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The Norwegian Corporate Governance Board
NCBG Chair Ingebjørg Harto
c/o Oslo Børs
PO Box 460 – Sentrum
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Norway

London, 31 August 2010

By email: info@nues.no

Dear Mrs Ingebjørg Harto

Response to the revised Norwegian code of corporate governance

I am writing to offer NUES Hermes' comments on the proposed revision of the corporate governance code ("the Code") for Norway.

Hermes is one of the largest pension fund managers in the City of London and is the principal manager of the BT Pension Scheme. As part of its Equity Ownership Services (EOS), Hermes advises and speaks for clients in approximately 8000 companies. Hermes is closely involved in corporate governance issues and environmentally and socially responsible investing across Europe.

Hermes takes a close interest in matters of company law and regulation because they set the context for the exercise of our clients' rights as part-owners of the companies in which they invest. We seek to safeguard our clients' current rights and also to enhance the transparency and accountability of companies and their directors to their long-term owners.

We appreciate this opportunity to provide our views on the ongoing revision of the Code in particularly in light of recent changes in EU recommendations, and hope you find our comments useful.

2. Executive remuneration

2.2. Cap on performance-based pay

Actual and potential awards should not be excessive, should be directly related to the success of the company and aligned over time to the returns achieved by shareholders. We suspect that boards sometimes fail to estimate the magnitude of the potential pay-outs under various future scenarios. Such an exercise of calculating the outcomes of the scheme would clearly demonstrate to the board whether and at what level a cap is appropriate. As important as actually setting the amount limit is the *requirement to perform these calculations* internally when defining the pay model. Good remuneration reports would also indicate the span of the scheme without running the risk of serving as guidance for the company performance.

In our view the Code should include a provision that the board is presented with the financial implications of the scheme at various future scenarios and that a limit to pay-out is set appropriately.

2.4. Claw-back provision of performance based remuneration
We support the proposal in the Code commentary section that companies should take steps to incorporate the right to demand repayment of remuneration which has been based on self-evidently incorrect preconditions.

2.5.1. The remuneration report
We welcome the practice where remuneration reports are presented for shareholders' vote at the general meeting. The report is only valuable for shareholders if it portrays the *substance* for which the remuneration is based. Unless the report presents the guiding principles for the internal discussions on pay, the report is of highly limited use for investors. The proposed schemes should be *explained clearly* to shareholders, *justifying the structure* of the scheme and the *relevance* of the performance criteria to the business strategy and performance of the company. Schemes should be structured as *simply* as possible to ensure they can be understood by participants and monitored by shareholders. The link between company performance and executive reward should be rational and clear. The effect of the scheme should be illustrated with examples showing rewards at various performance levels.

The Committee's proposal to specify that these reports should be *clear, easily understood and specific*, is shared by us.

2.5.2. Incentive schemes in general
On a general note incentive schemes should be designed to reward exceptional performance. We would point to the principles of the International Corporate Governance Network (ICGN) which accentuate that remuneration should provide *alignment with shareholders* and *link pay to value-creation*. "*Remuneration structures for senior management should be appropriately aligned with the drivers of value-creation over time-scales appropriate both for a company's business and for its shareholders."*[1]

Awards should be scaled against achievement of performance criteria, with a relatively low payout if the minimum target is achieved and full payout only for truly exceptional performance. No award should be made where targets are not met. The measure used will vary depending on the type of incentive but performance should be compared to an appropriate benchmark or peer group. Awards should not be made unless there has been improvement in the underlying real financial position of the company.

An important objective when designing the good remuneration model is to incorporate risk and the corporate culture. ICGN's principles read "*Remuneration structures and frameworks should reinforce, not undermine, the corporate culture. Performance measurement should incorporate risk considerations so that there are*

[1] ICGN Global Corporate Governance Principles: Revised (2009), Principles for remuneration 5.1. p.17.

no rewards for taking inappropriate risks at the expense of the company and its shareholders, and performance should be measured over timescales which are sufficient to determine that value has in fact been added for the company and its shareholders."[2]

From these principles we would view the examples provided in the EU Recommendation 5.2. to be useful additions in the commentaries of the Code.

