Excellence. Responsibility. Innovation.

Q4 2016

Hermes EOS

Public Policy Report

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Public Policy Highlights

This quarter on behalf of our clients we held 51 discussions with relevant regulators and participated in 10 consultations or their proactive equivalent. The breakdown of these was:

Region	Consultations or proactive equivalent*	Meetings and discussions
Global	3	17
Developed Asia	2	13
Emerging and Frontier Markets	0	5
Europe	2	4
North America	2	2
UK	1	10
Total	10	51

*for example a letter in absence of regulatory reform

Our key activities and achievements in the quarter were:

- We attended an event for the launch of the new **Access to Medicine** (ATM) index. We were pleased that the ATM Foundation has strengthened its business rationale following input from us and others.
- At the launch of the **Brazilian Stewardship Code**, we spoke about our experience in stewardship and formally signed up to the code. The code was drafted by a working group of members of the Association of Capital Market Investors AMEC, of which we were the only non-resident member.
- We responded to a consultation by IPIECA, the global oil and gas industry's trade association for environmental and social issues, on **climate change reporting**. We highlighted that the Financial Stability Board's Task Force on Climate-related Financial Disclosures is likely to become the expected benchmark for disclosure and that IPIECA should view any of its standards as a baseline.
- We attended the launch of the **Climate Investments** partnership by the Oil and Gas Climate Initiative. The initiative will focus on minimising methane emissions in the gas value chain and on carbon capture, use and storage.
- We responded to the consultation by the Swiss government on its **climate policy post-2020**. We suggested that the Swiss government support the 2015 Paris Agreement on climate change and encourage all other stakeholders in the country to contribute to the achievement of the objectives specified in the agreement.
- We provided feedback on the emerging draft guidelines for company reporting on **climate-related financial disclosures**. We highlighted the need for scenario-planning to include a qualitative description of the potential impacts of low-carbon scenarios, as well as a quantitative assessment of the value at risk.
- We participated in a panel session at the launch of the **Corporate Governance Scorecard**, a multi-stage project led by the International Finance Corporation and the Bombay Stock Exchange. The disclosure-based approach enables companies to score themselves against best practices, with a tilt that addresses governance characteristics specific to the Indian market.
- We provided evidence to the select committee of the UK's House of Commons that leads its work on **corporate governance reform**. In our evidence, which was based on the written response we had provided, we outlined our proposals on executive remuneration and showed our support for a rethinking of the composition of boards.
- Members of the Asian Corporate Governance Association from 40 countries, including us, visited the Financial Services Agency of Japan and raised concerns about the lack of transparency of **cross-shareholdings**.
- We participated in the launch of the guide to **engagement on methane in the oil and gas industry** by the Principles of Responsible Investment and the Environmental Defense Fund, to which we had contributed.
- Japan's Ministry of Environment invited us to trial its new **environmental reporting tool**. We welcomed the project, which we hope will promote dialogue between companies and investors and add to the growing momentum of responsible investment in Japan.
- We published a new paper calling on large publicly listed companies to overhaul **executive remuneration** structures so that they better align management with the interests of long-term shareholders and better factor in issues of fairness. We recommended that the chair of the board write annually to employees to explain the basis for the CEO's awarded pay for the current year, while the company should publish and comment on the ratio of CEO to median worker pay using internal and external comparisons.
- We responded jointly with two large pension funds to the consultation on the amendments to the **German Corporate Governance Code**. In our consultation response, we focused on investor dialogue with German supervisory boards, supervisory board composition, audit committee independence and stewardship activities of institutional investors.
- We presented the **Investor Expectations of Automotive Companies** report to the board of the Institutional Investors Group on Climate Change, institutional investors and automotive companies. As the lead author of this investor guide, we called on automotive companies to have long-term strategies in place that rest on resilient business models and take into account likely upcoming climate change regulation, significant shifts in demand and competition from high tech companies.
- We welcomed the launch of the **Korea Stewardship Code** in December 2016. We are pleased that it follows the global practice of comply-or-explain, instead of pushing for compliance only.
- We co-signed a letter, co-ordinated by an investor group from the Principles for Responsible Investment, to policy-makers with jurisdiction over much of the region to encourage greater **regulation of exploration and production in the Arctic**.
- We discussed with an executive from the Principles for Responsible Investment how to encourage Chinese stock exchanges to support the **Sustainable Stock Exchanges** initiative. This included engagement on climate change, green finance and green bonds.
- We supported the concept of a **universal proxy** at shareholder meetings in the US when we responded to a consultation by the US Securities and Exchange Commission on the issue. We argued that this is a fundamental shareholder right, enabling shareholders to vote in favour of or against director candidates regardless of whether they are on the board's or a dissident shareholder's slate. This would result in less confrontational proxy contests and a more accurate expression of the wishes of shareholders.

Global

Promoting best practice

Access to medicine

Lead engager: Natacha Dimitrijevic

We attended an event for the launch of the new Access to Medicine (ATM) index. We were pleased that the ATM Foundation has strengthened its business rationale following input from us and others. Key drivers such as improving reputation and licence to operate, limiting misconducts and strengthening the market environment, improving access to markets and unlocking growth figured prominently in the presentation. The new index also reflects the maturity of the issue by increasing the weight of performance as opposed to policy and the public sharing by companies of best practice, which had previously been viewed as confidential. We also commended the future inclusion announced by the ATM Foundation of cancer as a disease in its scope. While we understand that the foundation needs to remain focused on key diseases impacting poor countries, with a strong focus on infectious diseases, we had encouraged a more encompassing scope in chronic diseases, as we believe it is a growing concern in these geographies. In a private discussion with the foundation's CEO, we discussed options for collaborative engagements with other investors.

