

Public Engagement Report



Tectonic plates are shifting – Improvements in
US corporate governance

This report contains a summary of the stewardship activities undertaken by Hermes EOS on behalf of its clients. It covers significant themes that have informed some of our intensive engagements with companies in Q2 2015.

The report also provides information on voting recommendations and the steps we have taken to promote global best practices, improvements in public policy and collaborative work with other long-term shareholders.

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What is Hermes EOS?

Hermes EOS helps long-term institutional investors around the world to meet their fiduciary responsibilities and become active owners of public and private companies. Our team of engagement and voting specialists monitors our clients' investments in companies and intervenes where necessary with the aim of improving their performance and sustainability. Our activities are based on the premise that companies with informed and involved shareholders are more likely to achieve superior long-term performance than those without.

Through pooling resource with other like-minded funds to create a strong and representative shareholder voice, our joint company engagements are more effective. We currently act on behalf of 41 clients and £116 billion* assets under advice.

Hermes has one of the largest stewardship resources of any fund manager in the world. Our 26-person team includes industry executives, senior strategists, corporate governance and climate change experts, fund managers and lawyers.

The depth and breadth of this resource reflects our philosophy that stewardship activities require an integrated and skilled approach. Intervention at senior management and board director level should be carried out by individuals with the right skills, experience and credibility. Making realistic and realisable demands of companies, informed by significant hands-on experience of business management and strategy-setting is critical to the success of our engagements.

We have extensive experience of implementing the Principles for Responsible Investment (PRI) and various stewardship codes. Our chief executive Colin Melvin chaired the committee that drew up the original principles and we are actively engaged in a variety of workstreams through the PRI clearinghouse. This insight enables us to help signatories in meeting the challenges of effective PRI implementation.

How does Hermes EOS work?

Our corporate, public policy and best practice engagement programmes aim to enhance and protect the value of our clients' investments and safeguard their reputations. We measure and monitor progress on all engagements, setting clear objectives and specific milestones. In selecting companies for engagement, we take account of their environmental, social and governance risks, their ability to create long-term shareholder value and the prospects for engagement success.

The Hermes Responsible Ownership Principles¹ set out our fundamental expectations of companies in which our clients invest. These cover business strategy, communications, financial structure, governance and management of social, ethical and environmental risks. The engagement programme we have agreed with our clients, as well as the Principles and their regional iterations, guide our intervention with companies throughout the world. Our approach is pragmatic and company- and market-specific, taking into account individual company circumstances.

We escalate the intensity of our engagement with companies over time, depending on the nature of the challenges they face and the attitude of the board towards our dialogue. Some engagements involve one or two meetings over a period of months, others are more complex and entail multiple meetings with different board members over several years.

At any one time around 400 companies are included within our core engagement programmes. All of our engagements are undertaken subject to a rigorous initial assessment and ongoing review process to ensure that we focus our efforts where they can add most value for our clients.

While we are robust in our dealings with companies, the aim is to deliver value for clients, not to seek headlines through campaigns, which can undermine the trust that would otherwise exist between a company and its owners. We are honest and open with companies about the nature of our discussions and will aim to keep these private. Not only has this proven to be the most effective way to bring about change, it also acts as a protection to our clients, so that their positions will not be misrepresented in the press.

For these reasons, this public report contains few specific details of our interactions with companies. Rather it explains some of the most important issues relevant to responsible owners and outlines Hermes EOS' activities in these areas.

We would be delighted to discuss Hermes EOS with you in greater detail.

For further information please contact:
Colin Melvin on +44(0)207 680 2251

* as of 30 June 2015

¹ http://www.hermes-investment.com/Portals/0/Hermes_Corporate_Ownership_Principles_non-US.pdf

Hermes EOS team

Leadership



Colin Melvin
Chief Executive



Roger Hirst
Director



Dr Hans-Christoph Hirt
Director



Leon Kamhi
Director

Engagement professionals



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



Darren Brady
Sector lead: Technology
Sectors: Consumer Goods and Retail, Pharmaceuticals



Christine Chow
Sectors: Financial Services, Technology, Utilities



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



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



Rochelle Giugni
Sectors: Consumer Goods and Retail, Financial Services, Utilities



Lui Goldie
Sectors: Pharmaceuticals, Technology



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



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



Naheeda Rashid
Sector lead: Consumer Goods and Retail
Sectors: Industrials, Technology



Sachi Suzuki
Sector lead: Industrials
Sectors: Technology



Maxine Wille
Sectors: Consumer Goods and Retail, Industrials, Pharmaceuticals

Business and Client Development



Dominic Burke
Client Relations



Bram Houtenbos
Voting and Engagement Support



Amy Lunn
Head of Business and Client Development



James O'Halloran
Head of Voting and Engagement Support



Nina Röhrbein
Reporting



Lucy Saville
Client Relations

Engagement by region

Over the last quarter we engaged with 235 companies on 478 social, environmental, business strategy and governance issues. Our holistic approach to engagement means that we typically engage with companies on more than one issue simultaneously. The engagements included in these figures are in addition to our discussions with companies around voting matters.

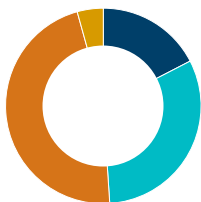
Global

We engaged with **235** companies over the last quarter.



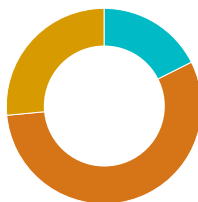
Australia and New Zealand

We engaged with **26** companies over the last quarter.



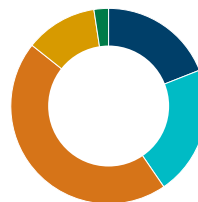
Developed Asia

We engaged with **15** companies over the last quarter.