2.6. Remuneration committee – competence and composition

A remuneration committee of independent directors is well placed to discuss executive remuneration on behalf of the board. Discussions about executive remuneration have a tendency to be complex and lengthy. A committee which has the responsibility to prepare the debate can be highly valuable in terms of decision efficiency and quality.

We question the usefulness of placing specific requirements to the skills of the committee members as we consider the attitude of mind and bringing good business judgement to the questions as key.

Committees and boards increasingly take external advice in remuneration questions. We would like to emphasise that the importance of independence from management equally applies to advisors as to committee members. The remuneration committee should therefore "own" the relationship to the advisers who ideally should not work for the organisation in other matters, unless agreed with the committee.

3. The role of stakeholders and corporate social responsibility

The proposal advises that the code should include a more explicit requirement for the companies to address and develop corporate social responsibility (CSR) policies. It is our view that a company run in the long-term interests of its shareholders will need to manage effectively relationships with its employees, suppliers and customers, to behave ethically and to have regard for the environment and society as a whole. We would like to stress that the companies should understand and report on issues which are *relevant* for the risk and long term valuation and prosperity. Environmental matters, employee relations, ethical and social issues must be managed and discussed to the extent *necessary* to understand the development, performance or position of the company. We recommend that directors consider how these factors fit within the context of the reporting to shareholders and stakeholders. Where such factors are important risks to the future success of the company, this will need to be managed and disclosed. Similarly we would expect companies to describe the prospects and opportunities changes in these issues encompass. Most companies may need to think about environmental impacts and the future costs that these may entail. Consumer-facing businesses are likely to need to discuss customer relations and management of risks to their reputation. Most boards will need to consider discussing the retention and development of key staff.

[2] ICGN Global Corporate Governance Principles: Revised (2009), Principles for remuneration 5.2. p.17.

We consider developing policies on these matters as an integral part of directors' and management's responsibilities. From this it is clear that we seek *tailored disclosure* and not philanthropic or generic reports.

So to the question whether the code providing corporate governance provisions should contain a requirement to report on so-called CSR matters. As shareholders we struggle with the semantics when debating these topics. We would prefer code provisions that encourage corporate culture which foster ethical behaviour. We support how the ICGN principles deal with this. Under chapter 3 in the ICGN principles - Corporate culture – there are provisions for the company to develop codes of conduct and policies for anti-corruption, employee share dealings, compliance with the law and whistle-blowing arrangements. Under 3.3, Code of conduct, companies are advised to stipulate the ethical values of the organisation and its interaction with internal and external stakeholders. Other topics that typically sort under the CSR-definition should be dealt with through the general description of handling risk or developing business strategy.

The success of a company to manage these topics is a board responsibility. We would encourage NUES to highlight the role of the board along the lines of the ICGN provision 3.1 "The board should seek actively to cultivate and sustain an ethical corporate culture in the company. The company should take active measures to ensure that its ethical standards are adhered to in all aspects of the business."[3]

To summarise our views on this we are sceptical to introducing the term corporate social responsibility in the corporate governance code. We strongly support however the need to encourage boards to ensure that the company behaves ethically and manages risks and opportunities associated with internal and external stakeholders. Our suggestion is that the Code still promotes principles for a strong corporate culture, ethical behaviour and emphasise the role of the board in the definition and implementation. Rather than to require a separate CSR-policy the code should ensure that all levels of *relevant* risk and opportunities are included in the business strategy and disclosure.

4. Legal requirements to report Code deviations

We acknowledge the comply-or-explain approach embedded in the Code which reflects the tradition of market-based regulation in the Norwegian market. We particularly welcome the active dialogue between owners and companies that these encourage. Legal enforcement may have the effect of reducing the motivation to thoroughly explain the company specifics which in some cases can be well-justified deviations from the Code provisions. If NUES, the stock exchange or shareholders observe a general lack of respect for the Code or failure from a significant number of companies to comply with established practices, legal measures may be a solution. We have however not observed this to be the situation in Norway. The Committee

[3] ICGN Global Corporate Governance Principles: Revised (2009), Chapter 3 Corporate Culture p. 15

may still outline in the commentary sections that there is an expectation that companies provide the corporate governance guidelines in some detail so that the report takes the form as comply-*and*-explain, rather than just explaining the deviations.

