requirement for the remuneration committee or board chair to write a
letter directly to all employees of the company, explaining executive pay outcomes for the year. The letter should make reference to other relevant data and ratios, including the CEO/employee pay ratio and the gender pay gap and how such pay is seen as appropriate in all the circumstances. There could also be a requirement for this letter to be highlighted more clearly to shareholders, including retail shareholders, to enable well-informed voting decisions. For example, it could be included in the notice of meeting materials. We believe this requirement to communicate more transparently to a wider range of stakeholders would help lead to simpler schemes and more appropriately calibrated pay outcomes.

- **Minimum shareholding requirements:** While most companies now have minimum shareholding requirements for executives, levels vary and are often, in our view, insufficient. We would suggest firmer guidelines, or even a requirement that these should target at least 500% of base salary. Executives should build up to this level rapidly and be required to retain this level for some period post-departure (we would suggest a minimum of two years), in line with the UK Corporate Governance Code’s latest guidelines, with phased sell-down permitted thereafter. This should drive more pay awarded in the form of shares.

- **Total pay cap:** Each remuneration policy should include a clearly stated headline cap on the maximum potential realised pay award. It would remain for each company to set their own cap, which would no doubt vary by sector and size of company. However, this would act as a limit on the particularly excessive pay outcomes which have occurred in certain cases in recent years and which often were way beyond what most investors, and indeed board directors and executives, ever envisaged. This requirement would dovetail with the requirements to report on the potential impact of share appreciation on pay outcomes introduced in the Corporate Governance Code in summer 2018.

In addition to the above, boards and their remuneration committees must be accountable for the design and outcome of pay schemes, and each remuneration policy must allow the remuneration committee to exercise discretion and where necessary adjust the amounts to be paid out, in line with the shareholder experience or other relevant data and ratios. As part of their stewardship responsibilities, investors should hold boards to account on pay practices and seek to drive good practice through high-quality engagement with companies and voting decisions. I hope these suggestions will be useful for the Committee’s deliberations and we look forward to reading the final report. I also enclose a recent article from Dr Hans Christoph Hirt, Head of Hermes EOS, which summarises our views.

*Bruce Duguid*

*Head of Stewardship Services*

*November 2018*
Executive pay is an emotive subject and one that is never far from the headlines. In fact, the 2018 AGM season in the UK was dominated by articles highlighting the excessive levels of pay rewarded to some executives, including Persimmon’s Jeff Fairburn, which led to debates about the “fairness” and morality of such large amounts and social inequality.

However, today’s executive remuneration systems raise important questions even before one gets to the financial reward in any given year.

The headline number is simply the tip of the iceberg and to have an informed debate around it requires an understanding of a policy’s outcomes in different scenarios. It is critical that the policy allows the remuneration committee to exercise discretion and where necessary adjust the amounts to be paid out to be in line with the shareholder experience.

Beneath every remuneration policy we review, our team ploughs through an average of 20 pages of complex, and often opaque, terminology describing multiple, often overlapping, components of a pay package.

Appearing before the Commons select committee on executive remuneration last week, we received some media criticism for expressing our view that often remuneration structures are unduly complex, making it difficult for all shareholders and, on occasions, even executives to understand and predict outcomes in different scenarios.

This was not a flippant comment. We work for millions of pension savers, representing and advising on £346bn of assets from across the globe. Appropriately structured remuneration practices can be key in aligning the activities of management with a company’s purpose, strategy and long-term performance. However, we know the frustrations caused by overly complex remuneration policies, the outcomes these can cause for investors and the ramifications these can have for a company.

In 2016, we wrote to the boards and CEOs of all of the FTSE companies proposing a fundamental shift in the structure of executive remuneration packages. In order to better align management with long-term investors and to provide transparency to all, we encourage companies to devise policies that are simple, transparent and focus on underlying business performance rather than share price, with less leverage and greater accountability by the board and its remuneration committee.

Our remuneration principles are based around five pillars:

1. Shareholding: Executive management should make a material long-term investment in the company’s shares.
2. Alignment: Pay should be aligned to long-term success and the desired corporate culture.
3. Simplicity: Pay schemes should be clear and understandable for both investors and executives.
4. Accountability: Remuneration committees should use discretion to ensure that awards properly reflect business performance.
5. Stewardship: Companies and investors should regularly discuss strategy, long-term performance and the link to executive remuneration.

For many investors, the opportunity to voice their frustration comes once a year at a company’s AGM where they can vote against remuneration and make their irritations known. Engineering company Weir experienced this first-hand in 2016 when it attempted to change its remuneration policy to introduce restricted shares into its long-term incentive plan (LTIP). It argued this reflected the difficulty in setting meaningful targets when operating in cyclical markets such as oil, gas and minerals.

However, it proposed introducing a mix of time-restricted shares and performance shares, resulting in a complex structure that undermined the justification for moving away from performance-based long-term incentives. For this reason, we could not recommend to our clients that they support the proposal and it was defeated with 72 per cent of votes against.

In 2018, the company returned to shareholders with a new proposal that Clare Chapman, chair of the remuneration committee, described to the Financial Times as having come to “the hard way”. It replaced its conventional LTIP with an entirely restricted shares scheme, in line with our remuneration principles published in 2016. The company now awards half the number of shares previously available, which must be held for seven years, subject to a simplified range of conditions being met.

We supported this transparent, simplified approach and the policy was passed with 92 per cent support from Weir’s shareholders.

Presenting a clear and concise remuneration policy at an AGM will not automatically secure investor support without dedicated communication. That said, we firmly believe that a well-structured remuneration policy can be an important factor in aligning the interests of senior management with those of long-term investors and thus the ultimate beneficiaries.

Companies must continue to strive for transparency and simplicity. In the case of remuneration policies, less really is more.

_Dr Hans-Christoph Hirt is head of Hermes EOS_