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16 April 2009

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Dear Sir/Madam

Corporate Governance and the Financial Crisis

We are writing to give the views of Hermes on the OECD's consultation paper on Corporate Governance and the Financial Crisis.

Hermes is one of the largest pension fund managers in the City of London and is the principal manager of the BT Pension Scheme. We also respond to consultations such as this on behalf of the Irish National Pension Reserve Fund and some 200 other clients. Hermes has approximately £30 billion under management and £50 billion on assets under advice (31 December 2008).

Hermes believes that companies with well-informed and involved shareholders will outperform in the long-term as oversight by owners encourages management to pursue strategies that achieve superior long-term returns. As such, Hermes generally supports regulation that increases transparency for shareholders and allows investors to take informed decisions. We do not, however, believe that excessive administrative burdens on companies are in the interest of shareholders and therefore also welcome attempts to alleviate obligations for companies as long as the protection of investors is ensured.

The financial crisis has highlighted some of the shortcomings in the current corporate governance system and as such the OECD's consultation is timely. In the following paragraphs we will answer the specific questions raised in the consultation.

Governance of Remuneration

What are the most important features of a well governed process for deciding on compensation in a company? Which should be the role of shareholders in this process?

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As a general principle, we believe that companies should design and implement remuneration policies that adequately incentivise not only their senior executives but all their employees. The aim of those policies should be the alignment of the interests of management with the interests of shareholders in the creation of sustainable, long-term value.

Focussing on the financial sector, there is a clear need to reform pay structures for employees at investment banks and financial institutions. We note that at most financial institutions, staff costs are by far the single biggest cost line. We believe that remuneration policy is a crucial issue which must be debated and handled by the whole board rather than a committee. Every director should participate in and have responsibility for related decisions. To highlight this responsibility boards could be asked to make a public statement outlining how the remuneration policy ensures the sustainable creation of value. The remuneration committee would prepare the board's deliberations on remuneration and continue to have its crucial role of taking pay decision-making on the CEO and top executives out of the whole board context.

Remuneration policies should be disclosed annually as an integral part of remuneration reports so that shareholders can assess whether the interests of managers and employees have been aligned with their own. Remuneration reports provide a chance to articulate policies with regard to remuneration and explain how they support strategic objectives and ensure sustainable value creation. As such, they can provide a useful starting point for constructive dialogue between companies and shareholders. Companies that produce remuneration reports should put them to a vote at the annual general meeting, whether or not that is required under the applicable law. This encourages valuable dialogue and gives shareholders the opportunity to endorse the decisions taken on their behalf with regard to remuneration policies.

As for the structure of remuneration, we believe that the Compensation Policies formulated by the Institute of International Finance in July 2008 provide a good starting point. We regard it as very important however that when setting policies the board considers and focuses on how the structure of remuneration ensures the sustainable creation of value over the long-term. Changing the periods over which performance is measured to reflect this time horizon is crucial in this regard.

What are the main risks associated with performance based compensation? How can they be identified and taken into account?

Flawed remuneration systems and cultures may encourage executives and employees to take excessive risks in order to generate short-term profits. The key issue in our view is for the remuneration structure to support effectively the culture of the organisation, so that it drives appropriate behaviours which create sustainable value rather than incentivises behaviours that are contrary to the long-term interests of the business as a whole. This will require an appropriate balance between fixed and performance pay. Variable or incentive pay should only paid out as a result of value-creation over an appropriate measurement period. This seems crucial as the recent experience in the banking sector suggests that the deferral of bonuses is not enough in itself. In order to change the timeframes focused on by the employees of financial institutions, we need to change the period over which performance is measured. This period needs to match much more closely the period over which it becomes apparent that a particular trade or deal is indeed profitable, ensuring that pay is aligned with the interests of the shareholders.

Performance measurement should take risks into account and make adjustments for different costs of capital. To ensure that risk factors are appropriately factored into remuneration structures, the audit committee should have some input into the setting of policies. Again, the Compensation Policies formulated by the Institute of International Finance in July 2008 provide a good starting point with regard to the issues that should be taken into account.