Emerging and Frontier Markets

We engaged with **20** companies over the last quarter.



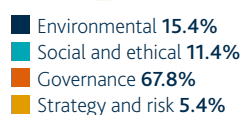
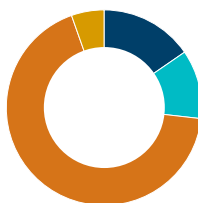
Europe

We engaged with **38** companies over the last quarter.



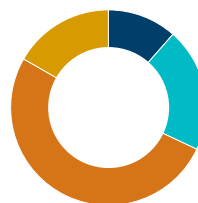
North America

We engaged with **93** companies over the last quarter.



United Kingdom

We engaged with **42** companies over the last quarter.

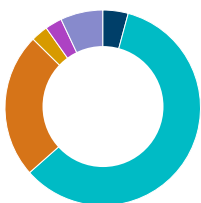


Engagement by issue

A summary of the 478 issues on which we engaged with companies over the last quarter is shown below.

Environmental

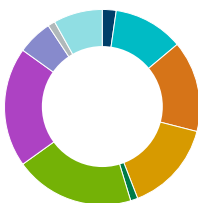
Environmental issues featured in **14.9%** of our engagements over the last quarter.



- Biodiversity **4.2%**
- Climate change/carbon intensity **59.2%**
- Environmental management **23.9%**
- Forestry **2.8%**
- Waste **2.8%**
- Water stress **7.0%**

Social and ethical

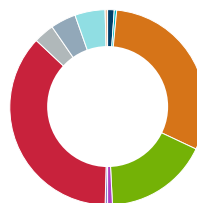
Social issues featured in **18.0%** of our engagements over the last quarter.



- Access to medicine **2.3%**
- Bribery and corruption **11.6%**
- Community relations **15.1%**
- Corporate culture **15.1%**
- Customer relations **1.2%**
- Employee relations **19.8%**
- Health and safety **19.8%**
- Licence to operate **5.8%**
- Operations in troubled regions **1.2%**
- Supply chain management **8.1%**

Governance

Governance issues featured in **54.8%** of our engagements over the last quarter.



- Accounting or auditing issues **1.1%**
- Acting in concert **0.4%**
- Board structure **30.5%**
- Other governance **17.2%**
- Poison pill **0.8%**
- Related-party transactions **0.4%**
- Remuneration **36.6%**
- Separation of chair/CEO **3.4%**
- Shareholder communications **4.2%**
- Succession planning **5.0%**
- Voting rights – not 1 share 1 vote **0.4%**

Strategy and risk

Strategy and risk issues featured in **12.1%** of our engagements over the last quarter.



- Business strategy **46.6%**
- Capital structure **3.4%**
- Reputational risk **6.9%**
- Returns to shareholders **3.4%**
- Risk management **39.7%**

Stewardship

Stewardship issues featured in **0.2%** of our engagements over the last quarter.



- Reporting/disclosure **100.0%**



Why engagement trumps divestment in the battle against climate change – The case for engagement with fossil fuel companies

As divestment from one or more types of fossil fuel company is becoming a more frequent occurrence, we believe that engagement can be a more effective tool in climate change mitigation efforts.

Setting the scene

As universal investors with interests across all sectors and asset classes, large-scale pension funds and endowments understand that the long-term returns on their investments are correlated to the long-term health of the economy. For this reason, they have long been genuine and vocal supporters of efforts to tackle climate change. This is based on the analysis that the cost of building a low-carbon economy, which may involve reduced returns on investment in the short term, will be well rewarded by the long-term gain of avoiding the harms of potentially catastrophic carbon levels and climate change.

Unfortunately, political and economic reality has not kept pace with investor ambition. Currently, the world's economy is on a de-facto trajectory of 4°C global warming, although national leaders have individually pledged to achieve a 3°C pathway and collectively still aspire to keep global warming to 2°C, the maximum limit judged safe by scientists to avoid catastrophic climate change. Limiting climate change to 2°C remains the goal of the UN climate talks in Paris in December 2015, although it is a challenging target, given the additional policy measures that will be required above and beyond those already pledged.

Fossil fuels will remain important in low-carbon scenarios

Investors support long-term policies that facilitate a smooth and cost-effective transition to a low-carbon economy. The International Energy Association has projected the most rational global demand response for fossil fuels in the case of the transition to each of the 4°C and 2°C pathways. In the 4°C pathway, demand for all fossil fuels would rise. However, in the 2°C pathway, demand for coal is projected to fall immediately, while oil demand peaks by 2020 before declining. Gas demand continues to increase, albeit at reduced rates.

In either scenario, continued investment is required in each of the coal, oil and gas industries, although the level of investment is naturally lower in the 2°C scenario. Reduced demand would have a significant impact on the price of fossil fuels and many current and

planned projects may prove to be uneconomic and result in the destruction of shareholder value. Meanwhile, it is estimated that up to 80% of all fossil fuel reserves could never be exploited under a 2°C pathway, including 60-80% of the reserves of companies listed on the stock exchange.²

The pros and cons of engagement vs divestment

Some long-term investors have expressed concerns about the apparent inconsistency of supporting efforts to tackle climate change and holding investments in fossil fuel companies. Following pressure from beneficiaries, some funds have decided to divest entirely from either a particular class of fossil fuels, such as coal, or even from all fossil fuels.³ In most cases, this position appears to be held on a point of principle instead of an economic appraisal of value. Other investors are decreasing their exposure to fossil fuels as a way to reduce risk