CDP

Lead engager: Bruce Duguid

We spoke at the launch of the UK Corporate Disclosure Report 2016 of the CDP initiative, formerly known as the Carbon Disclosure Project, which included various awards to the best companies in a number of categories such as carbon reduction or disclosure. In our presentation aimed primarily at UK companies, we highlighted the importance that investors attach to good reporting of greenhouse gas emissions and climate risk reporting. We also explained how investors use this information, including identifying key corporate risks and opportunities as part of investment decision-making, identifying appropriate issues for the engagement with companies and helping to identify opportunities for public policy and market best practice advocacy. In a panel discussion following the presentation, we described the different types of risk which concern investors, distinguishing between transition and physical risk. We explained our view that engagement is likely to be more effective than divestment and that companies need to work with investors in order to promote their improved public policy. We will continue to support CDP in its review of its scoring methodology to ensure that this is as relevant as possible to investors and does not overburden companies with excessive and potentially irrelevant reporting.

Climate change and the automotive industry

Lead engager: Michael Viehs

We presented the Investor Expectations of Automotive Companies report to the board of the Institutional Investors Group on Climate Change (IIGCC), institutional investors and automotive companies in Frankfurt, Germany. As the lead author of this investor guide, we called on automotive companies to have long-term strategies in place that rest on resilient business models and take into account likely upcoming climate change regulation, significant shifts in demand and competition from high tech companies working on developing autonomous and sustainable vehicles. We also highlighted that we expect automotive companies to accept and publicly advocate the move towards a low-carbon economy.

The European Commission subsequently welcomed the Investor Expectations of Automotive Companies. At a roundtable discussion of the GEAR 2030 High Level Group on Automotive Industry in Brussels, we presented the new guide along with our expectations of companies in the industry. The GEAR 2030 working group consists of representatives from automotive companies, NGOs, European policy-makers and investors. Disappointingly, representatives of the automobile industry said that they still see a bright future for diesel and the internal combustion engine, however, not for electric vehicles and other alternative power train solutions. In particular, they claimed that the demand for alternative vehicles technology is not yet at a scale where the development of product pipelines solely based on electric vehicles is economically viable. We countered this by referring to our anticipation of tightening climate change regulation and increasing competition from high tech companies, which are working towards developing fully autonomous and sustainable vehicles, which could eventually harm the automotive industry's competitiveness. We added that internal combustion engines might also struggle following the 2015 Paris Agreement on climate change.

Climate change scenario planning

Lead engager: Tim Goodman

We participated in a roundtable organised by the Institutional Investors Group on Climate Change to discuss the scenario plans that investors should push for in relation to the climate change risks facing oil and gas majors. The expert panel, which included academics and consultants, helped to refine the questions and concerns that we should raise in our engagements with the industry. In a separate smaller meeting on remuneration in the oil and gas industry, we suggested that our proposals on executive pay in the UK that highlight long-term share ownership provide a good basis for addressing the long-term tail risk that climate change contains.

Executive remuneration

Lead engager: Will Pomroy

We published a paper calling on large publicly listed companies to overhaul executive remuneration structures so that they better align management with the interests of long-term shareholders and better factor in issues of fairness. In the paper Remuneration Principles: Clarifying Expectations, we outlined why well-structured remuneration practices are key to aligning the activities of management with a company's purpose, strategy and long-term performance. We also highlight the need for companies to address the question of fairness in order to maintain public confidence and, ultimately, their social licence to operate. We have long held the view that executives have to be aligned with the long-term fortunes of a company and therefore consider how it delivers returns to its multiple stakeholders, including customers, employees, society, as well as its shareholders. To that end we published our Remuneration Principles for Building and Reinforcing Long-Term Business Success in 2013, with the BT Pension Scheme, USS Investments, RPMI Railpen and the former National Association of Pension Funds. The paper reflects on the disappointing progress made since that publication and thus calls for a shift in the structure of executive remuneration packages towards ones which are simpler, more transparent, more performance- than share price-driven and less leveraged, with greater accountability by the board and its remuneration committee. In addition to the structural reforms we propose, we suggested further measures publicly listed companies should adopt. To bring the issue of workforce inequality into greater focus, we recommended that the chair of the board should write annually to employees to explain the basis for the CEO's awarded pay for the current year, while the company should publish and comment on the ratio of CEO to median worker pay using internal and external comparisons.

Forced labour and responsible recruitment

Lead engager: Sachi Suzuki

We were invited to provide the investor perspective on forced labour in supply chains at an event co-hosted by the Principles for Responsible Investment, KnowTheChain and the Institute for Human Rights and Business. We explained that the issue matters to investors because of reputational and material risks, described how we approach engagement from different angles and outlined what we expect from companies. We also pointed out that the issue is not limited to developing countries but needs tackling in developed markets too.

Guide to engagement on methane

Lead engager: Tim Goodman

We participated in the launch of the guide to engagement on methane in the oil and gas industry by the Principles of Responsible Investment and the Environmental Defense Fund (EDF), to which we had contributed. We contributed to the group session as well as arranged a meeting with the EDF and a director of Saudi Aramco.

Greenhouse gas emissions database

Lead engager: Bruce Duguid

We met a market data provider who is building a database of companies' greenhouse gas emissions, using public data. This can then be used to generate index funds, provide a benchmark against which to measure performance, rank company performance in support of corporate engagement work and to estimate the carbon footprint of an investment portfolio. The key challenge is to attribute emissions to those companies that do not report, for whom they assume worst-in-class performance by default. We also exchanged notes on the political situation on climate change. The company believes there is significant emerging evidence that the cost of tackling climate change is lower than expected because of the rapid reduction in the costs of solar and wind energy, batteries and gas, which is why the transition to a low-carbon economy will be more rapid. The US presidential election may not prove too disruptive to regulatory progress we heard, partly because many US states will remain committed to decarbonisation, not least California and New York. We agreed to remain in contact.