Should risk managers and the boards' risk management function be formally involved in the design of compensation schemes?

We believe the board as a whole should take responsibility for remuneration policies. In practice, in preparing deliberations of the board, the remuneration and audit committees would work together to ensure that risk management concerns are effectively fed into the design and management of remuneration systems.

Implementation of Risk Management

What is the most important step a company can take if it wants to improve its risk-management system?

We believe that risk management needs to have a higher profile within organisations. Rather than being the lesser partners, whose role is simply to approve or bar a deal which has already been agreed by trading staff, the risk management function needs to be more integrated into the overall approach. It also needs to be remunerated as generously as trading because it safeguards as much wealth as trading generates – and it will thereby attract quality individuals who will be better able to take tough decisions and make the case for and develop appropriate risk management structures. The risk management function should be overseen closely by the audit committee and important issues brought to the attention of the whole board.

How shall the internal governance structure be designed to support active and effective implementation of risk-management throughout the company?

The non-executive directors as a whole and particularly the audit and risk committees where these exist need to generate a culture of openness and trust regarding risk management issues. They need to take ownership of the key risks which the company faces and consider the effectiveness of the way in which these are managed and mitigated. To enable them to do this, they need appropriate resourcing and information. At a minimum, this will require a direct dialogue with internal audit and the risk management function. To ensure this dialogue, the heads of these functions could have a soft reporting line to the chair of the audit/risk committee and their appointment and removal could be made dependent on the approval of this committee. In a similar way, there should be an open and honest dialogue with the external auditors. Shareholders would welcome clearer and fuller disclosures of these structures and approaches in annual reports to build confidence in the company's risk management approach.

Board Practices

What is the main lesson from the fact that boards have been unable to direct their companies away from important meltdowns? Is it just a matter of competence or have companies become too large and complex to allow effective board oversight?

Boards should ensure that they are comprised of members with an appropriate and diverse range of competencies, knowledge and experience. These include leadership skills to move the company forward, technical expertise to make informed decisions, and independence. All these are necessary if the board as a whole is effectively to challenge executive management with regards to strategy, operations and risk management. We encourage boards to ensure that a significant number of their members have relevant sector knowledge which often is a pre-requisite for effective challenge of executives.

Boards should maintain and establish an appropriate corporate culture, assume responsibility for remuneration policies and oversee the risk management function. Appropriate remuneration and effective risk management structures and procedures policies are essential for sustainable value creation. We thus believe that boards rather than committees should assume responsibility for remuneration policies and closely oversee the risk management function. Boards should review, discuss and decide on remuneration policies in plenum. Similarly, risk management needs to have a higher profile within companies. This should start at the top and we encourage boards to closely oversee the risk management function of their companies.

Boards should undertake a formal and rigorous evaluation of their performance and that of individual members on a regular basis to ensure that their composition is appropriate; that they are functioning properly and that each director makes a useful contribution. A focus in this evaluation should be on how effectively executives are tested on key issues. Companies should disclose the process for such evaluation.

What needs to be done to restore the confidence in the board of directors as a key pillar in corporate governance? Shall legislators and standard setters try to regulate further the composition, qualifications and size of boards in public companies?

We strongly believe that Investors need to rise to the challenge of playing their role in the now widely established comply or explain system and would regret seeing more involvement of legislators and regulators in this area. As already explained, boards should undertake a formal and rigorous evaluation of their performance and that of individual members on a regular basis. Furthermore, to help shareholders in playing a useful role in the corporate governance system, companies should provide information regarding their board appointment procedure, including the factors considered when searching for candidates. Planning for succession of senior board members and particularly the chair of the board is especially important to ensure the effectiveness of boards over time. At the very least, companies should provide investors with clear evidence of succession planning.