Investment approach	Pros	Cons	Conclusion
100% Divestment	<ul style="list-style-type: none"> Improved returns, if divestment based on an economic assessment of risk vs return ratio Ethically defensible position, as can claim that fund does not invest in high-carbon activities associated with exacerbating carbon Sends an easily interpretable signal to policy-makers of support of policies to tackle climate change 	<ul style="list-style-type: none"> Reduced returns or increased risk if divestment is not based on economic assessment Loss of ability to continue engagement Will not succeed in reducing global supply of (or demand for) fossil fuels, as new owner will almost certainly have fewer concerns about climate change 	<p>Appropriate if...</p> <ul style="list-style-type: none"> Based on an economic analysis of long-term risk and value opportunity Desire exists to take an ethically-driven position that can claim to not profit from high-carbon activities Desire exists to send a clear message to policy-makers on climate change <p>Inappropriate if...</p> <ul style="list-style-type: none"> Focus is on maintaining maximum risk-adjusted fund performance while improving chances of tackling climate change
Partial Divestment	<ul style="list-style-type: none"> Improved returns, if based on an economic assessment of risk vs return ratio Maintains ability to continue engagement Sends a positive signal to policy-makers of support of policies to tackle climate change 	<ul style="list-style-type: none"> Loss of some engagement influence, as shareholding is smaller Not obviously consistent with an ethically driven position 	<p>Appropriate if...</p> <ul style="list-style-type: none"> Based on an economic analysis of long-term risk and value opportunity <p>Inappropriate if...</p> <ul style="list-style-type: none"> Desire exists to take an ethically-driven position
Engagement	<ul style="list-style-type: none"> Potential to gain greater disclosure of a company's risk of exposure to low-carbon scenarios Potential to influence company to reconsider appropriate levels of capital investment, consider alternative business models and to cease lobbying against climate change policy 	<ul style="list-style-type: none"> Unlikely to succeed in changing the nature of the fundamental activity of the company, especially if it is government-controlled 	<p>Appropriate if...</p> <ul style="list-style-type: none"> Engagement goals are SMART (specific, measurable, achievable, realistic and time-bound) and resource is effective <p>Inappropriate if...</p> <ul style="list-style-type: none"> Company refuses to discuss the particular issues

and improve returns, although they have not excluded any category of fossil fuels entirely.⁴ Most investors have yet to formulate a specific investment strategy for fossil fuels. But they are pursuing a strategy of active engagement, requesting companies to increase the level of analysis of the risks to asset portfolios from policies to tackle climate change. This approach has met with some success, with a number of fossil fuel companies now publicly accepting the science on climate change and committing to conducting and then publishing stress-tests of their asset portfolio resilience in the event of stronger policies to tackle climate change.⁵ When weighing up whether to engage or divest, it is important to consider carefully the objective of the investor and the likelihood of success under each approach. In particular, it is important to distinguish between ethical objectives, such as avoiding association with activities that exacerbate climate change, and more pragmatic objectives, such as maximising risk-adjusted returns on investment and increasing the potential for companies to react more rapidly to policy signals.

In our view, divestment is unlikely to succeed in changing global levels of either supply or demand of fossil fuel production. Firstly, the new owner of the divested stock wants to see his or her investment pay a return and will almost certainly have fewer concerns about climate change risks. Even if all third-party investors were to shun a particular investment, ultimately the company's management team could buy the asset at minimal value or it would likely be nationalised. In addition, the vast majority of coal consumption and production is controlled directly or indirectly by national authorities. It is therefore difficult for private investors to alter coal supply or demand in the face of opposition from national policy-makers. Even countries that are ardently committed to the transition to a low-carbon economy, such as the UK and Germany, remain committed to some coal usage over the next decade and potentially longer.

It is also difficult to build an ethically purist position against any particular class of fossil fuel, given that all will remain in use at large scales for at least the next four decades under any foreseeable and orderly transition to a low-carbon economy. Fossil fuels therefore cannot be classed as morally repugnant per se. The challenge is the total quantity of global supply and demand, which is a function of the complex structure and incentives of national economies.

A differentiated engagement strategy

Hermes EOS has recently reviewed the nature of its engagement objectives with fossil fuel companies to ensure they are genuinely achievable. Below we set out a potential range of engagement targets depending on the nature of the fossil fuel company. It is important to note that this is a framework approach and that the appropriate engagement objectives for any particular company always vary based on their particular circumstances and history of engagement.

² Unburnable Carbon 2013: Wasted capital and stranded assets published by Carbon Tracker.

³ For example, Stanford University will not invest in any publicly traded companies whose principal business is the mining of coal (May 2014), the Rockefeller Brothers Fund is divesting from coal and tar sands investments (Sep 2014) and the Church of Sweden and University of Glasgow agreed to divestment from all fossil fuel companies (Sep/Oct 2014). The Church of England announced exclusion of companies with over 90% of revenues from coal or tar sands in April 2015.

⁴ Norwegian financial services company Storebrand announced reduced exposure to fossil fuel companies to "ensure long-term stable returns" in July 2013.

⁵ Exxon Mobil has shifted position to accept the science of climate change and to stress-test its investments against different potential costs of carbon. BP and Shell have committed to disclosing their assessment of asset portfolio risk arising from a move to a low-carbon economy (2015).

⁶ It may be possible to encourage diversified mining companies to invest in carbon capture and storage technologies. However, they generally do not have the skills or necessary experience to achieve this and so would need to invest in other ventures or collaborate at a wider industry level.

Engagement goal	Mining: Majority Coal >50%	Mining: Minority Coal <50%	Oil & Gas
Risk appraisal of portfolio resilience to low-carbon economy and appropriate level of capital expenditure across the portfolio	✓	✓	✓
Public policy position: avoid lobbying against climate change policies that limit use of fossil fuels; support global efforts to tackle climate change	✗	✓	✓
Investigate alternative business opportunities, including investing in low-carbon solutions (eg carbon capture and storage, renewables)	✗	✗ ⁶	✓

The result is a differentiated engagement programme with realistic and achievable goals. In the case of a majority coal producing company, it is still realistic to expect that it will carefully appraise the risks to its portfolio and future investment profile arising from low-carbon scenarios and to adjust its capital expenditure accordingly. This analysis should be published to investors so that they are fully aware of the financial risks involved in continuing to invest.

