

# The Hermes Responsible Ownership Principles

What we expect of listed companies  
and what they can expect of us



The Hermes Responsible Ownership Principles address a simple question: ‘What should owners expect of listed companies and what should these companies expect from their owners?’ The document’s aim is to create a common understanding, between boards, managers and owners, of the proper goals of a public company.

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**01.**

Introduction

# 01. Introduction

The Hermes Responsible Ownership Principles address a simple question: **‘What should owners expect of listed companies and what should these companies expect from their owners?’** The document’s aim is to create a common understanding, between boards, managers and owners, of the proper goals of a public company. It sets out a number of expectations which we believe should exist between owners, boards and managers. By being explicit about appropriate expectations, we aim to get a better framework for communication and dialogue between boards and management on the one hand and shareholders on the other hand, which can contribute to better management of companies and ultimately sustainable creation of wealth for their shareholders.

Hermes Fund Managers is a multi-specialist asset manager, independent of any broader financial services organisation. With our past and future aims firmly based around a long-term and responsible approach, we have developed a business model which combines both specialist investment teams and products with a robust operating platform from which to run them. Our pension fund management service, Hermes Pension Fund Management runs alongside our multi-specialist structure and acts as the executive arm of the BT Pension Scheme. Additionally, we have developed a stewardship business, Hermes Equity Ownership Services (HEOS), which advises and represents long-term investors in respect of over \$80 billion of equities (December 2008). This includes voting services and intensive company engagements which have the objective of delivering long-term value creation. Engagements may relate to the financial performance and strategic plans of portfolio companies or environmental, social and governance (ESG) issues. HEOS helps pension funds and other long-term investors optimise their capacity as responsible owners of the assets in which they invest and to incorporate longer-term sustainability and risk management issues into their ownership policies and practices

The expectations set out in this document are derived from Hermes’ extensive experience as an active and engaged shareholder. This experience suggests that there are a number of reasons companies fail in their primary goal of delivering long-term value. Our experience suggests there are good central management disciplines which will greatly increase the likelihood of value delivery. Moreover, there is strong evidence that companies with governance structures that facilitate control and accountability to their owners together with pro-active management of sustainability issues perform better over the long-term. We believe it is important that investors are explicit about the significance they place on these disciplines, structures and skills. Our expectations of listed companies are explained in Part 2. of this document.

We are not seeking to place new burdens on businesses. It is not in our interest as investors to do that. We believe that this document highlights what good companies already do, and it is only a minority of companies which will need to change their approach significantly better to generate long-term value for their shareholders. However, we believe that all boards will benefit from critically analysing how their companies operate against the principles and the discussion around them in this document. What we might expect as one outcome of this document is some reappraisal of the way that businesses communicate with shareholders. At all times Hermes stands ready to discuss our expectations with companies and will always be flexible in responding to particular circumstances. However, companies which do not meet our expectations should anticipate that, as responsible owners, we will seek explanations as to why they have failed to do so.

We also realise that responsible behaviour by boards and management requires investors to be responsible. A company that is demonstrating a clear commitment to delivering long-term shareholder value should expect ongoing support from its shareholders. At Hermes, we aim to give this support through adopting a consistent, constructive approach in our dialogue with companies and taking a long-term view. Again we believe it is important to be explicit about this commitment and therefore in Part 3. of this document we have described what listed companies can expect of us.

We would be pleased to discuss the Hermes Responsible Ownership Principles with the boards and managers of public companies, other shareholders and other interested parties with the aim of creating the greatest possible clarity about our mutual expectations.

1. We believe that the Principles outlined in this document are relevant and applicable to companies with one- and two-tier board systems and as such do not explicitly distinguish between the different board structure systems. Where Principles conflicts with local legislation or regulation their spirit should be taken into consideration when exercising discretion.

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What we  
expect of listed  
companies

## 02. What we expect of listed companies

At the most fundamental level, companies should economically, efficiently and effectively provide goods and services that individual customers and society need or want. In general this can only be sustainably achieved if in doing so they create value over time for their shareholders. Given this relationship, Hermes' overriding expectation is that companies be run in the long-term interest of shareholders.