Human Rights Assurance Guide

Lead engager: Christine Chow

We received an update on the progress of the Human Rights Assurance Guide, which is overseen by the Eminent Persons Group, of which we are a contributory member. The eight-page summary for internal auditors and the Institute of Internal Auditors and a summary guide for external assurance providers was set to be completed by the Shift Project at the end of January 2017. For the assurance process, it is important to define what is least and most resource-intensive to assure. The guide will contain separate indicators for appropriateness and effectiveness for human rights policies and processes. We previously stated that too many indicators will distract assurers from making effective assessments on companies' progress on deploying the UN Guiding Principles (UNGP) Reporting Framework. We agreed that companies tend to have existing human rights policies and frameworks in place and may enhance their policies and systems in line with the UNGP Reporting Framework but in different ways. However, as long as companies can explain their progress and are open to assurance procedures, we believe this is positive.

Human rights panel

Lead engager: Natacha Dimitrijevic

At the invitation of a multinational law firm, we participated in a panel at a Business and Human Rights Knowledge Group event aimed mostly at lawyers. In the panel discussion, we explored due diligence in relation to the Modern Slavery Act, investor expectations and what the Act means for lawyers advising in that space. We highlighted that beyond compliance with the Act's reporting obligations, companies should use the UN Guiding Principles on Business and Human Rights or other relevant frameworks to understand their risks and human rights footprints. Given the many complexities of modern slavery, the necessary policies and processes need to be complemented by strong capacity-building and collaborations in order to be meaningful and avoid unintended consequences. We reminded our audience that high-profile cases such as the Rana Plaza building collapse in Bangladesh in 2013 and the Thai fisheries forced labour scandal occurred in audited facilities. Our speech was well received and resulted in a number of good questions by the audience.

Oil and Gas Climate Change Initiative

Lead engager: Tim Goodman

We attended the launch of the Climate Investments partnership by the Oil and Gas Climate Initiative (OGCI), at which most of the member company CEOs presented together with the UK's energy minister, the executive director of the UN Global Compact and a number of other stakeholders. The OGCI announced a joint commitment to invest $1 billion over the next 10 years collectively, in addition to each member company's own expenditure, into climate related technology. The initiative will focus on minimising methane emissions in the gas value chain and carbon capture, use and storage (CCUS). It will also examine industrial and transportation energy efficiency. While welcome, the initiative seemed to be light on milestones and what it regards as success. Moreover, while we acknowledge that the collaboration and sharing of intellectual property is a step forward, we are concerned that the amount to be invested is tiny in comparison to the size of the problem and the other investments the industry is making, even during a period of low oil prices. Alarmingly, one of the CEOs present described gas as a destination instead of a transition fuel on the road to a low-carbon economy. While, with the use of CCUS this may be theoretically possible, it suggests that the industry continues to not face up to the transformation and disruption it will experience. We directly challenged executives from two oil majors after the presentations on the lack of detailed project methodology for the initiative and made clear that we expect a roadmap for the future.

Portfolio Decarbonisation Coalition

Lead engager: Bruce Duguid

Following a number of discussions with the secretariat of the UN-backed investor initiative which aims to decarbonise investment portfolios, a Hermes EOS representative agreed to stand for election to the steering committee of the organisation and was duly elected. This enables us to advocate the necessary public policy and market best practice approaches by which to achieve lower emissions in investment portfolios and the wider economy. Good stewardship and market-level engagement are the principal tools by which to reduce portfolio emissions, which is why we will make the case for greater adoption of more forceful stewardship approaches to better tackle climate change.

Proxy adviser meeting

Lead engager: Bruce Duguid

We introduced the key elements of our guidelines clarifying our market expectations for executive remuneration to a proxy adviser. The proxy adviser had empathy with a number of the proposals, including the preference for simpler schemes and for metrics to be aligned to strategy. We were comforted to hear that the proxy adviser could be supportive of restricted share awards, provided a good case is made by the board, they are aligned to strategy and results in lower overall maximum pay, reflective of the lower risk. However, on minimum shareholding requirements, the adviser maintains a commitment to only 200% of salary, compared to our preferred 300%. The proxy adviser also appears not to have a particular view on the nature of metrics in the long-term incentive schemes, provided these are varied and aligned to strategy. Furthermore, the proxy adviser's guidelines do not address the appropriate ratio of fixed to variable pay. While the agreement in some areas is promising, our reflection is that it will require further advocacy over a period to time to change market standards further towards the interests of long-term asset owners.

Supply chain management

Lead engager: Christine Chow

We chaired the social impact and human rights roundtable at Ethical Corporation's 10th annual CR Reporting and Communications Summit 2016. Some attendees said that companies find it difficult to assess human rights risks beyond the first tier of the supply chain but are well aware of the risks related to using contractors, such as bonded labour issues. Industry leaders therefore now focus on better understanding agency labour and the labour supply network at each of their sites, including how their contractors recruit workers. Collaboration among peers has also improved. The general view was that scheduled audits are necessary but insufficient to manage a sustainable and responsible supply chain. Instead of merely assuming that manufacturing in developing countries comes with higher human rights risks, the evaluation of associated risks should be tailored to individual sites. We also gave examples of how a European operation could violate human rights through inappropriate employment of migrant and temporary workers. We highlighted the importance of focusing on leading rather than lagging indicators. The latter include fines, disruption to supply chains and damage to reputation. Leading indicators on the other hand encompass underlying management practices, the attitudes of companies, as well as a focus on supply chain management, staff turnover and job satisfaction. Good leading indicators can only be met through a combination of better disclosure plus engagement with companies. All participants agreed that linking business goals to human rights with the sustainable development goals in mind is an appropriate approach, which includes access to water, education, healthcare, information and finance.