For a minority coal mining company, in addition to conducting the risk assessment above, it is also realistic to aim for the company to cease any lobbying against policies that tackle climate change and to publicly support achievement of policies to tackle climate change.

A typical oil and gas company can take an even more progressive stance on climate change. This is because with a sufficient advance policy signal, it can benefit from the opportunity to sell increasing amounts of gas to displace coal as a low-carbon fuel, while only seeing modestly reduced oil consumption over the next two decades. It would also potentially have the skills and expertise to invest in alternative business lines, such as carbon capture and storage, biofuels and renewables requiring significant engineering, such as geothermal power and offshore wind.

Conclusion

Divestment on the grounds of a hard-headed financial analysis of risks and opportunities is entirely justified. However, it is likely that this will lead to only partial divestment, as certain fossil fuel companies could still be well placed to thrive even in reduced demand scenarios. Divestment for any other reason may be justified on ethical grounds. While it can send a signal to policy-makers of investors' frustration at the lack of progress towards tackling climate change, divestment is very unlikely to contribute to the objective of reduced supply or demand of any class of fossil fuels.

Corporate engagement can help to improve the prospects of tackling climate change at the same time as reducing the investment risk and improving the returns of investments in the fossil fuel industry. However, it is important that the engagement approach is tailored to the nature of the fossil fuel company, with a different approach taken to pure play coal companies, diversified mining companies and oil and gas companies.

For further information, please contact:



Bruce Duguid

bruce.duguid@hermes-investment.com



The World Cup of controversy – labour rights and bribery and corruption concerns about Qatar 2022

Labour rights and bribery and corruption are key themes of our engagement.

Grounds for controversy

Investigations and reports by Amnesty International, law firm DLA Piper, Human Rights Watch, the International Trade Union Confederation (ITUC) and the UN have highlighted the plight of migrant workers in Qatar, citing poor working and living conditions, health and safety and recruitment practices.

One of the main factors facilitating the alleged human rights abuses is Qatar's sponsorship or kafala system. By requiring migrant workers to have an in-country sponsor, typically their employer, who is responsible for their visa and legal status and the exit permit needed for them to be allowed to return to their home country, the system ties workers to their employers. This means employers can control the movement of workers, including their ability to reside in Qatar, change jobs or leave the country. Furthermore, despite now being illegal under Qatari law, the passports of workers continue to be collected and held by employers. In 2011, Qatar University's Social and Economic Survey Research Institute found that 91% of foreign migrant workers surrendered their passports to their employers. But, according to the ITUC, workers are often afraid to report abuses or assert their rights for fear of retaliation.

Late or non-payments also continue to be an issue for migrant workers, say the reports. Having to pay high recruitment fees for migrating to Qatar, although ILO Convention 151 prohibits agencies from charging workers recruitment fees, and receiving false promises about salaries and types of work is another problem. Outstanding debt to recruiters can keep migrant workers in vulnerable positions.

On-site conditions for construction workers have often been reported to be dangerous, while workers struggle to access health care. According to Amnesty International, access to justice for victims of labour exploitation is also difficult and expensive and migrant workers are prohibited from forming or joining trade unions. NGOs have photographed accommodation for workers showing over-crowding and a lack of basics standards – such as fresh water and electricity – and they claim that inspections of labour standards are insufficient and not stringent enough.

Another problem is the Gulf state's heat. Summer temperatures reach over 50° between June and September. Workers are generally not allowed to work during peak heat hours but the heat can be dangerous outside these times.

Setting the scene

One of the biggest scandals to emerge in 2015 has been the FBI investigation of world football's governing body FIFA over allegations of bribery and corruption, including in its handling of the Russia 2018 and Qatar 2022 World Cup bids. At the same time serious concerns about the 2022 World Cup continue to surface. On top of the bribery allegations and worries about playing conditions, the host of the 2022 World Cup has been accused of mistreating its migrant workers and restricting their freedom of movement. This is particularly important because Qatar estimates it needs approximately 500,000 extra workers in the run-up to the World Cup, with around \$140 billion worth of infrastructure projects forecast to get ready for 2022, according to the International Trade Union Confederation (ITUC). Migrant workers currently make up more than half of Qatar's population – 1.4 million in a country of 2.1 million people.

The ITUC estimates that at least 4,000 workers could die in Qatar before the start of the 2022 World Cup. Based on the data from two countries – Nepal and India which make up around half of the total migrant workforce in Qatar – 1,200 workers have already died since the country was awarded the World Cup in 2010 from work-related accidents or from the effects of heat stress or squalid living conditions.

Amnesty International and the UN Special Rapporteur have pushed for fundamental reform of the country's kafala system and the abolition of the exit permit and called for wide-ranging changes to improve health and safety, access to justice and the recruitment process. They have also urged the Qatari government to ensure freedom of association for migrant workers and to guarantee legal protection for domestic workers.

Qatar's reaction

Qatari officials have increasingly acknowledged the abuses taking place against migrant workers and the need to address them, although Qatar's Ministry of Labour has reportedly denied fatalities occurring on World Cup project sites.

In May 2014, the government of Qatar promised to replace the kafala system and the exit permit as part of reforms. But instead of removing an employer's ability to block a worker from moving to another job, the government suggested it would instead limit this power to the duration of a worker's contract. Instead of abolishing the exit permit, the government proposed to issue permits to migrant workers 72 hours after they apply to leave the country – within that time employers could still object to the government and stop the worker from leaving. Amnesty International says these are at best minor improvements to the current system.

