

21 July 2016

Brent J. Fields  
Secretary  
Securities and Exchange Commission  
100F Street, NE,  
Washington, DC 20549-1090

**Re: file no. s7-06-16**

**Concept release on business and financial disclosure required by regulation S-K**

Hermes EOS welcomes the opportunity to provide our comments on this consultation on business and financial disclosure required by regulation S-K.

By way of background, Hermes is a London based asset manager, wholly owned by the BT Pension Scheme, one of the UK's largest pension schemes. As part of our Equity Ownership Service (Hermes EOS), we also respond to consultations on behalf of many clients from around Europe and the world, including the BBC Pension Trust (UK), VicSuper (Australia), Caisse de Depot et Placement du Quebec (Canada) and PNO Media (the Netherlands). In all, Hermes EOS advises over 40 clients with regard to assets worth a total of over \$250 billion (as at 30 March 2016).

Non-financial disclosure is so important because of the material financial consequences of environmental, social and governance (ESG or "non-financial") risks and opportunities. We only have to look at recent corporate disasters such as those at Volkswagen, Petrobras or BP to see that their governance of ESG matters was not good enough. Disclosure will not cure poor governance, but transparency helps investors to identify both good and bad practice and target their decision making, including the decision to engage with companies, accordingly. Moreover, companies' preparations to make disclosure should help them improve their practices, identify areas for improvement and re-enforce expectations within their organisations.

**Materiality**

We believe that the SEC should continue to use the current definition of materiality as arrived at by the Supreme Court, though we make an additional point in relation to materiality in relation to human rights.

We would also make the point that financial materiality is affected by investment time horizons. Much of the focus of the SEC is on buy and sell decision making. However, increasingly there is a shift to passive investing both by institutional and retail investors. What is material for a passive investor, owning the same companies for long periods, stretching into decades, is different from the time horizon of an active investor that may buy or sell after days, weeks or months. The SEC should afford the same investor protections to those who own shares for decades and require that boards consider materiality over long time frames.



### **Broad support for SASB's approach**

Given the extensive scope of the consultation we have not attempted to answer in detail every question asked. We are therefore focusing on some of the most important issues. We have had the opportunity to read SASB's response to the consultation and believe that the organisation has contributed through its work to a thoughtful approach that the SEC should consider adopting. We agree with its approach to supplement quantitative metrics with qualitative analysis because the assessment and management of ESG factors cannot be distilled into numbers in a spreadsheet. However, we wish to emphasise a few points that the SEC should additionally consider, relating to climate change, human capital management and human rights.

### **Climate change**

Most of our clients are large pension funds from around the world. Their liabilities stretch many decades into the future and so their time horizons are long. As a result, they are acutely concerned about climate change, not just at company level but at portfolio level, because of the systemic nature of climate risks. If the global intention, as represented by the Paris climate change agreement, to reduce its impact to below two degrees are unsuccessful our clients fear that there may be widespread dislocation to the global economy caused by the economic, social and geo-political consequences of severe weather events, drought, flood and rising sea levels. This will be likely to lead not only to reduction in economic activity but mass migration of displaced people and geo-political stresses and tensions, further worsening the economic outlook, affecting the global economy and therefore every public company. We therefore see climate change as a material issue for every company. Moreover, it is public, private and state controlled companies that will be the most important vehicles in the attempt to transform the global economy to one that is low carbon. Investors in the markets that the SEC regulates therefore should expect the SEC to examine closely the climate change disclosure by all companies that it regulates to ensure that it reflects the risks that companies face over the long-term.

Climate change is a material factor for every company over the long-term. We therefore believe that every company should have as a central plank of its core beliefs, support for the ambition of the Paris agreement and they should ensure that not only is the company publicly supportive of the Paris agreement, but that nothing within its strategy or operations undermines the ambition of the agreement. Companies must disclose how they manage these imperatives: both how they manage both the specific company risks of climate change and also the systemic risk presented by climate change.

### **Human capital management**

Almost every company states that its people are its most valuable asset. We agree with these statements. However, reporting on how companies manage their most valuable assets to preserve and enhance their value is notably absent from company reporting. Moreover, SASB's framework is not as good as it should be in this area. We note, for example, that SASB's standard for commercial banks has no direct human capital metrics and only a couple relating to regulatory settlements and fines and issues received through internal monitoring that relate to conduct. Nothing, for example, on training hours for compliance and non-compliance matters both of which might provide greater insight into the bank's culture and behaviour than the two measures chosen. We believe that there is a real opportunity for the SEC to encourage the reporting of metrics that shed some real light on companies' attitudes to their most valuable assets. Companies typically view their employees as merely a cost rather than as the primary source of adding value. Companies should be



encouraged to disclose how they govern their human capital to increase value rather than to minimise cost. While important and therefore disclosable, these should go beyond diversity, voluntary and compulsory turnover and results of staff surveys. The work of the Maturity Institute is developing some real insights in this area. We would also reference the thoughts of Working IDEAL who have some interesting and powerful thoughts on diversity.

### **Human rights**

The UN Guiding Principles on Business and Human Rights is the authoritative global standard on human rights for businesses. Moreover, most of the largest US public companies will be caught by the disclosure requirements of the UK's Modern Slavery Act which only requires a modest business relationship with the UK before being relevant.

