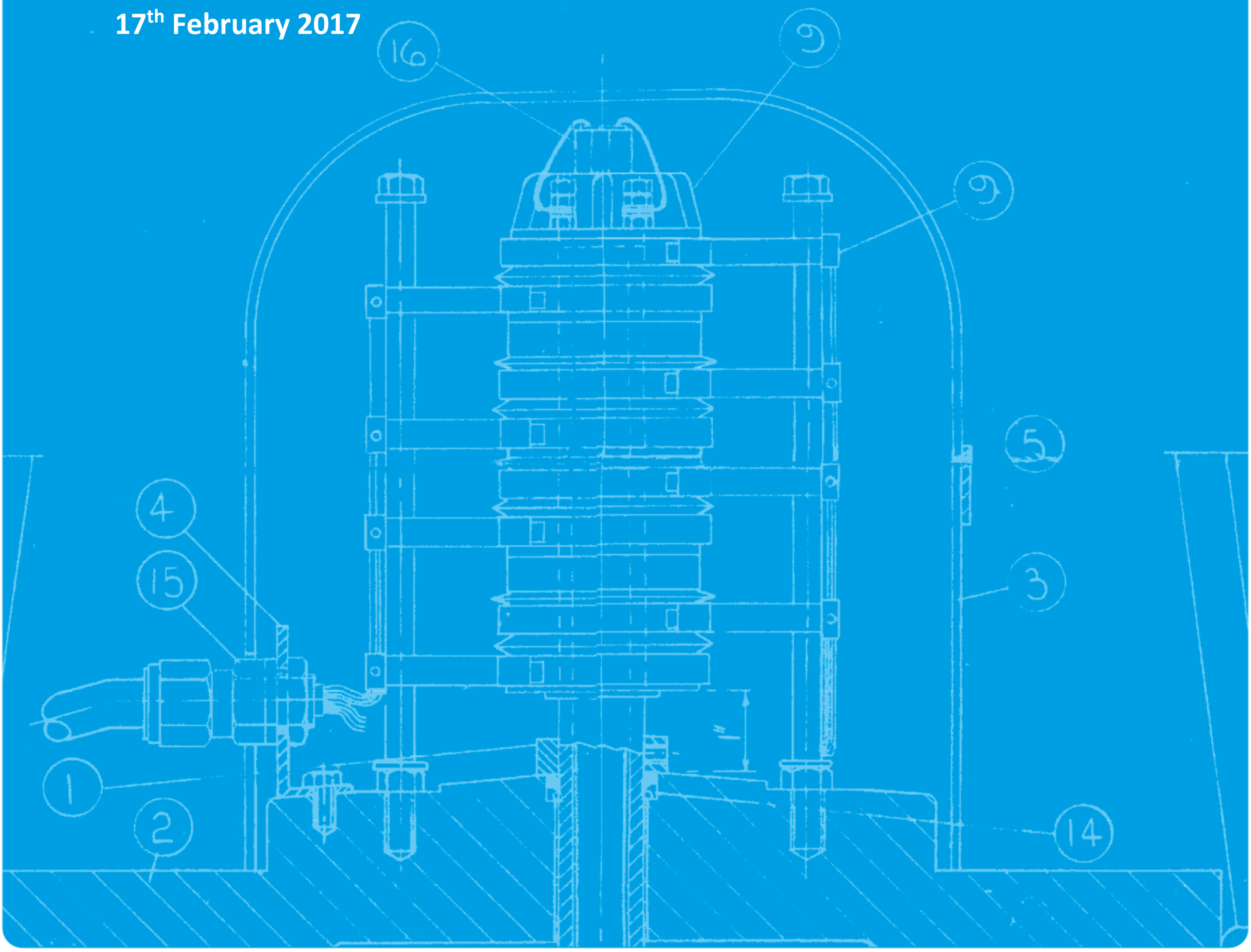
Corporate Governance Reform

Severn Trent

17th February 2017



Thank you for the invitation to respond to the Government’s green paper on corporate governance reform.

Good corporate governance is essential if the UK is to flourish economically, socially and environmentally. The UK’s corporate governance regime represents a best-in-class standard and acts as a model for the rest of the world. We need to preserve a regime that keeps the UK productive and maintains the trust of the people we ultimately serve.

From our perspective as a FTSE100 listed water company operating largely in the UK, we believe that there is much right with corporate governance in the UK. Business contributes hugely to our country’s wellbeing and, as a whole, most listed companies are responsibly run. There are, of course, examples of poor corporate governance that need to be addressed – it is crucial that business maintains the confidence of society – but we would suggest that the overall mind-set should be one of building on the positives whilst at the same time addressing small pockets of poor governance.

