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INVESTMENT MANAGEMENT

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To rule-comments@sec.gov

**File number: S7-07-15**

**Pay versus performance SEC consultation**

**7 July 2015**

Dear SEC,

### Background

By way of background, Hermes Investments is a fund manager based in London which is owned by the BT Pension Scheme, one of the largest pension schemes in the UK. Hermes Equity Ownership Services, wholly owned by Hermes Investments represents more than 40 long-term investors, mainly pension funds from around the world, to engage on their behalf with their investee companies on matters that affect their long-term value. In aggregate we have around $200 billion assets under advice.

As part of our services we also engage on public policy matters as the environment in which our clients make their investments and own their assets has an important effect on their value.

### Pay and performance

We believe that executive pay should be linked to performance of companies over the long-term. There is often a mismatch between management's rewards and that of our clients whereby when company performance is poor management's rewards continue to be good while our clients' returns are not. Management is insulated from risk in a way that our clients are not. Frequently compensation committees' justifications for such payments are weak, citing strategic objectives being met or competition for talent without convincing evidence for either.

### SEC's pay versus performance consultation

We agree with the broad thrust of the consultation and look forward to the implementation of the proposals. We believe that there is unfortunately too much gaming of executive pay and this simple measure will provide a reasonably good way to assess pay versus performance over a medium term period of five years.

We make some observations about the detail of the consultation and other points that the SEC may wish to consider. We have not answered every question, limiting ourselves to what we consider to be the most important points to clarify or where we disagree with the intentions of the SEC.

Our major concern is that the change may encourage even more use of TSR as a metric in compensation schemes. We do not think that TSR is a good performance metric. The SEC should make it clear in its rules that using it to measure performance is not an endorsement of its use as a metric for target setting. Notwithstanding our concerns as its use for targets, we think that compensation committees should take both absolute and relative TSR, measured over a number of years, into account when determining payouts under long-term incentive schemes, using their discretion to reduce awards when either absolute TSR is negative or when relative TSR is below median. In this way the shareholder experience can be reflected in final payouts without TSR actually being used as a target.

**Format and location of proposed disclosure - comment on questions 1 – 16**
We do not think that the proposed report needs to be reproduced in documents other than the proxy statement. It should be easily identified in the proxy statement, including via a reference in the contents page with a page number. We also encourage the use of hyperlinks so that the information can be found quickly from the contents page. We think that such links are as important as XBRL as they assist quicker navigation around the documents which help to save time and costs.

A summary compensation table should be used and we believe that the format of the disclosure should be prescribed. While compensation committees should have freedom to present their CD&A in the way that they choose we believe this information should be provided in as uniformly as possible to aid quick comparability. Similarly if graphics are used, the format should be mandated so that companies can be easily compared.

We believe that compensation committees should have the opportunity to provide narrative explanations of the results declared in the tables and graphs. It may be that the explanations can provide justifications for their decisions that are not obvious from the raw data or presentation of them.

**Executives covered - comment on questions 17 – 20**
We think that compensation committees should be able to use brief narrative should the averages of NEOs' pay require further explanation. Should a PEO change during the year the totals should be aggregated but also provided separately. In the event that any termination payments are yet to be made for either PEOs or NEOs there should be disclosure on the expected amounts to be paid (using the share price at the end of the year) so that all payments for a departing executive are including in the annual total. Without this change, payments may be disguised and/or rolled forward into future years to avoid scrutiny of possible rewards for failure.

**Determination of "executive compensation actually paid" – comment on questions 21 - 33**
This issue was much debated in the UK when similar regulation was proposed. It may be instructive to examine how the UK addressed the issue of defined benefit pensions. In summary the actuarial value of the pension increase during the year net of any inflationary increase and any contribution by the employee is multiplied by 20 to provide the approximate cost to the company[i]. We believe that such an approach serves to reflect the significant cost to shareholders of defined benefit arrangements which should be reflected in the single total for pay.

We agree with the treatment of equity vesting in the year. We also believe that the total value of equity granted in the year should be disclosed in a separate table so that we can see a trend. Over time we will easily be able to identify the percentage of equity vesting and the TSR trend helping us to understand the relationship between TSR, total pay realised both in dollar terms and as a percentage of that granted.