5. Other changes in the Code

5.1. Terms applied

We have no comments to the Norwegian corporate governance terms proposed.

5.2. Board composition

Forthcoming changes in the Companies' Act prevent the chief executive to sit on the board and thereby make the provisions in the code superfluous.

We have no comments to add.

6. Takeovers – need for enhanced shareholder protection?

The Code has detailed provisions about the conduct of the board in the event of a takeover situation. We find this level of detail highly useful and appropriate, and note that it is more specific than most governance codes. The provisions are more detailed than we generally prefer to see in a principle-based code. We do however consider the need for the code to articulate best-practice provisions as instrumental in protecting minority shareholders in takeover or merger situations. The board's handling of and the company's communication around such transactions are crucial to the trust investors put in the Norwegian stock market.

The amplification that the Code primarily governs the *target* company is fair and provides more clarity to the provision. We also support the now more explicit requirement for an independent valuation in case of a takeover bid. There should be indisputable reasons to waive the principle of attaining an independent valuation.

We note the Committee's observations that private discussions between the bidding company and the management or board of the target often take place prior to a formal bid. On one hand preliminary and non-binding contact between parties may be in all shareholders' interests as the transactions may be executed more smoothly, and early clarification can hinder speculations and disturbances around the target company. Both companies' conduct in such circumstances should be well governed in the securities and stock exchange regulation in matters of insider information, insider trading and equal treatment of shareholders. There may however be situations where negotiations involve incentives for management and board in the target companies which may influence their judgement in favour of the transaction potentially at the expense of the shareholders. Examples may be negotiations about key positions, incentive schemes after the transaction or any other financial advantages to the individuals who are key to the decision.

We support the proposals by the Committee and add the following:

We believe transparency is the key to ensure accountability in these circumstances. Consequently the Code could add a provision that preliminary or binding agreements between the bidder and the target should be disclosed

in offer documents. An explicit requirement for target companies not to negotiate or accept terms which may challenge the independent judgement of the board and management could be added.

In significant mergers or takeovers the positions as chair of the board and executive management and other governance arrangements become part of the merger decision put to shareholders for vote. We would strongly prefer to be able to separate these important voting decisions. Shareholders should be

able to vote for the financial terms and the actual transactions separately from other key decisions associated with the takeover or merger.

7. Minority rights

Response to NAU's recommendations

7.2. Waiving pre-emptive rights in rights issues

The Equity Markets Commission ("NAU") has made some suggestions to specify the requirements around rights issues where pre-emptive rights are waived. We assume that this applies to situations where the board already has gained the general meeting's approval to issue shares and potentially waive the pre-emptive rights. The NAU has identified a need to enhance the minority protection in such instances. NAU recommends that in the notice to the board prior to the directors approving a private placement should state a justification for waiving the pre-emptive rights. As an alternative to this proposal the NUES suggests that the company must disclose the reason for waiving the pre-emptive rights in form of a stock exchange notice when the issue is announced.

We would assume that the board of directors are well aware of the implications of a rights issue. By including a provision specifying the contents of the stock exchange notice the board is also implicitly required to consider the justifications when approving the notice.

We therefore support the proposal that the stock exchange notice should address the reasoning for waiving pre-emptive rights.

7.2.1. Nomination committee – need for specifications?

In our view structured and professional nominations procedures are pre-requisite for a good board composition. The Norwegian model where the committee is named by the general meeting and consists of non-directors to represent the shareholders is subject to international interest. Provided that the overall objective that the committee truly represent all shareholders is met and that the committee possesses sufficient information and insight to give good suggestions to the general meeting, this form of nomination procedure may work well. The current recommendations give clear guidance regarding the work and composition of the committee. We do however support the suggestion that the Committee should establish terms of reference for its work. In addition we would like to emphasise the importance of board assessment procedures for the Committee.

We favour that the Code should require a terms-of-reference document for the nomination committee and add that this should be put before the general meeting for approval. The terms-of-reference should include a requirement that the board performs an annual board assessment and that the outcome of this is thoroughly presented to the nomination committee.

We trust that you will consider our views and hope they provide useful input into the revision process. If you would like to discuss our views in further detail, please do not hesitate to contact me on email h.sjo@hermes.co.uk or phone + 47 994 20 678.

Yours sincerely

Hege Sjo

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