Qatar released two charters for workers, the Qatar Foundation Mandatory Standards in 2013 and the Supreme Committee Workers' Welfare Standards in 2014 in response to growing public pressure. While the documents do set standards, according to the ITUC, Qatar's labour laws have remained unchanged. Limited progress has been made on other issues, such as rigorous inspections of labour regulations, stricter accommodation standards and new wage protection measures.

The Business & Human Rights Resource Centre contacted 24 construction firms operating in Qatar about their policies and practices on working conditions. Initially only four provided responses, with two more committing to respond, while five companies declined a response outright.

One of the best practice responses was given by French construction firm Vinci. The company describes the initiatives it has undertaken with its Qatari joint venture partner QDVC to engage the Qatar government on employment practices.

One of the eight pillars of Vinci's manifesto is to strive for zero accidents. It has incurred two work-related fatalities, one in 2009 and one in 2015 and states lost time accident frequency rates as 0.87 for 2013 and as 0.90 for 2014. Vinci management has the responsibility to do its utmost to ensure the physical integrity and health of everyone on its worksites and in the facilities it operates. The company also stresses that its guidelines apply to its sub-contractors. It has outlined its health and safety and medical training and set up a workers committee that acts as a communication platform between staff and employee representatives. QDVC issues local Qatari identity as well as health and insurance cards to all its workers. It also uses local agencies in each country of hire, setting out the terms of the contract in the local language. Significantly, QDVC, which claims that it used to keep its workers' passports to safeguard them from theft, says with updated features in living quarters, workers now have a personal safe in their rooms to securely hold onto their passport.

However, Vinci has claimed that increasing the standards of every actor in the supply chain is challenging, as is the level of enforcement of Qatari labour laws. The company admitted that competitors not taking worker rights into account when conducting their own operations puts QDVC in a difficult position. Vinci added that poor control from governments over the workers' recruitment chain within their country of origin is a challenge for companies that want to implement an ethical process of recruitment.

Our engagement

We ask companies to explain how they balance the risk of operating in Qatar with the opportunities and how they mitigate the risks to which they are exposed. We ask them to disclose the health and safety and other policies they have in place, how they ensure their implementation, how they commit to industry standards and ensure an appropriate level of board oversight and governance.

We have had preliminary dialogue with companies alleged to have been involved in abuses of human rights and labour standards in Qatar through their sub-contractors. We emphasised that a failure to protect fundamental human rights and to ensure adequate labour standards for workers could result in significant reputational damage to them and their shareholders.

In response Vinci has stated that the labour standards policy of its joint venture QDVC, as outlined above, is in line or beyond the level required by local law. The company has also explained how it conducts due diligence, which includes the bidding process for sub-contractors, and regular inspections and audits. We learned that following an audit, Vinci terminated business relations with a supplier that was deemed non-compliant with its labour standards.

French diversified industrial company Bouygues has reassured us it is not involved in 2022-related projects. Its only exposure is through its Bouygues Construction Qatar joint venture, which has one small project remaining in the country. However, the company agreed to look at suggested best practice and to enhance its social reporting in the Middle East to provide better focus on migrant workers. We will monitor progress.

Korean Hyundai Engineering & Construction said that it has addressed the issue of human rights and labour abuses by terminating the sub-contractors responsible for them. In addition, it has provided details of

the selection and evaluation process for suppliers and subcontractors, which includes their ability to comply with international labour standards. The company also confirmed that it conducts regular audits of accommodations and facilities at all its project sites.

As 2022 approaches, the pressures on the workforce to meet the deadline are growing. Therefore, we will continue our engagement with the companies that have operations in Qatar and widen our dialogue.

Bribery and Corruption

While countries such as Nepal and India have been concerned about working conditions, the FBI and Swiss prosecutors are investigating alleged corruption at FIFA.

Hermes EOS has ongoing engagements with some of the large sponsors of FIFA, including Coca Cola, McDonald's, Visa and Hyundai Motor. While they have significant influence with FIFA, they also enjoy this huge marketing opportunity. In light of the allegations, they have to weigh that marketing opportunity against the related reputational risk.

We have been encouraging those companies in our engagement programme that interact with FIFA, in particular the sponsors, to explain the benefits of sponsorship relative to the potential reputational damage of association with FIFA should the current allegations prove founded. In the latter case, we call on them to put pressure on FIFA to reform.

More widely on bribery and corruption, we are a leader of the PRI's anti-corruption engagement work and have spoken on a number of public platforms on this topic, including the UN Global Compact's anti-corruption conference in December 2014.

In our dialogue with regulators, we are encouraging the introduction of anti-bribery legislation similar to the US Foreign Corrupt Practices and UK Bribery Act and their consistent reinforcement. We seek a zero tolerance policy of bribery and corruption with effective processes for identifying and addressing breaches, particularly in high risk countries or where companies work closely together with governments.

In our engagement with companies, we promote regular anti-bribery and corruption training, robust whistleblowing mechanisms and appropriate disclosure. Companies need to ensure that the same high ethical standards are established and adopted by employees across all their operations. We challenge and monitor the processes in place to ensure anti-corruption policies and programmes are rolled out across all sites and operations. We have closely worked together with BAE Systems and taken the learnings from the report by the UK's Woolf Committee in our engagement forward to other companies facing allegations of bribery and corruption.

For further information, please contact:



Natacha Dimitrijevic

natacha.dimitrijevic@hermes-investment.com



Tectonic plates are shifting – improvements in US corporate governance

Our efforts in pushing for improvements in US corporate governance practices are paying off.