We believe that narrative explanations (preferably cross-referring to the CD&A, with precise page references and hyperlinks) should be used to explain scenarios such as the one envisaged under Q23. The premise of this change is a simple one and so the SEC should strive to keep exceptions to a minimum.

For the same reason, while the CD&A provides ample flexibility to compensation committees to present their decision making in the way that they see fit, this simple disclosure should be kept simple with minimal flexibility so that the raw data across companies can be compared. Investors are capable of understanding the differences between companies and anomalies in the results taking account of compensation committees use brief narrative.

**Measure of performance – comment on questions 34 – 40**

We are wary of the unintended consequences of this disclosure. Too often TSR is used as a performance metric. This disclosure requirement will be likely to encourage this tendency. However, management should manage the business not the TSR which should take care of itself over time if the business is being run well. Boards should therefore focus on the business franchise, strategy and execution. A good business model, well executed will lead to shareholder value over time. Moreover, TSR is a backward looking measure. While targets like ROIC can be managed on a daily, monthly and annual basis, this is not possible for TSR which is responsive to market factors exogenous to the company.

Notwithstanding our concerns, we think that both absolute and relative TSR should be reported. Executives should not be rewarded well when their shareholders have lost value even if they have lost less value than their peers. Therefore reporting on both absolute and relative TSR provide two complementary lenses through which to view performance.

Excessive use of relative TSR can encourage herding behaviour by the fund management industry. It accentuates the tendency to beat indexes over the short term. The SEC should be aware of the potentially systemic problems focus on TSR could encourage amongst the fund management industry.

All companies are different and we are concerned that this measure will encourage companies to use TSR as a measure in their compensation programmes. We think that the SEC should issue guidance to the effect that every company is different, that companies should use their strategic KPIs as the basis of their compensation targets but that compensation committees should use their discretion when determining awards. In particular they should look at the five year, and longer, TSR, performance both absolute and relative and use downward discretion if TSR is not above median relatively and if it has not achieved a positive absolute return as well.

We believe that measuring free cashflow, ROIC and economic profit provide better long-term measures of a company's future prospects and ability to provide value to shareholders. We would welcome the company using its consistent long-term KPIs in addition to TSR to demonstrate the long-term link between pay and performance. Once chosen, we would not expect to see the chosen KPIs change except when the strategy changes. If they do change we would expect cogent strategic justification for the change.

The choice of and any change to the peer group should be explained and the peer group chosen should be the same as the peer group used for any compensation purposes. The table should contain the comparative TSR results for all peer groups used in the five year period.

**Time period covered – questions 42 – 47**

We agree that five years is a good starting point but we view five years as medium term at best. Any shorter time period encourages even greater short-termism. We see no reason why smaller companies cannot also transition to five years. We also suggest that five years could not be extended over time to a longer time frame. Why not seven or even 10 years? We would certainly encourage registrants voluntarily to report on longer periods. We believe that short-termism on the part of some investors who seek improved returns through trading percolates to boards. This helps to create additional volatility and systemic risk. The SEC should seek to mitigate such systemic risk. Extending the time period for reporting would help to promote longer term thinking.

**Clear description – questions 48 – 49**
We agree that plain English should be required for the disclosure though we are not sure that its use can be mandated by regulation.

**Smaller quoted companies – questions – 50 - 51**
While we understand the intent to reduce the burden on smaller quoted companies, we are not certain that reducing the reporting period to two years is a considerable saving nor is reducing the period from five to three years. As these companies only have to report for two years currently, we would suggest that perhaps they should transition to five years from two years rather than the three years proposed for larger companies. This provides a small saving to them in the first year but we do not see savings for them in providing three rather than five years' data and so would recommend this. Those companies with a strong track record on pay and performance over five years would benefit from this requirement. We therefore do not see that there should be an exemption as it would benefit the best companies and highlight the less good performers. This will help better long-term investment decision making to the benefit of market participants.

**General request for comments – questions 52 – 54**
We do not think that there will be significant transition costs. The benefit of being able to understand the longer term link between pay and performance in a consistent manner between companies should result in better investment decision making and engagement between boards and investors. Subject to our suggestions, we believe that the SEC has achieved broadly the right balance.