To sustainably create value, companies need to develop strategies that exploit or provide them with a competitive advantage over competitors and apply appropriate operational and financial disciplines. In order to succeed in the long-run, companies will need to manage effectively relationships with key stakeholders and have regard for the environment and society as a whole. Companies adhering to our overriding principle will not only create sustainable value for their shareholders, but also benefit stakeholders and the wider economy and society in which they participate.

### Overview: Our expectations of listed companies

#### Transparency and Communication:

##### Principle I

Companies should disclose adequate, accurate and timely information concerning their business and key personnel, so as to allow investors to make informed decisions about the acquisition, ownership obligations and rights, and sale of shares. In particular they should clearly communicate on their objectives, strategy, competitive position and operational and risk management. They should be willing to have an open, ongoing and high-level dialogue with shareholders on these issues.

#### Corporate culture:

##### Principle II

Companies should establish and maintain a strong internal culture which focuses its staff on sustainable value creation. Such a culture will ensure that employees act cohesively to promote the long-term success of the business. Boards should establish, maintain and oversee an appropriate corporate culture and ensure that related objectives are reflected in arrangements such as job responsibilities, performance measurement and assessments and remuneration.

#### Strategy:

##### Principle III (corporate and business unit strategy)

Companies should have, and continue to develop, a coherent corporate strategy and strategies for each of their business units. These should ideally be expressed in terms of their target markets and of the competitive advantage the business has in exploiting opportunities in them in order to generate sustainable returns in excess of the cost of capital. The company should understand the factors which drive the relevant market, and the particular strengths which underpin its competitive position. Companies should also be able to explain why they are the "best parent" of each of the businesses they run.

##### Principle IV (focus on operating performance)

Companies as a priority should seek to maximise the sustainable operating performance from their existing core business or businesses. Growth opportunities should be pursued in a measured way and be built on the core capabilities of the companies. They should not unduly divert resources from the existing core business. Ideally, any acquisition should be fully and properly integrated before further businesses are acquired.

##### Principle V (investment plans)

Companies should ensure that all investment plans have been critically tested in terms of their ability to create long-term shareholder value. If a company is considering diversifying from or rapidly expanding its core business, especially if by acquisition, it should apply significantly higher hurdles within such tests to reflect the greater risks inherent in such a strategy.

## 02. What we expect of listed companies continued

### Financial disciplines and structure and risk management:

#### Principle VI (measuring returns and managing risks)

Companies should have appropriate measures and systems in place to ensure that they know which activities and competencies contribute most to maximising long-term shareholder value. It is equally important that companies analyse and measure risks and have robust systems and procedures in place to do so in order effectively to manage the risks associated with its activities. Boards should have robust practices in place to oversee risk management.

#### Principle VII (appropriate cost of capital)

Companies should have an efficient capital structure which will minimise the long-term cost of capital. Where the capital structure is inefficient taking the particular circumstances of the company concerned into account, the balance of debt and equity should be reconsidered.

### Stakeholders, environmental and social issues:

#### Principle VIII (relationship with stakeholders)

Companies should manage effectively relationships with their employees, suppliers and customers and others who have a legitimate interest in their activities with a view to maximising long-term shareholder value.

#### Principle IX (management of environmental and social issues)

Companies should manage effectively environmental and social factors that affect their business and society at large with a view to enhancing their long-term sustainability. They should demonstrate how they identify and explore related business opportunities and explain the structures and procedures in place to manage related risks. Where appropriate, companies should support voluntary and statutory measures which minimise the externalisation of costs to the detriment of society at large.

### Governance:

#### Principle X (corporate decision-making and accountability)

Companies should allow shareholders to participate in an appropriate form in decisions concerning fundamental corporate changes, such as major acquisitions and disposals, and adopt governance structures and procedures that give shareholders the powers effectively to hold their boards and - at least indirectly - senior management to account.