Proxy access

One of the issues that has been dominating US corporate governance and shareholder proposals of late is proxy access. Proxy access is the right of shareholders to nominate candidates to be elected as directors on the board's AGM agenda. In a lot of developed markets such as Australia, the UK and most of continental Europe, shareholders can nominate director candidates to the board's slate but in the US this right has traditionally not been permitted. This has led to boards that are insufficiently accountable to their shareholders, ultimately risking costly, distracting and divisive proxy contests. We believe that the right of proxy access provides an important check and balance. While the right of access should be used prudently and within appropriate limits, it is a vital tool for shareholders.

US companies have not voluntarily granted this right, so led by the New York City Pension Funds, there has been a concerted campaign during the 2015 proxy season to file shareholder proposals on proxy access. Typically, these are based on the US regulator's, the Securities and Exchange Commission's (SEC), draft rule based on 3% of shareholders – individually or in a group – with three years' continuous ownership having the right to nominate director candidates up to a total of 25% of the board. The rule faced a successful legal challenge from the Business Roundtable and the US Chamber of Commerce on behalf of corporate boards.

However, shareholders now have their say with proxy access resolutions attracting strong support. As of 30 June 2015, of the 83 proxy access proposals voted on this year, 49 received the support of a majority of those shareholders voting, and the average vote in favour of all proposals was 55%⁷. This compares with only six majority votes during 2014. And in the handful of cases where boards have tabled resolutions or recommended support for proposals the votes have also been overwhelmingly positive. Clearly, proxy access is an idea whose time has come.

We hope that boards will be ready to provide proxy access based on the aborted SEC rule to settle the issue with their shareholders before the start of 2016 voting season. Some companies have already committed to doing so, a movement we encourage. However, we expect companies not to implement onerous restrictions on the right or dilute it. For example, we have seen some attempts by companies to limit the

Setting the scene

Although US sustainability organisation Ceres celebrated its 25th anniversary last year – it was set up in response to the Exxon-Valdez oil tanker spill in 1989 – uptake of good corporate governance practices and environmental and social factors in decision-making by US companies has lagged behind that of their European counterparts. In addition, investors in the US mainly use shareholder proposals to voice their dissatisfaction with company practice, a method that is rarely applied in the UK and the rest of Europe.

Almost all shareholder proposals filed are precatory in nature, meaning that the company is under no legal requirement to implement them regardless of the level of investor support received. However, even a strong minority of votes can give a proposal enough momentum to trigger serious consideration and movement from the board. Some of the most significant changes in the US corporate governance landscape we have recently seen were a result of shareholder proposals.

ability of shareholders to work together, impose limitations on which shares may be used and attempts to limit the number of directors that may be nominated.

Some companies are concerned about the disruption and the risk of narrow interest groups, including activist investors with short-term horizons, being elected. But boards should not rely on the suppression of shareholder rights to solve this problem. Active and thoughtful dialogue with long-term investors, in particular the underlying asset owners, on governance, risk management and strategy is the best way to reduce the likelihood of the nomination of shareholder candidates by short-term investors or campaigners with narrow interests. Moreover, we remind boards that such candidates require more than 50% of the votes cast to be in their favour to be elected and that only candidates with a message appealing to the majority of shareholders will be elected.

We accept that effective boards require the fine balancing of different skills and personalities and that outside candidates may upset this equilibrium. However, many boards need to work harder at their own performance, renewal and communication with shareholders. The right of proxy access can therefore act as a vital catalyst for the improvement of board performance, responsiveness and accountability – such improved boards will not need to fear the onset of greater democracy.

Shareholder proposals

We encourage companies to demonstrate enlightened self-interest not only to proxy access proposals but also to those filed on other governance, as well as environmental and social, matters.

If a shareholder has taken the time and expense to file a proposal, it probably means that the company should improve either its performance or disclosure on the issue at the centre of the proposal or conceivably both.

Our experience has shown that constructive engagement between shareholders and directors on strategy, finance, corporate governance and risk management, including the opportunities and risks stemming from environmental and social issues, can lead to improvements in companies' performance and value and help to prevent value destruction.

Where boards interact with shareholders in an active and engaged way, we see less need to file or support shareholder resolutions. Where we have filed proposals, they are often withdrawn in the event of progressive dialogue with the company that in our experience tends to continue after the proposal has been settled.

From transactional to meaningful relationships

This year we have received several invitations from US large cap companies for us to meet their independent chair or lead director. It is yet another sign that the biggest US companies increasingly want to engage with asset owners or their representatives.

We are seeking a change in the US governance landscape for it to be relationship- rather than transaction-driven. Modern business depends on successful relationships. One of the most important of these relationships is between shareholders and the company board. While this includes AGM voting, management presentations and discussions, it should also include active dialogue between representatives of the board and long-term shareholders.

Positively, in our recent experience, engagement with US directors has been on the rise and improving in quality. An increasing number of companies have begun to realise the benefits of direct, good quality dialogue between long-term shareholders and their independent directors and have therefore started to address some of our engagement objectives.

Significantly, the trend to better engagement is based on evolving best practice, not on mandatory rules. While initiatives like the Shareholder Director Exchange, in which we participate, have reflected the rapidly changing landscape, it has mainly been company directors' own enlightened self-interest that has driven changes in their approach to engaging positively with their long-term shareholders.

However, a large number of US companies still chooses to make interactions with their long-term shareholders transactional, defensive and of limited value for themselves and investors. We continue to encourage these companies to embrace the benefits of more meaningful dialogue.

Lead independent director

At companies where the roles of chair and CEO are combined, we expect to see a lead independent director in place with powers equivalent to those of an independent chair. The lead independent director should be able to challenge the combined chair/CEO and play a significant role in establishing the board agenda and evaluation, as well as in the succession planning of the board and the CEO. Ultimately, he or she should be accountable for the board, its committees and all of the directors, including the CEO.