Sustainable Stock Exchanges initiative

Lead engager: Christine Chow

We discussed with an executive from the Principles for Responsible Investment (PRI) how to encourage Chinese stock exchanges, including Shanghai, Shenzhen and Hong Kong, to support the Sustainable Stock Exchanges (SSE) initiative. We explained that the exchanges have been hesitant to join the initiative because they are concerned about the risk of handing over the sustainability agenda to a wider group. We discussed the most promising initiatives that may encourage participation. They included engagements on climate change, green finance and green bonds, as China seeks leadership on this issue, as evidenced by the progress made since the 2015 UN summit on climate change in Paris and the G20 meeting in Hangzhou in September 2016. We also discussed the challenges we faced with a Chinese company listed on the Nasdaq stock exchange, which has not held any AGMs since 2008. We asked the PRI to approach Nasdaq for a list of companies that have not held an AGM for three years. If this proves to be a systemic rather than company-specific issue, SSE initiative members can act on it collaboratively, possibly through naming and shaming. We also said that the influence of independent non-executive directors needs to be strengthened, adding that most Chinese companies would opt for a board evaluation conducted by one of the big four professional services firms. We highlighted the importance of getting an independent third party, not the consulting arm of a large group, to conduct a fair and informative board evaluation. The PRI promised to include our insights and comments in its next steps plan.

Transparency International

Lead engager: Tim Goodman

We met Transparency International's London team to discuss how we could improve our engagement work with the Principles for Responsible Investment. We also agreed to exchange views on political and lobbying activities. In particular, we discussed the methodology of its TRAC system of scoring companies and suggested some qualitative assessment of the board's leadership on the issue. We agreed to continue to collaborate.

Public policy

Climate change reporting

Lead engager: Tim Goodman

We responded to the consultation by IPIECA, the global oil and gas industry's trade association for environmental and social issues, on climate change reporting. We highlighted that the Financial Stability Board's Task Force on Climate-related Financial Disclosures is likely to become the benchmark for disclosure and that IPIECA should view any of its standards as a baseline. We also noted that there is already evidence that the energy transformation might be happening more quickly than companies in the industry expect. Disclosures should therefore demonstrate how companies ensure that they do not have a blind spot over the pace and extent of this transformation, including by reporting on the sensitivities they use to stress-test projects and portfolios. We also called on oil and gas companies unequivocally to support the ambition of the 2015 Paris agreement and to describe their escalation processes in the event that trade bodies do not agree with their own public positions. We asked companies to report on the reasons for not having greenhouse emission reduction targets and to outline what they do to reach the goals. Companies should provide qualitative assessments of quantitative data to help provide context for any apparent anomalies. Reporting on the activities of individual companies and the industry with regard to climate change should provide progress indicators and milestones against which stakeholders can judge progress and success.

Climate-related financial disclosures

Lead engager: Bruce Duguid

We provided informal feedback on the emerging draft guidelines for company reporting on climate-related financial disclosures. We highlighted the need for scenario-planning to include a qualitative description of the potential impacts of low-carbon scenarios, as well as a quantitative assessment of the value at risk. In this context, we set out the key elements of a potential stress-test for the energy and resources sectors which would include assessments against low commodity price scenarios. We will continue to review and give input into the draft guidelines. We anticipate their publication early in 2017, to be followed by further formal consultation before the guidelines are finalised later in in 2017.

Oil and gas exploration in the Arctic

Lead engager: Tim Goodman

We agreed to co-sign a letter, co-ordinated by an investor group from the Principles for Responsible Investment, to policy-makers with jurisdiction over much of the region to encourage greater regulation of exploration and production in the Arctic. In particular, the letter called for a moratorium to all exploration in the Arctic High Sea area and stricter licencing requirements and uniform standards on drilling across the rest of the Arctic, with increased protection of areas with heightened ecological importance.

Developed Asia

Promoting best practice

Asian Corporate Governance Association

Lead engager: Hans-Christoph Hirt

We moderated a panel on North-Asia at the annual conference of the Asian Corporate Governance Association in Tokyo. Drawing on the experience of the panellists from China, Korea and Taiwan, the discussion focused on key developments and obstacles in corporate governance and stewardship in these markets. It was particularly exciting to hear from the chair of one of the biggest Taiwanese pension funds about the progress in the market where we have promoted the adoption of a stewardship code for a number of years prior to its launch in late 2016. A professor from Seoul confirmed that Korea remains a difficult market due to a lack of political leadership on corporate governance and stewardship, while the National Pension Service does not have a clear mandate to push for governance changes in the local market. Lastly, according to the partner at a leading audit firm, China remains a special case in relation to corporate governance, depending on the ownership structure of companies and the place of listing. The panel was well received by the audience.

Cross-shareholdings

Lead engager: Masaru Arai

In a meeting with the Financial Services Agency (FSA) Japan, we raised concerns about the cross-shareholdings by Japanese companies and pointed out that many companies still do not understand why investors ask them to reduce theirs, particularly in view of the new cross-shareholding arrangements agreed by some of them. We suggested the FSA ask Japanese companies to improve disclosures in annual securities and corporate governance reports. The director said that the Council of Experts Concerning the Follow-up of Japan's Stewardship Code and Japan's Corporate Governance Code continues to discuss cross-shareholdings and retain dialogue with investee companies on the issue. We were pleased that the director welcomed feedback from investors. We also explained the European view of acting in concert and suggested that existing Japanese guidance on this is fraught with uncertainty for investors, especially in relation to the term 'agreement', pointing out that many investors cannot take risks against a backdrop of legal uncertainty. The director said that it would take the regulator several years to revise this regulation but he appeared willing to continue to exchange views with us on the interpretation of the issue.

Environmental reporting tool

Lead engager: Sachi Suzuki

Japan's Ministry of Environment invited us to trial its new environmental reporting tool. The platform will give investors access to the environmental reporting of listed companies registered on the system. It is designed to enable asset owners to communicate directly with those in charge of investor relations or ESG information disclosure at a company, in addition to searching for financial and non-financial company reports. We welcomed this project, which we hope will promote dialogue between companies and investors and add to the growing momentum of responsible investment in Japan.