#### Principle XI (boards)

Companies should be guided by boards that are made up of members with an appropriate and diverse range of competencies, knowledge and experience to enable them effectively to carry out their duties and responsibilities. These include selecting, guiding, monitoring, challenging and where necessary, replacing management and thus require an ability to step back and act objectively and independently in the long-term interests of the company and its shareholders. The leadership structure of boards should reflect these objectives. Ideally, boards should be led by an independent non-executive chair. Where a different approach is preferred, this should be explained and justified. Boards should establish and maintain an appropriate corporate culture and assume responsibility for remuneration policies and oversee the risk management function.

#### Principle XII (alignment of interests through remuneration)

Companies should design and implement remuneration policies that adequately incentivise their senior executives and align the interests of management with the interests of shareholders in the maximisation of long-term value. Companies should seek shareholder approval of their remuneration policies and of any significant changes to those policies.



## Transparency and Communication:

### Principle I

Companies should disclose adequate, accurate and timely information concerning their business and key personnel, so as to allow investors to make informed decisions about the acquisition, ownership obligations and rights, and sale of shares. In particular they should clearly communicate on their objectives, strategy, competitive position and operational and risk management. They should be willing to have an open, ongoing and high-level dialogue with shareholders on these issues.

A company cannot control its share price, which will be affected by many external factors. However, it can seek to be clear about its objectives, strategy, financial disciplines and control and accountability mechanisms.

Transparency and pro-active communication will create the best chance of a company being evaluated properly. This way it will gain the full benefit of access to a lower cost of capital through public capital markets and be able to deliver value to its owners. This requires a continual process of providing information and correcting misinformation to ensure the fullest possible understanding of the company by the market.

It is important that companies are honest about their prospects. For those companies with a long investment time frame, such as those involved in drug development or aerospace, there may be considerable delay between an investment and its subsequent return. However, there may be cases where companies simply promise better returns in the future without any credible strategic or operational plan to achieve that improvement. It is therefore important that companies are able to articulate a credible plan as to how and when sustainable performance and shareholder value will be delivered.

## Corporate culture:

### Principle II

Companies should establish and maintain a strong internal culture which focuses its staff on sustainable value creation. Such a culture will ensure that employees act cohesively to promote the long-term success of the business. Boards should establish, maintain and oversee an appropriate corporate culture and ensure that related objectives are reflected in arrangements such as job responsibilities, performance measurement and assessments and remuneration.

Companies and the businesses they run rely on their people and on the decisions taken by individual members of staff. No company of any size that aims to generate value over the long-term should leave decision-making in a few pairs of hands. In order to ensure that individuals to whom authority is devolved take decisions that are

appropriate for the sustainable creation of value, boards and management need to generate and sustain a culture which establishes the aims and values of the business. This will often require significant effort over a sustained period of time.

It is often easier to spot a weak or failing culture than one which will foster thriving business success. For example, cultures which encourage individuals to agree a deal early even if that will mean there are lower profits in the long-run or which drive staff to cut corners in relationships with customers or suppliers, are cultures which will destroy value over the long-term. Cultures which stifle change and improvement can be just as damaging. Boards and management need to limit the tendency to stagnation as much as over-aggressive ambition.

Often companies make public statements about their values and beliefs. If these are not in fact embedded in the culture and practices of the organisation, for example through job requirements, performance measurement and assessments and remuneration policies, this can be damaging to staff morale and relations. In addition the confidence in the organisation of shareholders, customers and suppliers can be affected. Regular internal surveys of employees at all levels can be a valuable method of tracking both corporate culture and staff morale.

## Strategy:

### Principle III (corporate and business unit strategy)

Companies should have and continue to develop a coherent corporate strategy and strategies for each of their business units. These should ideally be expressed in terms of their target markets and of the competitive advantage the business has in exploiting opportunities in them in order to generate sustainable returns in excess of the cost of capital. The company should understand the factors which drive the relevant market, and the particular strengths which underpin its competitive position. Companies should also be able to explain why they are the "best parent" of each of the businesses they run.

Long-term shareholder value requires the generation of return well into the future. If shareholders are to assess the degree to which a company will generate long-term value, they will need to understand the corporate strategy and the strategies of its business units. We believe an appropriate requirement is that boards should be able not only to discuss the objective of strategy, but also the methods by which that objective is to be achieved.