Bank of America's decision to recombine its chair and CEO roles in 2014 was hugely controversial. However, for the first time in any proxy statement, the specification of the role of its lead independent director has been explicitly equated to that of an independent chair. While we continue to remain concerned about the combination of the role of chair/CEO, we push for companies to make the same explicit commitment as Bank of America on the role of lead independent director. This should include powers to recruit and terminate the CEO and other directors.

In addition to strong formal powers, fulfilling the role of a lead independent director requires great soft skills, including emotional intelligence. It is essential that the lead independent director has the character to act decisively, when necessary, while for the most part being a mentor and sounding board. We expect companies to provide opportunities for lead and other independent directors to meet their long-term shareholders and have an open and honest dialogue to enable us to assess their qualities.

Boards that cling to old style practices of resisting legitimate shareholder democracy and dialogue will be increasingly at odds with not only a large group of investors but a growing number of their peers. The tectonic plates of US corporate governance are shifting and the new landscape is set to provide far greater scope for fruitful collaboration and co-operation between boards and long-term investors based on mutual respect and understanding.

For further information, please contact:



Tim Goodman

tim.goodman@hermes-investment.com

⁷ According to the US Council of Institutional Investors as at the end of June 2015, 49 of 83 proxy access proposals voted on in 2015 have received majority support, compared with just six in 2014. Average support for all proxy access proposals stands at 55% of the votes cast. http://www.cii.org/article_content.asp?edition=4§ion=13&article=594 (member only content)



The culture challenge – banks' attempts at reforming conduct

We have been engaging intensively with banks on a variety of issues including cultural change.

Setting the scene

The banking sector has had a poor reputation since the global financial crisis of 2007. Banks such as HBOS, Lloyds and Royal Bank of Scotland in the UK and AIG, Bank of America, Citigroup, Goldman Sachs, JP Morgan and Morgan Stanley in the US had to be partially or significantly bailed out by governments and the resulting austerity programmes following high state borrowing led to the erosion of trust in banks. Further scandals – such as rogue traders and involvement in the manipulation of interbank rates – added to the suspicion surrounding banks.

As governments have tightened regulation to avoid a repeat of the crisis, the spotlight has also been cast on the changing behaviour and conduct of bankers. Heavy fines have been handed out to banks found guilty of serious misconduct, most significantly in the US. Conduct costs – such as fines, settlements and provisions – of the 16 world's largest banks amounted to £206 billion (€288 billion) between 2010 and 2014, according to the CCP Research Foundation (see table), and in 2015 the UK's regulator, the Financial Conduct Authority, handed out its largest fine to date – £284 million – to UK bank Barclays after concluding its investigation into suspected misconduct on foreign exchange markets.

Banking Industry Litigation Costs table

	Total Conduct Costs 2010-2014 (GBP billion)	Provisions as at December 2014 (GBP billion)	Total Conduct Costs (incl. Provisions) 2010-2014 (GBP billion)
Bank of America	55.8	8.3	64.1
JP Morgan Chase	28.7	4.3	32.9
Lloyds Banking Group	12.2	3.4	15.6
Citigroup	12.2	2.6	14.8
Barclays	7.6	4.6	12.2
RBS	6.8	4.1	10.9
Deutsche Bank	6.0	3.4	9.4
HSBC	6.4	2.5	8.9
BNP Paribas	6.0	1.7	7.8
Santander	3.9	3.1	6.9
GS	4.1	2.1	6.1
Credit Suisse	4.0	1.8	5.9
UBS	3.4	2.0	5.4
National Australia Bank	1.8	1.0	2.8
Standard Chartered	1.0	0.1	1.0
Société Générale	0.1	0.9	0.9
	159.9	45.6	205.6

Source: CCP Research Foundation

A governance issue

Culture at banks generally refers to their corporate conduct and the behaviour of their employees. Improvement should start with a strong tone from the top, establishing a culture where good behaviour is rewarded and where lapses in ethical integrity are not tolerated. The leadership of banks needs to be ready to introduce a cultural change programme on top of a conduct risk management framework.

But even the UK's regulator, the Financial Conduct Authority, admits that little information or insight has been provided about what 'good' culture looks like. The final enforcement notices of regulators – who say that culture has been the cause of many regulatory breaches – have predominantly described bad culture.

In our engagements, we seek to establish whether senior management and the board have identified potential conduct risks and controls are in place to manage and mitigate these risks. We also seek to ensure that they focus on achieving and maintaining a culture of ethical and responsible behaviour, as well as a customer-centric mentality. Conduct risk management needs to be integrated within all divisions and should form part of formal performance assessments throughout the bank. A board conduct committee should be established and improvements in corporate culture need to be supported by appropriate remuneration and governance structures.

Although bad behaviour gained particular notoriety in the investment banks, cultural change also needs to extend to retail banks, particularly to the development and marketing of their products, such as teaser rate products – those that lure customer in with low introductory rates only to increase them rapidly soon after – and payment protection insurance (PPI). While these products have in the past led to short-term gains for companies, their sale has been restricted as the focus has shifted to more long-term relationships and sustainable, transparent products.

Progress

It can take several years to change culture, especially in investment banks but we have seen progress.

Our meetings with the chairs of banks have confirmed that cultural change is high on their agenda and that they are attempting to change behaviours across their organisations. The approach they have taken is to emphasise on how employees achieve their targets, as opposed to solely what they achieve, meaning that unlike in the past, employees are rewarded and promoted based on their values-based behaviour.

Naturally some banks have been more proactive than others in addressing conduct risk. The best have introduced extensive internal programmes and board committees solely to address inappropriate behaviours and raise standards of conduct.