Principles for reform

We would specifically suggest five principles for successful reform:

1. Any changes should be based on a full consideration of what is working well, not just what is working less well. Successful reform is dependent on building upon strengths, not just addressing weaknesses.
2. Reform should aim to strengthen the UK’s international competiveness, not diminish it. We need to send a signal to the world that the UK is a safe, stable and straightforward place in which to invest.
3. Reform should be proportionate to the scope and significance of any problems identified. It should be evidence based, not driven by anecdote.
4. Reform needs to leave the overall UK corporate governance framework simpler and clearer. Complexity and a lack of clarity can easily lead to, and make it harder to expose, poor governance.
5. A robust but flexible framework should be maintained. Prescriptive solutions are likely to be counter-productive; reform should instead be underpinned by transparency and the principle of ‘comply or explain’.

The consultation questions

The consultation asks a number of questions about corporate reform. We are not in a position to offer insights on all of these questions, but we do believe our experience qualifies us to make the following points:

1. Do shareholders need stronger powers to improve their ability to hold companies to account on executive pay and performance? If so, which of the options mentioned in the Green Paper would you support? Are there other options that should be considered?

We believe that the current framework for controlling executive pay in listed companies is adequate.

Analysis of the levels of shareholder approval for remuneration policies and remuneration reports in 2016 shows that a significant majority of those FTSE350 companies who have sought approval of a remuneration policy received in excess of 90% votes in favour, and the average percentage of votes in favour of FTSE350 companies' remuneration reports was also in excess of 90%. This would suggest that the current regime, along with shareholders' ability to vote against the reappointment of individual directors, provides investors with adequate tools to combat perceptions of excessive executive pay.

We have also been told by investors that, given the effectiveness of the existing framework, there is limited desire or capacity among shareholders for enhanced consultation in respect of remuneration setting other than in the event of significant pay policy changes or following contentious remuneration outcomes.

However, if Government considers it necessary to give shareholders further powers, we would favour elements of options (ii) and (v) in the paper, whereby stronger consequences of losing the advisory vote on remuneration would be introduced, combined with clearer guidance for shareholders to identify those parts of the company's remuneration policy and its application against which they have voted. Similarly, for companies responding to a significant vote against a remuneration policy or its implementation, encouraging targeted feedback from shareholders regarding the specific element(s) of remuneration to which they are opposed would be welcomed.

2. Does more need to be done to encourage institutional and retail investors to make full use of their existing and any new voting powers on pay? Do you support any of the options mentioned? Are there other ideas that should be considered?

At present, meaningful consultation and engagement with shareholders is a time consuming and resource intensive process. Whilst it is undoubtedly a valuable and useful process when used in a targeted way around key strategic issues, we consider that forcing an increase in the frequency and nature of shareholder consultation is likely to place a significant time and resource burden, both on companies and shareholders, and introduces the risk that the quality of the conversation is diluted as a result.

Option (ii) in the paper seems administratively impractical, and would require significant resources on the part of companies and their shareholders to work.

We are supportive of efforts to increase transparency around shareholder voting patterns, although given the large number of individual retail investors and potentially very wide range of concerns and issues which might be raised by them, option (iii) presents a significant challenge for companies to understand.

3. Do steps need to be taken to improve the effectiveness of remuneration committees, and their advisers, in particular to encourage them to engage more effectively with shareholder and employee views before developing pay policies? Do you support any of the options set out in the Green Paper? Are there any other options you want to suggest?

For the reasons outlined above, we believe that the current mechanisms for shareholders to control executive pay are broadly effective already. We support better, rather than more frequent, engagement with shareholders generally, but particularly in the case of remuneration we believe that shareholder engagement should be focused on proposed significant changes to existing pay policy, whether in respect of the quantum or composition of remuneration.

In respect of employee engagement, directors are presently bound by duties to act in the long-term best interests of the company, having regard to the needs of all stakeholders. We believe that these duties are clear and adequate, but that directors should demonstratively discharge their legal duties and report transparently on their activities in the annual report.

We do not support the introduction of a requirement for remuneration committee chairs to have served for at least 12 months as a director before taking up the role. This appears to be an unnecessary restriction, and the discretion of a board to determine whether a director has the requisite skill, experience and objectivity to discharge such a role should not be fettered in such a way.

4. Should a new pay ratio reporting requirement be introduced? If so, what form of reporting would be most useful? How can misleading interpretations and inappropriate comparisons (for example, between companies in different sectors) be avoided? Would other measures be more effective? Please give reasons for your answer.