Critical to describing the method is a clear understanding of (i) the demands and dynamics of the market, and (ii) the business's competitive advantage in terms of, for example, consumer value, cost or access, which allow it

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to maintain a superior return compared to other competitors within the market.

In assessing competitive advantage, a company should be able to explain what particular strengths or resources it has access to, which allow it to maintain the advantage. For example, a company may have a cost advantage which derives from scale, factor costs, brands, technology or a combination of many of these and other features. The greater the competitive advantage which a company enjoys, the higher should be its profitability relative to other industry participants.

Many larger quoted companies participate in a number of different businesses, whether these are defined by market, product or activity. In each case it is essential, if the corporate goal is to generate long-term shareholder value, that the board can explain why it is the 'best parent' of any subsidiary company it owns. If a business would generate greater value if it were independent, or managed by another corporate body, and there are no clear synergies at the corporate level, then the board should consider plans to divest it.

### **Principle IV (focus on operating performance)**

Companies as a priority should seek to maximise the sustainable operating performance from their existing core business or businesses. Growth opportunities should be pursued in a measured way and be built on the core capabilities of the companies. They should not unduly divert resources from the existing core business. Ideally, any acquisition should be fully and properly integrated before further businesses are acquired.

Companies with strong and effective management will attract investors. Efficient operations go to the core of effective management and no company will succeed in the long-run if it neglects the operational performance of each element of its ongoing business. A company should obtain and maintain a clear picture of its operational performance in comparison to its competitors and performance in related industries by effective benchmarking.

It is not enough for a company to be innovative or to have a clear and strong strategy: even the greatest innovations and the best strategy need to happen within the context of a strong performance of the existing business. If not, they will likely fail to create the value that they should and destroy value in the core business through a diversion of resources and lack of appropriate management attention. Yet too often the efficient management of operations is neglected in favour of the next big idea or the strategic story. The best managements are not distracted in this way, even if some advisers or investors encourage them to be.

This should not suggest that a focus on operations is a static process, nor a simple one-off event. Effective

management will always be actively considering how it can better align its internal structures to customer demand, and so more efficiently deliver its core products and services to customers. It is through this ongoing internal process of challenge and improvement that operational efficiency is delivered.

Once there is a position of operational strength, management will have a concrete foundation from which to expand. They are more likely to have shareholder support for that expansion to the extent that they have demonstrated their effectiveness in managing existing operations.

### **Principle V (investment plans)**

Companies should ensure that all investment plans have been critically tested in terms of their ability to create long-term shareholder value. If a company is considering diversifying from or rapidly expanding its core business, especially if by acquisition, it should apply significantly higher hurdles within such tests to reflect the greater risks inherent in such a strategy.

Companies should focus first on deriving the strongest sustainable operating performance from their existing business and assets before considering growth and expansion. Having said this, we fully support companies that seek to exploit their competitive advantages and grow sustainably, provided this generates a capital surplus.

Both organic and acquisitive growth may involve taking considerable risks, and appropriate risk structures and procedures should be put in place to manage and oversee these. In particular, companies should ensure that all investment plans have been critically tested in terms of their ability to create shareholder value. Experience suggests that companies should apply significantly higher hurdles within such tests when they consider diversifying from their core businesses to reflect the greater risks inherent in such a strategy. However, even (major) acquisitions within core businesses can be value destructive and similar disciplines should be applied.

Even then, we fully recognise that some plans may fail. That is why our investments are spread so widely. As a result we support companies which take well judged risks, well explained to shareholders, in order to grow. Companies often seem unwilling to take advantage of this, and instead seek to balance risk within their portfolio of businesses. Such approaches make little sense to diversified investors.

## Financial disciplines and structure and risk management:

### Principle VI (measuring returns and managing risks)

Companies should have appropriate measures and systems in place to ensure that they know which activities and competencies contribute most to maximising long-term shareholder value. It is equally important that companies analyse and measure risks and have robust systems and procedures in place to do so in order effectively to manage the risks associated with its activities. Boards should have robust practices in place to oversee risk management.

