Hermes Equity Ownership Services

Hermes Equity
Ownership Services Limited
1 Portsoken Street
London E1 8HZ
United Kingdom

Tel: +44 (0)20 7702 0888
Fax: +44 (0)20 7702 9452

www.hermes.co.uk

European Securities and Markets Authority
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Dear Sir

We welcome this opportunity to provide feedback on the ESMA MiFID remuneration guidelines.

By way of background, Hermes is a leading asset manager in the City of London. As part of our Equity Ownership Service (EOS), we also respond to consultations on behalf of a number of pension funds and institutional investors from the US, Australia and Canada, as well as across Europe. We assist these clients to act as good owners of the assets in which they invest. In all, EOS advises clients with regard to assets worth a total of over €100 billion (as of 31 December 2011).

As a representative of long-term investors, we have long advocated a client-oriented approach to financial incentives. As pension funds were particularly severely affected by many practices prevalent in the market, we have a special interest in promoting fairness and stability in the financial system. We see ESMA's guidelines as an useful step towards consolidating efforts in many parts of the EU to better align the interests of financial professionals with those of their clients. Ensuring this basic alignment would remedy a major cause of the ongoing financial crisis. Widespread performance measures have put a greater emphasise on has been achieved for the firm over what has been achieved for the client. An acceptable incentive structure should take account of all product impacts, be adjusted for all relevant risks, and discourage favouring own interests over those of the client. Rewards based entirely on revenue and sales volumes disregard important aspects of performance, and we agree that the addition of non-financial criteria would be helpful in correcting this. It is crucial to update the definitions of what constitutes good performance, and to ensure that risk management and client interest are included in that. What is more, the results achieved for clients should weigh more than results achieved for the firm when determining appropriate rewards. We would furthermore welcome more detailed examples of good practice, specifically of the appropriate metrics to use and of appropriate models to calculate risk.

Another important factor is the length of time over which performance is measured. For many roles, it would be sensible to introduce a longer time-frame than the current standard of one year periods. We would welcome further encouragement in the guidelines to evaluate performance over longer time periods, and to avoid rewarding returns that can, in a longer-term frame, be attributed more to luck than to consistency of skill.

We are answering to the specific questions below. We are also attaching our thought piece “Epidemiology” which outlines our views on the problem of interest alignment within the banking and financial sector.

Yours sincerely,

PAUL LEE
Director

Questions

Q1 Do you agree that firm's remuneration policies and practices should be aligned with effective conflicts of interest management duties and conduct of business risk management obligations so as not to create incentives that may lead relevant persons to favour their own interest, or the firm's interests, to the potential detriment of clients? Please also state the reasons for your answer.

Q2 Do you agree that, when designing remuneration policies and practices, firms should take into account factors such as the role performed by relevant persons, the type of products offered, and the methods of distribution? Please also state the reasons for your answer.

We can see no justification for creating incentives that may lead to favouring personal interest over client interest. Remuneration should take account of the adequate fulfilment of duties related to conflicts of interest and business risk in order to avoid rewards for excessive risk-taking and to ensure appropriate interest alignment. The conflicts of interest and risks that are likely to arise are very specific in regard to role, product type, and distribution method. Furthermore, clients with varying levels of experience are likely to require differing levels of protection. For that reason, these factors should be taken into account when designing remuneration policies.

Q3 Do you agree that when designing remuneration policies and practices firms should ensure that the fixed and variable components of the total remuneration are appropriately balanced?

Q4 Do you agree that the ratio between the fixed and variable components of remuneration should therefore be appropriate in order to take into account the interests of the clients of the firm? Please also state the reasons for your answer.

In our view, appropriate balance does not necessarily imply a fixed ratio between fixed and variable compensation. It does, however, require an alignment with client interests, and does need to be adjusted according to changes in the client base. A further important aspect is what type of factors are included in the determination of variable compensation. Including risk management and compliance parameters into these factors is likely to achieve much more effective interest alignment than merely restricting the amount of variable pay.

Q5 Do you agree that the performance of relevant persons should take account of non-financial (such as compliance with regulation and internal rules, market conduct standards, fair treatment of clients etc.), as well as financial, criteria? Please also state the reasons for your answer.

We agree that a more complex view of performance that includes not only financial performance but also non-financial impacts is required to ensure incentivising is appropriate and excessive risk-taking is not rewarded. Clients are keen to reward risk-adjusted returns not returns as such so unless risk is factored into incentives their structure would be entirely inappropriate.

Q7 Do you agree that senior management should be responsible for the implementation of remuneration policies and practices, and for preventing and dealing with any the risks that remuneration policies and practices can create? Please also state the reasons for your answer.

It is particularly important that performance awards are risk-adjusted, so that only the performance, and not the risk-taking as such, are rewarded. Risk-adjustment of payouts is a central instrument for ensuring that the remuneration policy does not incentivise risk-taking over acting in clients' interests. We also believe that, in addition to senior management, the supervisory function should also be involved in and responsible for, risk prevention and the implementation of remuneration policies. In that regard, creating robust internal procedures for the cooperation between senior management and the compliance function is crucial.

Q12 Do you agree that the compliance function should be involved in the design process of remuneration policies and practices before they are applied to relevant staff? Please also state the reasons for your answer.

The compliance function can provide an adequate view of the precise types of risk that arise out of the firm's activities. In our view, appropriate risk-adjustment of remuneration requires the participation of the compliance function, both at the design at the application stage. As mentioned above, an effective cooperation between the compliance function and senior management is key to ensure decisions are made based on a complete view of conflicts of interests and other risks currently resulting out of the firm's activities.