Shenzhen and Hong Kong stock exchanges

Lead engager: Christine Chow

In a meeting to discuss the Shenzhen-Hong Kong Stock Connect mechanism, we challenged a number of issues relating to market practices. These include an extended period of trading suspension and foreign holding restrictions that limit the aggregate shareholding of foreign investors in A Shares to no more than 30% of total issued shares, thus restricting liquidity. We sought insights into the investor communication platform developed by the Shenzhen Stock Exchange, including a mobile app that monitors the interactions of companies with investors. Although an average of 1.5 million investors click on the platform every day and companies are expected to reply within two working days, we challenged how the exchange monitors the quality of questions and whether any sensitive information is communicated. We also expressed our frustrations with the lack of engagement from some listed companies to the senior executives of the two exchanges. The Hong Kong Stock Exchange reassured us that it is looking into developing a similar investor relations app that should help to monitor companies' efforts in terms of investor communication and shareholder engagement. We offered to share our views as a representative of shareholders, which was appreciated.

Public policy

Earnings release

Lead engager: Sachi Suzuki

We sought to gain more clarity on the consultation on proposed changes to the rules for earnings releases. The Tokyo Stock Exchange assured us that companies are likely to continue the existing standard of reporting after the change, given that all of them currently include detailed financial statements in the earnings releases, which are not compulsory and only requested by the exchange. We asked it to continue to reiterate to companies that this information is vital to investors. We also voiced concerns that the inclusion of corporate strategy on a voluntary basis, only available in annual securities reports, which are published after the AGMs, will affect the ability of investors to be able to make informed voting decisions. While the stock exchange told us that the intention of the proposed amendment is to bring the reporting requirements in line with those in the US and UK, allowing companies more flexibility, we argued that relaxing rules on this particular type of reporting without aligning the timings of other reports would not be beneficial for investors. We subsequently co-signed a joint investor letter to respond to the public consultation by the Tokyo Stock Exchange, in relation to rules for earnings releases. The letter raised concerns that the proposed changes could lead to companies no longer publishing detailed financial statements ahead of their AGMs.

Korea Stewardship Code

Lead engager: Christine Chow

We welcomed the launch of the Korea Stewardship Code in December 2016. A number of local fund managers, such as Samsung Asset Management and Mirae Asset Global Investments, have reportedly expressed interest in signing up. We are pleased that the code follows the global practice of comply-or-explain, instead of pushing for compliance only. The voluntary approach enables investors to make the decision to sign up to the code in their own time, depending on their experience and availability of resources. We compared the seven principles of the Korea and the UK Stewardship Code. Key similarities are clear policies on how to discharge stewardship responsibilities, manage conflicts of interest, monitor companies for long-term success, guidelines on how to escalate stewardship activities, clear voting policies and the disclosure of voting and engagement records. However, the UK code encourages institutional investors to act collectively with other investors where appropriate, while the Korea code does not provide any guidance or encourage any collaboration among investors. This is in line with Japan's code where much emphasis is on the challenges of investors being perceived as acting in concert. In addition, the Korea code highlights that institutional investors should have in-depth knowledge and expertise to appropriately fulfil their stewardship activities, while the UK version does not explicitly require this.

Emerging and Frontier Markets

Promoting best practice

Board evaluation in India

Lead engager: Christine Chow

We participated in a high level expert forum hosted by the Securities and Exchange Board of India (SEBI) and the OECD on the effective implementation of board evaluation in India. Current regulation requires all listed companies to undergo board evaluations for all listed companies, and with the 2015 revised OCED corporate governance principles, guidelines were added in relation to the protection of minority shareholders and stewardship expectations from institutional shareholders. SEBI encourages companies to apply the spirit of the law instead of the letter of the law in order to make board evaluations a useful exercise as part of engagements with stakeholders. We expressed our views on the usefulness of high-quality board evaluations and how we analyse evaluation outcomes as part of our engagement with companies. Takeaway recommendations from experts and the audience were better guidelines as to what constitutes a good standard of board evaluation, root cause analysis and action plan for each evaluation to avoid annual assessments becoming a box-ticking exercise, the importance of monitoring changes and the disclosure of best practices to help shareholders gain a better insight into the essence of the evaluation.

Capital Markets Board of Turkey

Lead engager: Jaime Gornsztejn

We met a delegation from the Capital Markets Board of Turkey to discuss the country's corporate governance framework and share best practice. The delegation was accompanied by the corporate governance officer of the European Bank for Reconstruction and Development and two representatives from Nestor Advisors, who prepared a benchmark study of corporate governance in Turkey. We discussed board composition and independence, engagement of independent board members with minority shareholders, the quality of reporting and comply-or-explain. We were encouraged by the openness of the delegation and its proactive approach in seeking feedback and best international practice.

Corporate Governance Scorecard

Lead engager: Christine Chow

We participated in a panel session at the launch of the Corporate Governance Scorecard, a multi-stage project led by the International Finance Corporation and the Bombay Stock Exchange. The scorecard is based on the OECD's corporate governance principles, four major categories of governance assessment, namely shareholder rights, stakeholder engagement, disclosure and transparency and board responsibilities. The disclosure-based approach enables companies to score themselves against best practices, with a tilt that addresses governance characteristics specific to the Indian market, such as related party royalties, the influence of family or founder-controlled shareholders – so-called promoters – and CSR efficacy. The scoring tool is available on the stock exchange's website for benchmarking and gap analysis. During the panel discussion, we explained why governance is important in risk management. We also stated that we believe that governance is a growth- and performance-driver because companies that are willing to undertake self-assessments tend to embrace change with a progressive mindset, which is vital to a positive corporate culture and the generation of long-term shareholder value. Against the background of the removal of the chair at Indian holding company Tata Sons, references were made to the importance of articles of association that limit the influence of the founding families or promoter groups to ensure better accountability on activities such as the appointments of directors and chairs.

Shanghai Stock Exchange

Lead engager: Christine Chow

During an open discussion with the chief legal counsel and the deputy director of the Shanghai Stock Exchange (SHSE), we put forward concerns about the corporate governance of China-listed companies. The legal counsel shared his views on the matter and asked us for suggestions on how governance could improve at Chinese companies. We suggested policies that enable regular engagements between global investors and board directors would benefit the building of trust. We also encouraged a review of the nature of current CSR reports which should focus on linking corporate social activities to the business. These comments were much appreciated. We were invited to share more of our experience on governance and engagement during our next visit.