The primary goal of a company should be to maximise long-term shareholder value through the economic, efficient and effective provision of goods or services that customers or society need or want. In financial terms, the creation of value is best measured by the present value of the cash flows from investment, discounted at an appropriate cost of capital, not an accounting measure. Companies should bear in mind that their ultimate goal is the creation of long-term shareholder value, and that this is best measured in terms of cash flow returns. We welcome initiatives by companies and their advisers to establish systems based on this measure.

Boards should be encouraged to review investment assumptions and projections not only before but also after any investment is made to track against reality, rather than just comparing the outcome through budgetary processes. If they do not, managers and investors will have little guide as to which of their decisions have been successful.

Risk management needs to be given a higher profile in companies. The risk management function should be integrated into the overall approach and at the operational level. Risk analysis, measurement and management should be built into all operational activities. The risk control systems and procedures put in place should be regularly reviewed to ensure they are effective and risks are appropriately measured and managed. The risk management function should be overseen by the board.

### Principle VII (appropriate cost of capital)

Companies should have an efficient capital structure which will minimise the long-term cost of capital. Where the capital structure is inefficient taking the particular circumstances of the company concerned into account, the balance of debt and equity should be reconsidered.

Companies should seek an appropriate balance of debt and equity. If they do so, they will lower their overall cost of capital, thus generating shareholder value. The appropriate debt/equity ratio is a question for the board and will be dependent on the particular situation of the

company concerned as well as the wider economic circumstances. However, we would note that there are companies which have, for considerable periods of time, had substantial cash balances or undergeared balance sheets. This may be inappropriate for companies which are seeking to maximise shareholder value.

Equally there are companies which have found themselves 'over-geared', but believe that their relationship with their shareholders is such that they feel unable to come to the equity market for the necessary funds. It is essential that there is honest and open dialogue between directors and shareholders, so that a company can have access to the necessary funds to maintain an effective capital structure. Investment institutions should support companies seeking to achieve such a goal.

## Stakeholders, environmental and social issues:

### Principle VIII (relationship with stakeholders)

Companies should manage effectively relationships with their employees, suppliers and customers and others who have a legitimate interest in their activities with a view to maximising long-term shareholder value.

Well managed companies cannot ignore the impact of their activities on the wider society. This does not mean, however, that businesses have limitless social obligations. It is the responsibility of businesses to generate value for long-term shareholders. Hermes believes that they will only be able to do so in the long-term by effectively managing relations with their key stakeholders.

Hermes also believes that ethical behaviour by companies is likely to involve some notion of fairness and reciprocity; that managers seek to understand the position of those whom their action affects, and that they deal fairly with them.

We believe that doing well economically in the long-term and behaving ethically and responsibly are not mutually exclusive. At the very minimum, based on economic efficiency, we would argue it is appropriate that companies are open about and prepared to discuss the impact of their activities.

### Principle IX (management of environmental and social issues)

Companies should manage effectively environmental and social factors that affect their business and society at large with a view to enhancing their long-term sustainability. They should demonstrate how they identify and explore related business opportunities and explain the structures and procedures in place to manage related risks. Where appropriate, companies should support voluntary and statutory measures which

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minimise the externalisation of costs to the detriment of society at large.

We recognise that a range of environmental and social issues may affect long-term shareholder value and the company's sustainability. As such, we believe companies should effectively identify and explore related opportunities and manage relevant risks. We also encourage companies to disclose to shareholders on a regular basis how they do so and provide evidence that this process is effective.

As companies operate in a competitive environment, there may be circumstances where there is a high incentive to 'externalise' costs – i.e. to make a profit for the company while high costs are incurred by society at large. We ask companies to welcome frameworks, voluntary where possible, statutory where necessary, which encourage businesses not to externalise costs. Most investors are widely diversified; therefore it makes little sense for them to support activity by one company which is damaging to overall economic activity. The ultimate beneficiaries of most investment activity include the greater part of the adult population who depend on private pensions and life insurance. As such, it makes little sense for pension funds to support commercial activity which creates an equal or greater cost to society by robbing Peter to pay Paul. Where companies are aware that such conditions exist, it is appropriate for them to support measures to align shareholder interests with those of society at large.

