



Lloyds Chambers  
1 Portsoken Street  
London E1 8HZ  
  
Tel: (020) 7702 0888  
Fax: (020) 7702 9452

[www.hermes.co.uk](http://www.hermes.co.uk)

Mr C Dallara  
Managing Director  
The Institute of International Finance, Inc  
1333 H St NW  
Suite 800E  
Washington  
DC 20005-4770  
USA

16 May 2008

Dear Mr Dallara

Hermes Equity Ownership Services is pleased to rise to the invitation from the Institute of International Finance's Committee on Market Best Practices to comment on its interim report.

By way of background, we represent the interests of major pension schemes and fund managers from around the world. Among these clients are some of the largest pension schemes internationally, including the BT Pension Scheme in the UK, the National Pension Reserve Fund of Ireland, Denmark's PKA, the Netherlands' PNO Media Stichting Pensioenfond, the Public Sector Pension Investment Board of Canada and Australia's VicSuper. We are particularly well-known for our work in the area of corporate governance, and indeed have often worked with the IIF, most often in emerging markets.

Our clients all have very significant investments in large financial institutions and have therefore suffered significant losses in the ongoing turmoil. They have also faced calls for additional capital, and dilution of their interests where banks have sought funds from new investors. We have sought to call the managements and boards of these financial institutions to account for these issues and have therefore had a series of face-to-face discussions with board members and/or senior management at all the most significant financial institutions in North America and Europe.

We have discussed many of the issues which are covered so effectively in the Committee's interim report. We welcome the bulk of the report, and look forward to being able to welcome the final report when that is produced; we have high hopes that this will be a comprehensive industry response to the issues which have arisen and we will certainly be looking to encourage investee companies and other agencies to take up its recommendations. However, there is one area where we believe that the interim report lacks detail and development, and we restrict our comments to this area: incentives for individuals in trading and selling.

Such incentives are difficult for any one party to address. We note that there have been some calls for formal regulation in this area, and that there is increasing political interest. We do not welcome this and believe that political or regulatory intervention would be impractical and wholly unwelcome to the efficient working of the market. But we do believe that such calls emphasise the need for an effective private sector response in this area. In our discussions with individual financial institutions on this issue, it is clear that none feels able to take the first step: they believe that to do so would risk putting themselves at a significant competitive disadvantage in retaining and winning staff. Many of them have mentioned the IIF's work as a way of moving the entire market so that all the financial institutions can move in ways which they agree would be more in the interests of their shareholders but which they cannot take alone.

.../...cont'd

We would therefore strongly encourage the IIF to bolster its work in this aspect of the Best Practices proposals in order to supply the framework which the market believes is necessary to help address these concerns. We welcome the Committee's comments on the need to align the interests of staff and shareholders, and particularly the declarations on the need to integrate cost of capital measures into any assessment of performance, on severance packages and on the need for transparency. However, we do not believe that these comments go far enough.

We focus our comments here on the incentives not for senior management but for the trading and selling staff whose motivations also need to be more clearly aligned with long-term shareholder value creation. We believe that the structure of these incentives needs to include not just deferrals of bonuses – after all these have been in place for some years and have not prevented the current problems. Deferral of bonuses into shares which are locked up for a period of time is helpful to align the interests of trading staff with those of shareholders, but it does not go far enough. The crucial element of a bonus structure that will align those interests more effectively and limit the risk of problems such as those seen recently is that the performance which drives the bonus must be judged over a period longer than a single year. Many of the instruments originated and traded have appeared profitable for financial institutions in individual years, and annual bonuses have been paid; however, subsequent years have proved that profitability to be phantom and overwhelmed by later losses. Only if employee performance is judged over a period sufficient to ensure that it is clear the apparent profits are genuine will there be proper alignment of staff's interests with those of shareholders. It is not practical to stretch the period over which performance is measured to encompass time periods within which black swan events might occur, but the measurement period needs to be at least three years (five or ten would be better but less realistically achieved) in order to change the culture of staff such that they will consider not just the short-term but also the potential for longer term negative events.

We believe that the IIF can take an important leadership position and help the industry take steps which management believes will be in shareholders' interests but which they believe they cannot take alone. We furthermore believe that it is important for the IIF to take this leadership position to neutralise the ongoing talk of political or regulatory intervention in this area. We would therefore welcome the IIF expanding its recommendations in the important area of incentives for staff.

We would be pleased to discuss these issues further with you or any other member of the Committee on Market Best Practices, if either our comments are unclear or if you wish to develop them further in conjunction with us.

Yours sincerely,



PAUL LEE  
Director

cc: Rick Waugh - Chairman, IIF Committee on Market Best Practices  
Cees Maas – Chairman, IIF Committee on Market Best Practices