Public policy

Launch of the Brazilian Stewardship Code

Lead engager: Jaime Gornsztejn

At the launch of the Brazilian Stewardship Code, we spoke about our experience in stewardship and formally signed up to the code. The code was drafted by a working group of members of the Association of Capital Market Investors AMEC, of which we were the only non-resident member. The process comprised a benchmarking of stewardship codes, interviews with International Corporate Governance Network (ICGN), the Financial Reporting Council, local and international asset managers and asset owners and a public consultation. The code is aligned with the ICGN's global stewardship code. We believe that the new code will be instrumental in developing a stewardship culture in the Brazilian market and were pleased by the attendance of some major local asset managers at the launch. We will continue our public policy engagement on the Brazilian Stewardship Code as AMEC develops the guidelines for implementation during 2017.

Europe

Promoting best practice

Ansvarlig Fremtid NGO

Lead engager: Bruce Duguid

We discussed our approach to engagement with the oil and gas sector with A Responsible Future (Ansvarlig Fremtid), a Danish NGO focused on tackling climate change and in particular the role of companies in delivering this. The NGO was inspired by the divestment campaign triggered by 350.org and generally proposes radical action by investors and companies on climate change. However, we established that it also appreciates the efforts of investors to engage with companies, which it sees as potentially achieving divestment from within a company, for example such as a decision made by a company to cease development of off-shore Arctic oil. The NGO does not believe gas can be an effective bridging fuel and prefers a direct move to renewables. However, it accepts that it may be infeasible to expect oil and gas companies to become renewable businesses. We agreed that engagement with the energy-consuming sectors such as utilities, automotive and industrial companies, in particular on commercial opportunities, not risks, is likely to be more effective in limiting climate change. We then discussed potential feasible engagement objectives, acknowledging that investments in utilities are often constrained by government policy. We agreed to remain in contact.

Communications between investors and supervisory board chairs

Lead engager: Hans-Christoph Hirt

We presented the rationale behind the guidelines for communications between investors and supervisory board chairs, which we developed together with other investors, German companies and lawyers at a conference in Berlin. We highlighted board composition and accountability as principal concerns of institutional investors and the critical role direct dialogue plays in providing reassurance to such shareholders, specifically when it comes to the two-tier German system. We accept that dialogue between investors and the chairs of German supervisory boards will have to focus on the responsibilities of the upper board in the two-tier system. However, some lawyers continue to dispute whether this dialogue should take place at all. We had a robust discussion of some of the underlying questions, as well as safeguards that can be put in place to ensure that dialogue does not cross any legal boundaries. We were pleased to get strong support from the corporate secretary at Deutsche Bank where supervisory board chair level dialogue has been practised for many years. The impact of the guidelines that were launched in July 2016 has been significant in practice and in literature.

Danwatch

Lead engager: Bruce Duguid

We met Danwatch, a not-for-profit organisation comprising a team of investigative journalists. It conducts in-depth investigations into corporate issues affecting human rights and the environment, as well as their impact on conflict zones. The organisation typically conducts 10 to 12 investigations per year, each lasting between four to 12 months. Recent examples include investigations into the environmental implications and labour rights associated with low-cost ship recycling on beaches in Southeast Asia and modern slavery and illegal pesticide use in coffee growing. The team has also focused on infrastructure, including human rights abuses arising from land seizures associated with the development of Kenya's largest wind farm project. Danwatch focuses on its expertise in journalism and allows others such as politicians, NGOs, the media and companies to work out the implications. We explained how we have used its research in our engagement with a major shipping line. Danwatch agreed that aligning the interests of responsible investors and NGOs in Denmark is challenging. We agreed to work together to support effective change at companies.

EU Corporate Governance Conference

Lead engager: Natacha Dimitrijevic

We spoke at the 19th European Union Corporate Governance Conference, where we highlighted that corporate governance codes must apply the principle of comply-or-explain to avoid prescriptive governance. Responsibility for this falls equally on the company and its shareholders. As institutional shareholders represent the ultimate beneficiaries – workers and their pensions – we highlighted that no financial performance will compensate for the exploitation of valuable, increasingly diminishing resources and that a resilient and prosperous economy is needed to meet pension liabilities. Too much focus on short-term financial returns ultimately compromises returns to pension beneficiaries. We pointed out that a wealth of studies have demonstrated that environmental, social and governance (ESG) factors are material to the financial performances of companies. It is therefore essential for investment managers and part of the fiduciary duty of shareholders to monitor the ESG performance of companies.

Public policy

Climate policy of Switzerland post-2020

Lead engager: Michael Viehs

We responded to the Swiss government's consultation on its climate policy post-2020. In our response, we suggested that the government should support the 2015 Paris Agreement on climate change and encourage all other stakeholders in the country, such as investors and companies, to contribute to the achievement of the objectives specified in the agreement. Ultimately, we asked the Swiss government to ratify the Paris agreement, as ratification will support its own businesses, some of them global, in the transition towards a low-carbon economy.

German Corporate Governance Code

Lead engager: Michael Viehs

We responded jointly with two large pension funds to the consultation on the amendments to the German Corporate Governance Code. In our response, we focused on four major issues, namely investor dialogue with German supervisory boards, supervisory board composition, audit committee independence and stewardship activities of institutional investors. We welcomed the proposed new recommendation that chairs of supervisory boards should have regular dialogue with investors and suggested the commission reference our Guiding Principles for the Dialogue between Investors and German Supervisory Boards to specify the contents, format and participants of such dialogue. While we welcomed the proposed addition to the code that companies should publish competency profiles for supervisory board directors, we pushed for more transparency on how individual directors can fulfil such briefs. In addition, we encouraged the commission to consider including a recommendation to the effect that all directors which the company considers independent are named and explicitly mentioned in the corporate governance section of the annual report. This will, in our view, improve transparency and governance quality in Germany. Furthermore, while we agree with the code's existing recommendation for the chair of the audit committee to be independent, we encouraged the commission to consider the introduction of a recommendation requiring all members of the audit committee to be independent. Against the backdrop of the recently agreed EU Shareholder Rights Directive, we applauded the commission for specifying explicitly in the code that institutional investors are required to exercise their ownership rights actively and responsibly. However, we encouraged it to ensure that any impediments to stewardship, for example practical limitations regarding the exercise of voting rights by proxy, are reviewed.