**Economic analysis**
We are somewhat sceptical about how accurately costs can be assessed. However, we believe that investors' costs are likely to reduce rather than to increase despite the increased disclosure. The proposed disclosure will help to identify companies on which greater or lesser effort is required to understand more fully their compensation arrangements by being convenient shorthand to identify companies that appear to have either good or bad alignment between the *outcomes* of their pay schemes and performance. This will enable us to spend more time focusing on those companies that may have problems in the *design or oversight* of their pay schemes. This is likely to extend to wider governance issues, including board quality and composition.

The chief unintended consequence is that compensation committees may choose to use TSR as a driver of their pay schemes which we do not think is desirable; we prefer compensation committees to use key performance indicators and metrics that drive sustained value creation. However, this risk is outweighed by the benefits and can be mitigated by good quality compensation committees and engagement with investors. We believe that this reform will help capital flows toward companies with good medium term performance and alignment between pay and performance over this period, aiding market efficiency.

Lastly, for a high level view of our views on compensation we also attach a copy of our compensation principles which we trust may be useful to the SEC's staff when considering this consultation and more widely.

Should you wish to contact us to explore the views expressed in this response please contact Tim Goodman at [redacted].

Yours sincerely

Tim Goodman

**Tim Goodman**

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[i] http://www.legislation.gov.uk/uksi/2013/1981/pdfs/uksi_20131981_en.pdf

Hermes | Equity Ownership Services

NAPF Securing the future of pensions

# Remuneration principles for building and reinforcing long-term business success

These principles have been jointly produced by Hermes EOS, the National Association of Pension Funds (NAPF), BT Pension Scheme, RPMI Railpen Investments and Universities Superannuation Scheme (USS). They are intended to provide high-level guidance to companies about our expectations of their remuneration structures and practices. The Principles deliberately avoid prescribing any specific structures or measures; instead we expect companies to articulate clearly to shareholders how their pay policies meet these principles in a manner which is most appropriate for their specific situation.

## The Principles

1. Remuneration committees should expect executive management to make a material long-term investment in shares of the businesses they manage
2. Pay should be aligned to long-term success and the desired corporate culture throughout the organisation
3. Pay schemes should be clear, understandable for both investors and executives, and ensure that executive rewards reflect long-term returns to shareholders
4. Remuneration committees should use the discretion afforded them by shareholders to ensure that awards properly reflect business performance.
5. Companies and investors should have regular discussions on strategy and long-term performance.

BT Pension Scheme

RPMI RAILPEN

USS INVESTMENT MANAGEMENT LIMITED

## Introduction

At the beginning of 2013, Hermes EOS and the NAPF, in conjunction with RPMI Railpen Investments and USS Investment Management, the wholly owned investment management subsidiary of USS, published "Remuneration Principles for building and reinforcing long-term business success". Since then, we have held discussions with the chairs and remuneration committee chairs of almost half of FTSE 100 companies, along with executives responsible for reward, remuneration consultants and other institutional investors. We are encouraged by the willingness of many to fundamentally rethink current practices. The principles within this final document reflect the feedback we have received. We believe that these principles provide a sound framework for remuneration committees to use when thinking through, devising and implementing their remuneration policies.

Each company is unique and as such faces different challenges and opportunities. While we hope that our principles will provide a useful framework, it is for boards to determine which specific pay structures will work best for their company's executives and to communicate intelligently their reasoning to investors. We seek neither to prescribe a particular structure, nor to micro-manage pay, but rather to start a healthier and more constructive on-going conversation than often occurs today.

We firmly believe that there is a significant appetite for change and urge companies to consider how they might align pay more closely with the interests of their long-term owners in order to position themselves best for future success. We look forward to supporting those companies who share our desire for change.

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## The Principles

1 **Remuneration committees should expect executive management to make a material long-term investment in shares of the businesses they manage.**

We consider that the best form of alignment between executives and shareholders is the ownership of shares over the long-term, with ownership obligations increasing with seniority. While we recognise that flexibility is needed to ensure that effective executives are appropriately remunerated, remuneration committees should strive to ensure that, to the extent this is feasible and appropriate, the bulk of their variable rewards flows over time from the benefits of being an equity owner.