We believe that a single pay ratio would be a crude and meaningless solution to pay reporting. Any pay ratio should build in qualitative elements such as how all employees benefit from the success of a business, the impact of all employee share schemes, and the availability of bonus plans. Such qualitative elements need to be accompanied by meaningful explanatory narrative, and we are concerned that such context will be missed by users of a simple ratio.

We are also concerned about an unintended consequence of a simple ratio. Whilst increasing the remuneration of the lowest paid employees would improve the ratio of employee pay to executive pay, this may still be prohibitively expensive for companies and create an incentive to outsource or off-shore jobs as a way of improving the ratio. Conversely, employing more frontline employees might create jobs and improve service for customers but make a pay ratio worse.

5. Should the existing, qualified requirements to disclose the performance targets that trigger annual bonus payments be strengthened? How could this be done without compromising commercial confidentiality? Do you support any of the options outlined in the Green Paper? Do you have any other suggestions?

We continue to support the ability for companies to preserve the commercial confidentiality of bonus targets by delaying their disclosure until after the end of the performance period to which they relate. We would not support any legislative amendment which removes such protections, although non-legislative guidance, applied on a comply-or-explain basis, setting out shareholders' clear expectations about reasonable timeframes for retrospective disclosure within a reasonable timeframe would be acceptable.

6. How could long-term incentive plans be better aligned with the long-term interests of quoted companies and shareholders? Should holding periods be increased from a minimum of three to a minimum of five years for share options awarded to executives? Please give reasons for your answers.

The structure and vesting duration of awards under long term incentive plans should be proposed by remuneration committees and agreed by shareholders on a case by case basis. In order to align executives' and shareholders' long-term interests, a comply-or-explain requirement to increase post-vesting holding periods could be introduced, so long as no further performance criteria are attached.

7. How can the way in which the interests of employees, customers and wider stakeholders are taken into account at board level in large UK companies be strengthened? Are there any existing examples of good practice that you would like to draw to our attention? Which, if any, of the options (or combination of options) described in the Green Paper would you support? Please explain your reasons.

We believe that the interests of multiple stakeholder groups are best balanced not by having individuals on boards who represent these interests, but by the presence of a majority of independent directors, bound by duties to act in the long-term best interests of the company whilst avoiding conflicts of interest, seeking to balance the needs of all stakeholders.

We fully support the existing role of transparent corporate reporting in enabling shareholders and other stakeholders to scrutinise the performance of company boards. It is important to note that shareholders retain the ability to assess how well directors have discharged their duties, and can vote whether or not to re-elect directors. The majority of listed companies offer shareholders the ability to vote annually on the election and re-election of all directors in line with the principles of the UK Corporate Governance Code. We believe that directors should demonstratively discharge their legal duties, and continue report transparently on their activities in the annual report.

8. Which type of company do you think should be the focus for any steps to strengthen the stakeholder voice? Should there be an employee number or other size threshold?

Caution needs to be applied to ensure that any proposed amendments to company law or corporate governance best practice are proportionate to the perceived risks which they are trying to address.

We believe that any reforms should strengthen the UK's international competiveness and boost the UK's reputation as a safe, stable and straightforward place in which to invest. As such, any reforms may be more appropriately addressed to listed companies and should not impose bureaucratic barriers to growth and productivity for smaller, mainly private companies, consistent with the Government's strategy for reducing red tape.

9. How should reform be taken forward? Should a legislative, code-based or voluntary approach be used to drive change? Please explain your reasons, including any evidence on likely costs and benefits.

We believe that boards should be able to regulate their conduct, balancing business and stakeholder needs, on a case by case basis. As such, a robust but flexible governance framework, underpinned by transparency and the principle of 'comply-or-explain', will be more appropriate than prescriptive legislation.

14. Is the current corporate governance framework in the UK providing the right combination of high standards and low burdens? Apart from the issues addressed specifically in this Green Paper can you suggest any other improvements to the framework?

Good corporate governance is essential if the UK is to flourish economically, socially and environmentally. The UK's corporate governance regime represents a best-in-class standard and acts as a model for the rest of the world. We need to preserve a regime that keeps the UK productive and maintains the trust of the people we ultimately serve.

From our perspective as a FTSE100 listed water company operating largely in the UK, we believe that there is much right with corporate governance in the UK. Business contributes hugely to our country's wellbeing and, as a whole, most listed companies are responsibly run. There are, of course, examples of poor corporate governance that need to be addressed – it is crucial that business maintains the confidence of society – but we would suggest that the overall mind-set should be one of building on the positives whilst at the same time addressing small pockets of poor governance.