North America

Promoting best practice

US governance developments

Lead engager: Tim Goodman

We had a positive call with a professional services firm outlining our views on the US governance landscape and our priorities. These included the points we raised in our letter to the chairs of the S&P 200 with our updated US principles, which we subsequently forwarded to the firm, such as the importance of a corporate purpose with societal benefits, public support for the 2015 Paris Agreement on climate change and extending the boardroom discussions on diversity to include inclusion and human capital management throughout companies' value chains. We also discussed our latest thinking on executive pay, proxy access and enhancing the current provisions that are not workable in practice, how taxation policy and practice must take account of regulatory and reputational risk and how much of the market's short termism comes from mainstream investors. We therefore agreed with the need for a US stewardship code and flagged our work on them globally and the difficulty of how to implement one in the US without a regulator with whom such a code would comfortably sit. We shared some of our recent materials and agreed to keep in closer contact, as we see this body as a useful ally in amplifying our message in the US.

Public policy

Ontario Business Corporations Act

Lead engager: Bill Mackenzie

Missing from the list of recommendations for changes to the Ontario Business Corporations Act (OBCA) was a recommendation to enshrine a majority voting requirement for director elections, as it currently only recognises a plurality vote. In our response to the consultation, we noted that despite the Toronto Stock Exchange recently adding as a listing requirement the adoption of a director resignation policy, a form of majority voting, Canada lags behind most other overseas markets in denying shareholders this right. We expressed concern that of the 20 directors of S&P/TSX Index companies who failed to receive support of a majority of votes cast and submitted resignation letters in 2015, nine of the resignations were dismissed by their fellow directors, allowing them to continue in their roles. We concluded that majority voting is key to maintaining confidence in Canadian capital markets and that majority voting must be part of the next round of amendments to the OBCA.

Universal proxy

Lead engager: Tim Goodman

We supported the concept of a universal proxy at shareholder meetings in the US when we responded to a consultation by the US Securities and Exchange Commission (SEC) on the issue. We argued that this is a fundamental shareholder right, enabling shareholders to vote in favour of or against director candidates regardless of whether they are on the board's or a dissident shareholder's slate. This would result in less confrontational proxy contests and a more accurate expression of the wishes of shareholders, which we believe would be beneficial to long-term shareholders. We were pleased that the US Council of Institutional Investors thanked us directly for our submission after it was posted on the SEC's website.

United Kingdom

Promoting best practice

Anti-corruption legislation

Lead engager: Tim Goodman

We met the newly appointed coordinator of the UK's All Party Parliamentary Group on Anti-Corruption as part of our ongoing efforts to encourage better anti-corruption legislation and its enforcement, as well as to develop the resources available to companies to help them in their efforts to stop corrupt behaviour. In particular, we noted that its work to develop assistance for UK exporters to countries with perceived high levels of corruption is suffering from a lack of traction with smaller companies. After the meeting, we connected the group to the Quoted Companies Alliance to help.

Anti-corruption roundtable

Lead engager: Tim Goodman

We spoke on a panel with the head of the UK's Serious Fraud Office (SFO), as well as representatives from Transparency International and a mining company at the UK's chapter of the UN Global Compact roundtable on anti-corruption. We encouraged the move by the SFO to start more serious investigations into alleged corruption, expecting more prosecutions. We also reminded the audience, which comprised mainly UK companies, that our experience of working with companies that had been at the centre of enforcement action is that those that did not previously have good systems and controls in place now do so as a result of the SFO's or other enforcement actions. We also talked about the importance of setting ethical standards and expectations and described how these benefitted organisations that worked hard on embedding their values. The feedback from participants was positive, in particular our focus on the importance of anti-corruption measures to long-term investors.

Climate change disclosure

Lead engager: Tim Goodman

As requested by our contact at the UK's Financial Reporting Council (FRC), we followed up our correspondence in support of a request by environmental consultancy ClientEarth for the Financial Reporting Council to investigate the reports and accounts of Soco International and Cairn Energy concerning the lack of disclosure in relation to climate change risk. We wrote a formal letter to the FRC's CEO to reconfirm our support for this action while also pointing out that other companies do not report sufficiently well either.

Corporate governance in the UK

Lead engager: Will Pomroy

At a roundtable of large UK-based asset managers, we contributed to the development of the policy position of the Investment Association in relation to corporate governance and executive remuneration in the UK. During a discussion of the proposals outlined by the country's Prime Minister, we indicated our support for enhancing the voice of the worker within governance arrangements and encouraged the association to be mindful of the social pressures that the government is responding to when formulating its response. In line with our thinking on executive pay, we encouraged the association's Institutional Voting Information Service Principles of Remuneration to include post-employment shareholding requirements for executives, as well as encourage the practice of executives purchasing shares with their own funds. Encouragingly, the association recognised the need to make explicit references to quantum when communicating its new principles.

Corporate governance reform

Lead engager: Hans-Christoph Hirt

We spoke at a meeting to a large group of directors of German and

UK companies about our views on employee representation and wider UK corporate governance reform. We highlighted three main ways to encourage companies to focus more on the long term and take into consideration wider stakeholder consideration, namely enhanced stewardship by investors, more focus and accountability on section 172 of the 2006 Companies Act, which sets out directors' duties and board composition and decision-making. We shared our experience with employee representation in Germany and the positive anecdotal evidence that we have received on it over the last decade. While there are other ways to ensure that the voice of employees and stakeholders is factored into the decision-making of boards, representation is one way to directly involve employees who are providers of human and – as savers – financial capital of companies. Overall, the experience with employee representation among the participants was positive, although some highlighted potential conflicts of interest as a concern. In the discussion, there was agreement that a longer-term focus of companies requires more far-reaching changes in the investment chain that go beyond the corporate governance changes under consideration in the UK. Given the publication of the government's green paper, our talk was timely and well received by the participants.