### Governance:

#### Principle X (corporate decision-making and accountability)

Companies should allow shareholders to participate in an appropriate form in decisions concerning fundamental corporate changes, such as major acquisitions and disposals, and adopt governance structures and procedures that give shareholders the powers effectively to hold their boards and – at least indirectly – senior management to account.

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 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.

Shareholders holding a significant amount of shares should have the right to propose nominees for election to the board and request extraordinary general meetings to raise and discuss issues of significant concern, such as fundamental corporate changes. There should be appropriate safeguards to prevent abuse of these important rights which already exist in many markets but are generally only used in exceptional circumstance where engagement has failed.

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.

#### Principle XI (boards)

Companies should be guided by boards that are made up of members with an appropriate and diverse range of competencies, knowledge and experience to enable them effectively to carry out their duties and responsibilities. These include selecting, guiding, monitoring, challenging and where necessary, replacing management and thus require an ability to step back and act objectively and independently in the long-term interests of the company and its shareholders. The leadership structure of boards should reflect these objectives. Ideally, boards should be led by an independent non-executive chair. Where a different approach is preferred, this should be explained and justified. Boards should establish and maintain an appropriate corporate culture and assume responsibility for remuneration policies and oversee the risk management function.

Boards should ensure that they comprise members with an appropriate and diverse range of competencies, knowledge and experience. These include leadership skills to move the company forward, a facility with group dynamics, technical expertise to make informed decisions, and sufficient independence and courage effectively to challenge executive management and to hold it to account. We encourage boards to ensure that a significant number of their members are likely to be able to exercise independent judgment. We would highlight

however that it is the balance of the composition that matters most.

The non-executive directors should have the wherewithal to enable them to fulfil their duties and responsibilities properly. Above all, boards need to ensure that non-executive members receive all necessary information in a timely manner and that they have access to senior executives and appropriate support resources. Boards should establish and maintain a strong internal culture which focuses company staff on sustainable value creation. Such a culture will ensure that employees act cohesively to promote the long-term success of the business.

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 ultimate 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, that each director makes a useful contribution, and that board leadership is structured and exercised effectively. Companies should disclose the process for such evaluation.

Companies should also provide information regarding their board appointment procedure, including the factors considered when searching for candidates. Boards should provide adequate information on board candidates to the company's shareholders well in advance of the shareholder meeting at which elections take place. 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.

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## **principle XII (alignment of interests through remuneration)**

**Companies should design and implement remuneration policies that adequately incentivise their senior executives and align the interests of management with the interests of shareholders in the maximisation of long-term value. Companies should seek shareholder approval of their remuneration policies and of any significant changes to those policies.**

Remuneration packages should be sufficient to attract, retain and motivate executives of a calibre required to run the company successfully in the long-term. At the same time, remuneration should be structured in a way that provides senior executives with adequate incentives to maximise shareholder value in the long-term. The objective of any remuneration scheme should thus be to align the interests of executives with those of shareholders by linking their rewards to the company's performance over at least three years and to the underlying returns earned by shareholders over such period. To ensure such an alignment, performance metrics should also include market or sector relative measures. "Bonus-malus" systems with regard to longer-term, variable remuneration can help in aligning effectively the interests of executives with those of shareholders.

Flawed remuneration policies may encourage executives to take excessive risks in order to generate short-term profits and fail to align their interests with those of shareholders in the longer term. For companies in the financial sector in particular, we will therefore look for evidence that variable incentive structures reward sustainable profits and incorporate some risk metric and measure of the cost of capital involved in any deal related activities.

Remuneration policies should be disclosed annually so that shareholders can assess whether the interests of senior management have been aligned with their own. Furthermore we encourage companies to prepare and publish remuneration reports. Such reports provide a chance to articulate policies with regard to remuneration and explain how they support strategic objectives. As such, they can provide a useful starting point for constructive dialogue between companies and shareholders. Companies that produce remuneration reports are encouraged to 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.

**03.**

What listed  
companies can  
expect of us



## 3. What listed companies can expect of us

We have long been a proponent of responsible ownership, which we would define as taking an active interest in the long-term performance of the companies in which we and our clients are invested. We refer to responsible ownership as stewardship. Companies run by managers and directors in the best long-term interests of shareholders can be confident of Hermes' continuing support. We will become more active when situations arise where investor involvement could lead to better company performance.