To ensure an appropriate degree of accountability we strongly believe that all directors should stand for re-election subject to continued satisfactory performance on a regular basis. The frequency of re-election should support the accountability of directors but also take into consideration the stability of the board. In this context, other accountability mechanisms, such as an annual vote on the discharge of directors should be taken into account. Normally, at least some, and, if required by local regulation or best practice, all of the directors should be submitted for re-election every two to three years. Shareholders should be entitled to vote on the election and re-election of each director separately. This should normally occur on the same date and for the same length of tenure. Companies governed by legal systems that do not allow the removal of directors by a majority of shareholders should consider providing such right by an amendment of the company's constitutional documents.

As described earlier, we consider that a change in the culture of companies, particularly financial institutions, is also the key to restore the confidence in boards as a key pillar of corporate governance. We believe that boards should establish and maintain a strong internal culture which focuses executives and employees on sustainable value creation. Such a culture will ensure that employees act cohesively to promote the long-term success of the business.

Exercise of Shareholder Rights

What role did large institutional shareholders play in the financial crisis? In their role as investors and in their role as owners?

Whilst there are many and interrelated reasons for the financial crisis, we recognise that institutional investors have played a part. For example, investors did not call financial institutions to account effectively and some bought financial products they did not fully understand sometimes relying on others to do their work for them for example the credit rating agencies. We are currently considering what can be learnt from the experience and - working together with other investors - are setting out measures that will ensure that we will do better in the future. For example, we strongly believe that pension and insurance funds and other long-term institutional investors - individually and collectively - should be more active and engaged owners of companies going forward. This will involve a constructive dialogue with board members of investee companies to ensure the necessary level of accountability.

Would additional shareholder rights have changed anything in terms of their ability or willingness to monitor CEO's and boards?

We believe that the key issue to address in most countries is ensuring that existing shareholder rights are used appropriately and effectively to create corporate cultures that facilitate the sustainable creation of value over the long-term. Having said this, there are a number of key rights that facilitate an adequate involvement of shareholders in fundamental corporate decisions and ensure an adequate level of board accountability.

Shareholders should have the right to participate in, and to be sufficiently informed about, decisions concerning fundamental corporate changes, such as amendments to constitutional documents, authorisation of additional shares, major acquisitions or disposals, and closure of businesses. Companies should also ensure effective shareholder participation in key corporate governance decisions, such as the nomination, election and removal of members of the board as well as external auditors and give shareholders the opportunity to express their views on remuneration policies for top managers and board members.

To ensure an appropriate degree of board accountability we strongly believe that all directors should stand for re-election subject to continued satisfactory performance on a regular basis. The frequency of re-election should support the accountability of directors but also take into consideration the stability of the board. In this context, other accountability mechanisms, such as an annual vote on the discharge of directors should be taken into account. Normally, at least some, and, if required by local regulation or best practice, all of the directors should be submitted for re-election every two to three years. Shareholders should be entitled to vote on the election and re-election of each director separately. Companies governed by legal systems that do not allow the removal of directors by a majority of shareholders should consider providing such right by an amendment of the company's constitutional documents. We would note that all of these rights need to be considered in a particular national legal and regulatory context.

In terms of their own business model, incentives and governance structure, what is the most important obstacle to more active and informed ownership by institutional investors?

There seem to be a number and interrelated obstacles. Going forward, we believe that pension funds and other long-term owners need to invest in a long-term way and ensure that the message that they and their agents give to companies in which they invest is appropriately long-term to drive sustainable value creation. This may well require changes to the fund management mandates that are given out, and changes in the way fund managers are called to account. In addition to changing the time horizons of their fund managers, asset owners may also need to think more actively about their need to encourage long-term thinking among their investee companies in other ways. Sending messages direct as beneficial owners rather than relying on fund managers as the sole route for communication may be an effective way forwards. Whatever form active and informed ownership will take effective engagement with boards and senior management, which requires significant resource, will come at a cost. The difficulty of justifying engagement resource and costs seems to be another important obstacle to more active and informed ownership by institutional investors.

We trust that you will carefully consider our comments and find them useful input when developing OECD's response to the financial crisis. If you would like to discuss our views in more detail, please do not hesitate to contact me.

Yours sincerely,

Dr. Hans-Christoph Hirt