Diversity Project

Lead engager: Christine Chow

We attended the launch seminar of the Diversity Project where we discussed the problem of unconscious disconnection, referring to the difference between what people believe in and what they do. The chief economist of the Bank of England provided different perspectives. He suggested that the project could go beyond the gender pay gap and lack of representation to also focus on ethnic diversity. He recommended investment companies measure and disclose the relevant diversity data. As groupthink has been deemed a significant contributor to the lack of diversity on company boards, unconscious biases and recruitment practices need to be addressed, in particular because candidates tend to be judged based on academic performance, former work experience, social skills and team-building capabilities. We concluded that recruitment consultants ought to review candidates based on the diversity principles of the individual employer and not screen out suitable candidates based on their own unconscious bias.

Internet shutdowns

Lead engager: Dominic Burke

We attended a briefing on the threats that internet shutdowns by governments pose to human rights, including to the freedoms of expression and assembly. The Ranking Digital Rights project, in collaboration with the Global Network Initiative, is seeking to raise investor awareness of the fact that technology companies are implicated in these shutdowns and therefore also the threat to human rights. Vodafone presented the collaborative work of large telecommunications operators in developing common standards in relation to such orders, and Ranking Digital Rights has published guidance on what investors should expect from companies exposed to this issue.

Smaller companies corporate governance review

Lead engager: Will Pomroy

We spoke at the Quoted Companies Alliance's annual Corporate Governance Behaviour Review 2016. This was the fourth annual Corporate Governance Behaviour Review and the theme of the report was Establishing Trust and Confidence with Investors. As the investor representative, we explained the need for smaller companies to see the annual report as an opportunity to tell their story openly and effectively. We focused in particular on the disclosures with regard to board composition and the need for companies to clearly convey the skills present on their board and how these are aligned with the growth strategy of the company. Our overriding message was that, for smaller companies in particular, the annual report is a crucial tool to build and establish trust with investors, cautioning that this can be undermined by a tendency towards boiler-plating or supported by making clear links between strategy, performance and governance.

Public policy

Corporate governance reform

Lead engager: Hans-Christoph Hirt

We provided evidence to the select committee of the UK's House of Commons that leads its work on corporate governance reform. In our evidence, which was based on the written response we had provided, we outlined our proposals on executive remuneration and showed our support for a rethinking of the composition of boards. We explained how simpler and less leveraged pay packages could increase transparency and lower the average payout. While we welcomed the proposals made in the green paper by the government on corporate governance reform, we also highlighted the important role of stewardship for remuneration committees and investors. We specifically welcomed the government's exploration of different ways to give stakeholders in general and employees in particular a stronger voice in the decision-making of the board. We recognise that there are a number of ways to achieve this and shared our positive experience with employee representation in Europe. While we are not in favour of mandatory representation of employees on boards, we believe that this is a good way of enhancing diversity and bringing different perspectives to the boardroom. We will now put together a written response to the questions raised in the green paper, which is due in February.

Inquiry on corporate governance

Lead engager: Will Pomroy

We made a submission to the UK Parliament's Business, Innovation, and Skills Committee's inquiry on corporate governance. The inquiry focused on executive pay, the duties of directors and the composition of boardrooms, including worker representation and gender balance. In our response, we explained that we believe that the duties of directors are well defined in law and understood to be directed at the long-term success of the company, however, the day-to-day operations of capital markets too often shorten their time horizons. Recognising this context, we suggested that companies should be required to disclose more in relation to their interactions with key stakeholders and outline a number of proposals for improving remuneration structures. In addition, we noted that, due to intermediation, individual workers have become disconnected from how their savings are invested. We therefore argued that it is appropriate that employees be given a greater voice in UK governance arrangements. Finally, we advocated the introduction of an explicit positive duty on investment managers and other providers of tax advantage savings vehicles to undertake or otherwise ensure the good stewardship of the entities in which they invest.

Appendix | Hermes EOS team

Leadership

Dr Hans-Christoph Hirt
Co-Head

Emma Hunt
Co-Head

Bruce Duguid
Director
Sector lead: Mining, Utilities
Sectors: Oil and Gas, Pharmaceuticals

Tim Goodman
Director
Sector lead: Oil and Gas
Sectors: Financial Services, Mining

James O'Halloran
Director
Head of Voting and Engagement Support

Carl Short
Director of Engagement

Engagement professionals

Dr Emma Berntman
Sectors: Financial Services, Mining, Oil and Gas, Pharmaceuticals, Utilities

Roland Bosch
Sector lead: Financial Services
Sectors: Consumer Goods and Retail

Darren Brady
Sector lead: Technology
Sectors: Oil and Gas, Pharmaceuticals

Dr Christine Chow
Sectors: Financial Services, Mining, Oil and Gas, Technology

Natacha Dimitrijevic
Sector lead: Pharmaceuticals
Sectors: Consumer Goods and Retail, Financial Services, Industrials, Oil and Gas

Claire Gavini
Sectors: Consumer Goods and Retail, Industrials

Jaime Gornsztejn
Sectors: Mining, Oil and Gas, Technology, Utilities

Sachi Suzuki
Sector lead: Industrials
Sectors: Technology

Dr Michael Viehs
Sectors: Industrials, Mining, Oil and Gas, Pharmaceuticals, Utilities

Maxine Wille
Sectors: Financial Services, Industrials, Technology

Business Development and Client Service

George Clark
Voting and Engagement Support

Amy D'Eugenio
Head of Business Development and Client Service

Alan Fitzpatrick
Client Relations

Rochelle Giugni
Client Relations

Bram Houtenbos
Voting and Engagement Support

Nina Röhrbein
Reporting and Communications

Lucy Saville
Client Relations

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

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