This approach is consistent with the recommendations of the International Corporate Governance Network's Statement of Principles on Institutional Shareholder Responsibilities (available at: [www.icgn.org](http://www.icgn.org)). It means working with boards, management teams and other share- and stakeholders to bring about changes in either strategy, financial structure, operational or risk management or governance that will, over time, lead to superior long-term performance by the company. This is what we term engagement. Importantly, the focus on long-term value ensures a consistent approach in all our engagements.

In Hermes' view there are five core principles of stewardship and engagement that responsible shareholders ought to observe. These are discussed in detail below. Hermes undertakes to operate in accordance with these principles whenever it engages with companies on behalf of its clients.

### 3.1 A clearly communicated set of expectations on investor communications, corporate culture, operations, strategy, financial disciplines and structure, sustainability and governance

The Hermes Responsible Ownership Principles set out our expectations and form the basis of our engagements with companies on a wide range of issues, including investor communications, corporate culture, operations, strategy, financial structure and disciplines, risk management and oversight, sustainability and governance. They also explain what companies can expect from us and set out what we regard as responsible ownership. Most importantly, companies can expect a consistent approach based on the overriding requirement that companies be run in the long-term interest of shareholders. Having said this, whilst we conduct our engagements with companies in accordance

with the Hermes Responsible Ownership Principles, we apply them pragmatically and with thought and will be flexible as relevant.

Hermes' policy documents are sent to companies with which we engage and published on our website ([www.hermes.co.uk](http://www.hermes.co.uk)). Hermes reviews its policies periodically to ensure that its approach continues to be consistent with its objective of encouraging practices that enhance long-term shareholder value creation. Hermes is also an active participant in national and international forums that seek to promote shareholder interests and debate matters of corporate governance best practice.

### 3.2 A consistent approach

Hermes aims to maintain a consistent approach in its dealings with investee companies. Where we are seeking changes at a company then the changes sought will remain consistent over time unless a company's circumstances change. As far as possible, we will make the same people available to meet with the company on each occasion. We will keep records of all meetings so that, where this is not possible, Hermes representatives voice a consistent view.

### 3.3 A thorough understanding of markets and companies around the world

#### 3.3.1 Holistic analysis

Hermes applies a holistic approach to analysing companies. This enables us to identify those which are failing to perform, whether in terms of immediate financial returns or in terms of failure to manage adequately risks or relationships which may destroy value over the long term. It is those companies which will receive our greatest attention and are likely to be ones with which we engage most intensively.

When undertaking an engagement we assess the company's historical financial performance, the degree to which its strategic objectives have been met, its risks managed and the logic of the component businesses and

## 3. What listed companies can expect of us continued

financing structures. This helps us identify the causes of the company's underperformance and the changes necessary to remedy them. Further, it enables us to estimate the fundamental value of the company which might be realised once the changes are made. We also review the appropriateness of the company's governance structures and try to identify other shareholders with whom we might work. From this analysis we take a view on the potential for us to be successful catalysts for change. Our analysis is based on information produced by the company itself, supplemented by research from a wide range of sources and Hermes staff. We put considerable effort into understanding the reasons for a company not fulfilling its performance potential and the appropriate course of action for the board and management team to take to turn the situation around.

To be effective as responsible shareholders we need to have constructive, informed discussions with boards and management teams based on a thorough understanding of the company's past and potential. We need also to build trust and respect between Hermes and the management teams of the companies we engage with. It is important to emphasise that we believe in the delegated nature of corporate management; we are very clear that we do not want to micro-manage companies. We see our role as providing the board and management with a shareholder's perspective and working with and supporting them to address weaknesses that are detrimentally affecting the company's performance. Meeting with senior management and board members is also a critical part of our intelligence gathering before and during an engagement programme.