The meaning of "long-term" will differ from company to company but three years, the most commonly used time period for long-term awards, is often not long enough. In many situations it may be appropriate for a material proportion of shares granted to be held for a longer period, the length of time would be aligned to the business cycle and strategy of the company and take account of the demographic of the executives.

Wherever possible, we believe that remuneration committees should foster a culture in which executives are encouraged to invest in the shares of the company they manage. It is important, of course, that the board monitors and guards against the possible unintended consequences of long-term ownership such as overly aggressive dividend policies, encouraging takeovers to crystallise awards and overly risk-averse strategies intended to preserve, rather than increase, the value of shares. In particular, as executives approach retirement they will wish to ensure they are appropriately diversified, however, they should continue to maintain a material holding. Having "skin in the game" is an important motivator and one that we believe is under-used.

Companies should also consider ensuring that executives are exposed to some tail risk for an appropriate length of time once they leave a company, for example, by requiring that any sale of shares be staggered over time, notwithstanding competitive or regulatory barriers to continued share ownership. In practice, many long-serving executives have significant holdings in the company, but this kind of commitment can help to encourage longer-term thinking to continue right through to the end of a career. While clawback is one way of aligning executives and shareholders it does not necessarily encourage a CEO actively to develop a new generation of talent to succeed the current executive directors. At the same time, it is recognised that outgoing executives cannot be held responsible for the actions of their successors and so remuneration committees must strike an appropriate balance.

2 **Pay should be aligned to long-term strategy and the desired corporate culture throughout the organisation.**

We encourage remuneration committees to design rewards that encourage the specific behaviours required to drive long-term strategic success. Too much of the debate between companies and owners has focused on the minutiae of short to medium term performance conditions. This is exacerbated when the ultimate owners of companies delegate their oversight responsibilities to agents who themselves operate according to short-time horizons. As a result, certain performance measures, such as earnings per share (EPS) and total shareholder return (TSR) have been over-emphasised, with little regard for the company's specific strategy or the timeframe over which that strategy should be achieved. Rather, we believe remuneration committees should take as a starting point the company's strategic plan and key performance indicators (KPIs) and ensure there is a strong read across from the company's strategy to the drivers of executives' remuneration.

While we do not believe that well-structured remuneration is a panacea we do believe that it is a vital indication of and contributor to the desired culture, values and ethos of a company. We therefore encourage a coherent remuneration philosophy which is cascaded down the organisation. For example, it is not always clear why some executive directors receive pay increases that are greater than those awarded elsewhere in the organisation, and which feed through to the bonus and long term incentive plan (LTIP) to widen the pay differentials within the company, or enjoy preferential tax treatment or far more generous pension arrangements – or cash in lieu – than less senior colleagues. Remuneration committees should consider whether they are able credibly to justify any such differentials.

The nominations committee and the remuneration committee must also work closely together, particularly in agreeing the parameters around the remuneration for new appointees to the board. The remuneration committee should ideally be involved at a sufficiently early stage of succession planning to be able to agree the acceptable parameters for pay with the nominations committee during the initial stages of recruitment, rather than waiting until a preferred candidate has been selected.

3 **Pay schemes should be clear, understandable for both investors and executives, and ensure that executive rewards reflect returns to long-term shareholders**

The desire of some investors to encourage improved company performance by focusing on metrics and targets rather than behaviour and outcomes is at least in part responsible for the increased complexity we have seen in remuneration schemes in recent years. So too is the feeling among executives and non-executives that the outcome of long-term incentive schemes is unsatisfactory, frequently being described as a "lottery".

As a result of these and other factors, many companies now operate multiple long-term schemes because one or more has been deemed not to have worked well and executives often have outstanding awards under a number of them. There may also be a deferred bonus scheme, or a share matching scheme on top of the short and long-term awards. We wonder therefore whether this multiplicity of awards, with varying performance conditions really helps to motivate executives and give them a clear line of sight over what they need to achieve.