While there is a clear reputational and legal risk associated with human rights breaches by companies and therefore financial risk, the SEC should not stop there. The concept of materiality is different in relation to human rights. Companies should concern themselves not only with the financial risks to themselves but to the risks to the human rights holders that the company and its value chain, often most especially its supply chain, represent. We therefore believe that even if there is no short term link to financial materiality, companies should explain their view of the risks to human rights that their businesses represent and how they assess and manage them. We would add that increasingly it is clear that there are strong links between effective human rights management and financial materiality, in particular from reputation, social licence to operate and better quality management of operations and supply chains. We would also add that with the long time horizons that we expect the SEC to use, as discussed previously, there may well be clear material financial risks associated with human rights even if they are hard to quantify.

### **Every company is different**

While SASB is developing a very useful framework that will be able to help comparability of companies over time and between them, we believe that our comments will help to develop an even better framework. However, companies should report on what is material to them. If they believe that certain of SASB's measures are not as important to them as others we would encourage them to explain to investors the reasons for their decisions and additionally report on their preferred metrics. However, we believe that companies must support any quantitative analysis with qualitative assessment. We would further add that methodologies such as GRI's that have undoubtedly played a positive role in encouraging companies, investors and stakeholders to think about ESG metrics are flawed by insufficiently taking into account the thoughtful omission, with convincing explanations, of immaterial metrics and data.

Companies should focus on the most material risks and opportunities from ESG factors in their reporting, noting that the materiality of human rights issues must be looked at through two lenses and the most material human rights risks to the rights holders must be disclosed together with any more obviously financially material risks.

### **Other specific points**

**Item 301** – We believe that the external auditor should review non-GAAP measures. We also believe that the "equal or greater prominence" requirement of GAAP measures should be extended to those appearing outside of SEC filings so that sustainability reports and similar do not provide information that might mislead.



**Item 304** – We believe that the reasons for the change in external auditor should be disclosed in all cases.

**Item 703** – We are concerned about the increased use of share buybacks, eroding the permanent capital of the company for reasons that are not always cogent in our view. We are concerned that buybacks are used to counteract the excessive dilution of overly generous compensation schemes and are a hidden cost of those schemes. Clearly they can affect EPS, a common measure used both by sell side analysts, who encourage stock trading rather than stock ownership, and in executive compensation schemes. However, their benefit to long term owners of the stock are less clear as the funds used to make the purchases could be used to invest in the business. Companies should describe why the share backs conducted during the year were in the best interests of shareholders with specific reference to the difference between the average price paid and the lowest share price in the year and how the compensation programme's results would look, including the resulting dilution if there were no share buybacks. They should also describe the decision making in relation to capital allocation in relation to the source of funds used for buybacks, leverage and other options considered.

**Tax** – we believe that companies should provide disclosure sufficient for investors to obtain comfort that the company's tax policies and practices are sustainable.

**Political, lobbying and charitable activity and donations** - we believe that there is scope to improve disclosure in this area and we provide some thoughts below:

- Companies benefit from being open and transparent with investors on their public policy activity, both direct and indirect to manage legal and reputational risk. Being seen to be open and co-operative with regulators, and state, federal and international policy makers helps the company more effectively to argue its case.
- We look at the CPA-Zicklin Index as a quick check when initially evaluating companies and encouraging companies to report in line with this methodology would be a significant step forward, even if it does not focus on lobbying.
- The governance of decision making is vital, For example, some granularity on how decisions are made would be helpful. For example:
  - What factors are taken into account when approving donations or lobbying expenditures?
  - To what extent is there board oversight over the strategy and individual large or contentious expenditure?
  - What happens if the board disagrees with the strategy or specific, material activity or expenditure?
  - Is there a tiered process for expenditure/activity approval? For example, what is the least senior role that can authorise expenditure and in what circumstances? How are lower tiers overseen by higher tiers? What requires CEO or even board approval? Some expenditure might be more sensitive than other expenditure. How does the board factor in reputation and other factors other than dollar amounts?
- Trade associations: we accept that a company may not always agree with the views of these bodies of which it might be a member or otherwise contribute. However, the company should explain what it does when it disagrees with these bodies. Presumably it can escalate its views. For example, it could

privately disagree, it could withhold funds or specify what its subscriptions or donations are to be used for, it can publicly disagree with the body, it could resign from positions within the body and ultimately it could resign from the body. The company should explain how it ensures that its trade association and chambers of commerce activity is governed and what oversight both, before and after the event, the board has over the governance arrangements.

- Our overarching requirement is to understand how the board oversees the expenditure and activity to ensure that it is in the best interests of shareholders and the benefit exceeds the cost, including the reputational cost of such activity.
- Charitable donations and activities: we are particularly concerned about charitable donations and activity relating to charities associated with directors, senior management and their families. The disinterested directors must ensure that such donations do not jeopardise independence nor be could be seen to do so and disclose how they have arrived at the decision.

We trust that our comments are useful and we are very happy to discuss any of the points that we have raised with the SEC further. Please contact [REDACTED] should you wish to do so.

Yours faithfully



**Tim Goodman**  
**Director**