### 3.3.2 A multi-disciplinary, multinational team

Effective engagement requires a range of skills, many of which are not traditionally found in fund management houses. Hermes' team of stewardship professionals have experience in corporate management (operational and board-level), investment, legal, financial, risk, strategic management consultancy, and forensic accountancy environments. Many of them have been part of or worked closely with executive teams going through major corporate change. This equips them with the necessary skills, insight and experience to contribute to discussions on a wide variety of structural, governance, strategic and financial matters. Moreover, as Hermes operates across markets on a global basis, the team is multi-national and multi-lingual. This diversity provides an understanding of the financial, legal and cultural environment in which the companies we engage with operate.

## 3.4 A long-term perspective when exercising ownership rights

Hermes seeks to address strategic, operational, financial and structural governance weaknesses with solutions that are long-term. Any change we encourage the board

or management to make through the exercise of voting rights or engagement will be with the intent to improve the company's ability to perform better over time and in the interests of all long-term shareholders.

### 3.4.1 Voting

We consider the vote as part of the asset a shareholder owns. Hermes will therefore lodge proxies at AGMs and EGMs in accordance with the Hermes Responsible Ownership Principles, unless its contact with the company or interpretation of its disclosures suggests that voting differently would better support the achievement of our engagement objectives and/or the long-term performance of the company. Where we consider voting against or abstaining on management resolutions, or voting in favour of shareholder resolutions opposed by management, we will whenever practicable contact the company before the meeting to discuss our concerns, thus ensuring that we are making a fully informed decision. If we vote against management recommendations on any matter we will inform the company after the meeting of our reasons for so doing.

Hermes recognises that it is not always economically efficient to vote at company general meetings. Where this is the case Hermes works to raise awareness amongst companies and their regulators as to the importance of voting in terms of costs of capital and market integrity of protecting shareholder rights and allowing shareholders to influence companies through the general meeting.

### 3.4.2 Takeover situations

Hermes generally prefers change from within companies and thus will normally support incumbent management in hostile takeover situations. However, such support is conditional on Hermes being confident that the target company, through its board and management, is acting in the interests of long-term shareholders. Where confidence has been lost in a board and/or management team or where there are clearly synergistic or strategic benefits to be realised through a take-over, Hermes will consider supporting a bid.

### 3.4.3 Share-lending

Hermes has developed its own policy on stocklending and fully endorses the Code of Stock Lending Code of Best Practice issued by the International Corporate Governance Network (available at: [www.icgn.org](http://www.icgn.org)). Share-lending is an important practice which improves market liquidity, reduces the risk of failed trades, and adds significantly to the incremental return of investors. At the same time share-lending gives rise to the risk that shareholder votes are lost in important situations or that shares are being voted by parties who have no equity capital at risk in the issuing company, and thus, no long-term interest in the company's long-term success.



We believe responsible shareholders have a duty to see that the votes associated with their shareholdings are not cast in a manner contrary to their stated policies and economic interests. While fiduciaries have a duty to maximise economic returns to their beneficiaries, they equally have a fiduciary duty to protect their long-term interests through voting and other actions sometimes precluding lending. Fiduciaries also have a duty to ensure that the pursuit of more income is not subjecting their beneficiaries to greater risks. These responsibilities must be appropriately balanced in accordance with the ultimate beneficiaries' preferences.

There may be situations in which share-lending could contribute to inappropriate short-selling of selected stocks. Hermes has developed a system to alert its fund managers and clients to such situations. We are happy to discuss our stock-lending policy with issuers and encourage them to alert our team to situations in which shareholders should consider re-calling shares in order to exercise voting rights.

### **3.5 A constructive, confidential dialogue with boards and senior management**

Hermes prefers not to take a public route when seeking change at companies. In our experience, working constructively with boards and management in private is most effective in achieving positive change. However, where no progress is made over an extended time period, Hermes may use the press and other public forums to drive change. We will normally notify a company in advance of briefing the media about an engagement. Should a story break through no action of our own, we will work with the company to try to ensure that the information in the public domain is representative of the situation. A committee comprised of senior Hermes executives and non-executives monitors engagement activities to ensure the consistency and integrity of its policy implementation. Further, our clients receive regular reports on our governance and engagement activities and have the opportunity to question the engagement team on its performance against the objectives they have set.

## Further information

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