Setting a long-term course and measuring, explaining and incentivising progress annually may be a more effective way to encourage long-term value creation than the current prevailing system. For example, in some circumstances it may be better to have a single bonus scheme – with no long-term incentive plan – using a single balanced scorecard of metrics based on KPIs, over which the remuneration committee may use its discretion, and which pays out predominantly in shares which must be held for the long term. The significant component of the reward is accrued over time through being a share owner. This type of award might be more highly valued by executives than traditional LTIPs due to the increased certainty of outcome. A number of companies have adopted this approach recently and we applaud their desire to ensure that rewards better reflect individual and company performance.

4 **Remuneration committees should use the discretion afforded them by shareholders to ensure that awards properly reflect business performance**

Running companies is far more complicated than even the best designed remuneration policies can ever hope to reflect. To distil complex company performance into a few metrics is an oversimplification that can sometimes lead to awards that are not reflective of actual performance, eroding trust and increasing reputational risk.

We wish to see remuneration committees taking greater ownership of, and being accountable for, both the remuneration policy and its outcomes. Remuneration committees consist of experienced individuals; they can, and we believe should, exercise their judgement about the overall performance of the company when determining awards. In particular, the committee should consider how the results have been achieved, not just what was achieved. For instance, if targets have been met by employing aggressive accounting policies, by deferring important investments in the business or by unnecessarily increasing leverage, then the remuneration committee should consider scaling back payments. Similarly, if the executives have hit their performance targets but the company has had serious reputational issues or has underperformed the market or peer group, there are strong arguments for making lower awards.

We support committees that take a holistic approach to performance rather than applying simplistic mechanistic formulae to determine awards to executives. We recognise that shareholders will require additional explanation to be included in the remuneration report when judgement and discretion is exercised by the committee. Committees should ensure their considerations and judgements are thoroughly explained and appropriately justified, this will be of particular importance if the committee exercises upward discretion. Such an approach will allow investors to have greater confidence that the remuneration committee is acting in their best interests.

5 **Companies and investors should have appropriately regular discussions on strategy and long-term performance.**

While much of the focus of the debate around remuneration has been on companies, we believe it is also vitally important that investors are aware of their responsibilities under the Stewardship Code to engage with companies on a full range of issues. Our preference would be for this dialogue to take place throughout the year, rather than compressed into the period leading up to the shareholder meeting.

We recognise that trust between some companies and investors has diminished over time and believe that both parties have a role to play in helping to rebuild this relationship. Investors should inform themselves properly ahead of meeting a company and ensure that they are able to have intelligent, holistic conversations about the business, its strategy and how remuneration structures support that strategy. Likewise, companies should consider how they might identify and engage with those investors who are committed to stewardship. These should include investors who are outside of their top ten shareholders and asset owners such as those we represent.

As investors, and investor representatives, we encourage remuneration committees to be more innovative in designing pay schemes that drive the behaviours required of executives to deliver long-term business performance. We urge them to be less mechanistic in determining awards. To enable this to happen we recognise that we need to give the companies in which we invest sufficient space to innovate and we must take time to consider carefully new proposals with an open mind.

## Time for change

We strongly believe that the time is right for companies and investors to fundamentally rethink their approach to executive remuneration.

We are confident that there is a significant appetite for change among many to consider how they may more closely align pay with the interests of their long-term owners in order to position themselves best for future success.

The above principles do not seek to prescribe any particular structure or model of remuneration. Instead we encourage companies to innovate and come forward with proposals which are most appropriate to their own business model. We stand ready to support this change which we believe is in the interests of both companies and their investors.

## Hermes Equity Ownership Services

Hermes Equity Ownership Services (HEOS) enables institutional shareholders around the world to meet their fiduciary responsibilities and become active owners of public companies. HEOS is based on the premise that companies with informed and involved shareholders are more likely to achieve superior long-term performance than those without.

## National Association of Pension Funds

The National Association of Pension Funds (NAPF) has been at the forefront of promoting good corporate governance for over 20 years, and as representatives of major institutional investors we have a real interest in seeing high standards achieved and maintained.
We regularly engage with the companies in which pension funds invest on issues including board structures and executive remuneration.
Our Corporate Governance and Voting Policy provides guidance to investors and companies on a wide range of corporate governance matters, including remuneration.

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