Having had to address conduct issues from 2012, global bank HSBC was forced to make changes and fulfil its commitments under the deferred prosecution agreement with US authorities. The bank's new CEO has embarked on a cultural change programme to reduce the command and controls aspects of the culture towards one based on behaviour, while at the same time retaining its strong emphasis on effective risk management. The bank's board also focuses on ensuring global policies and standards are applied rather than enabling business units to dictate their own approach. HSBC has significantly simplified its business, rationalised its products and made changes to its sales incentives as well as its whistleblowing procedures and compliance standards. In addition, HSBC created a conduct and values committee in 2014 to provide board oversight of its efforts to raise standards of conduct. Our meetings with HSBC suggest that the bank is focused on embedding the right risk culture throughout the organisation.

Remuneration

Remuneration plays a big part in cultural change programmes with banks and can be a good indicator of progress. Overall, the framework for ensuring that remuneration is aligned with risk has improved significantly in recent years. The Financial Stability Board concluded in November 2014 that implementation of its international principles and standards for sound compensation practices had been essentially completed. The UK's rules are set to be among the most demanding globally, reflecting among other things the recommendations of the Parliamentary Commission on Banking Standards. Its authorities have consulted on proposals for deferred bonuses of senior bank managers to last for periods of up to seven years – instead of the current three to five years – during which time they may be reduced or cancelled in the event of employee misbehaviour, so-called 'malus'. Variable remuneration that has already been paid may also be clawed back in certain circumstances. We believe that a combination of increased deferral alongside increased shareholding requirements for the long term is the most appropriate way to improve the accountability of senior managers.

Remuneration has been at the front and centre of, for example, Lloyd's strategy and a key factor to reconcile with the UK public. Financial awards should be based on behaviours instead of short-term drivers and excessive risk-taking. The introduction of more sustainable incentive schemes and metrics by awarding bonuses in company shares rather than cash, as well as rewarding sales bonuses on customer feedback instead of the volume sold, is a good way of helping create the right corporate structure and favour the long-term performance and soundness of a company.

At HSBC, executive directors are required to hold their share awards with the company until leaving the company, incentivising them to act in the best long-term interest of the bank. Its new remuneration structure includes behavioural elements, appraising and rewarding individuals on how and whether they achieve certain objectives.

Lloyds has been another good example of progress and we have completed all our engagements with the bank on remuneration, leadership structure and the embedding of sustainability in its strategy. Its strong leadership structure and long-term incentive plan with a mix of financial and strategic performance measures suggest

that the fundamentals for better corporate behaviour are in place, while sustainability is now at the front and centre of the company's business strategy.

In our engagements, we push for risk-adjusted remuneration and incentive schemes and seek to ensure that the link between pay, performance and risk management is properly disclosed. Furthermore, we raise and promote our remuneration principles as part of corporate engagement.

Risk management

Appropriate risk management also contributes to better corporate culture. This can be supported by appointing more independent board members and ensuring board members have the right qualifications, experience and skills. We encourage the adoption of best practices in risk reporting and that the risk management practices are in place, regularly reviewed and communicated through the company. We ask banks to improve their risk reporting and oversight based on the recommendations of the Financial Stability Board's Enhanced Disclosure Taskforce.

However, despite increasingly severe penalties imposed by regulators for misconduct and a general acknowledgement that culture has to change and sustainability improve, for some banks a change in culture is still a long way off.

Regulators

Governments have come under pressure from the public to increase regulation of the financial sector, including the separation of banks' retail and investment parts via ring-fencing rules, and we have been engaging with the regulators in key markets.

But measuring the success of programmes introduced to improve corporate behaviours is difficult. A reduction in the number or an absence of conduct issues and penalties as well as a decline in whistleblowing incidents can indicate that behaviour is improving although scandals can take years to surface.

Outlook

There has already been widespread reform to regulation, market and individual bank structures, systems and controls and some standards of market practice have been clarified or strengthened.

However, companies need to provide better disclosure on their cultural change efforts and some need to try harder.

Strong leadership at the top of companies, instilling a culture where ethical behaviour is rewarded and non-ethical manners are not tolerated, will pave the way for good conduct at a systemic level.

For further information, please contact:



Roland Bosch

roland.bosch@hermes-investment.com



Engagement on strategy

Many of our most successful engagements undertaken include discussions on business strategy and structural governance issues.

Overview

We adopt a holistic approach to engagement, combining discussions on business strategy and risk management, including social, environmental and ethical risks, with structural governance issues. Our engagements seek to challenge and support corporate management in their approach to the long-term future of the businesses they run, often when there is minimal outside pressure for change. We are generally most successful when we engage from a business perspective and present environmental, social and governance issues as risks to the company's strategic positioning. Companies may benefit from new perspectives on the board and from promoting fresh thinking at the head of the company. An independent chair or change of CEO is frequently the key to improving performance and creating long-term value for shareholders.

Examples of recent engagements

Arctic visit

Lead engager: Tim Goodman

Despite a thorough dialogue with an oil major on the topic, we continue to engage with it on the risk posed by its activity in the Arctic. At its socially responsible investor day, the company explained that it had learned the lessons from its abortive Arctic drilling attempts in 2012 and subsequent moratorium. The company pointed out that it will only drill during the summer months and cease operations 40 days before ice is anticipated to allow sufficient time to respond to any spills.

We subsequently met the head of the company's Alaska operations and members of her management team. We met them on site at Anchorage and at the Inupiat settlement of Barrow in the Arctic Circle, the nearest inhabited point to the company's prospective drilling activity. The company has made a strategic decision to focus even more on this area of the Arctic. As a result of this decision, the need to obtain more stringent regulatory approval and the lessons learned from 2012, the company has strengthened its on-the-ground management team. We were impressed by its quality, commitment and the way in which the team worked together. The logistics of the exploration efforts have been improved and the company has people in charge of community relations, drilling and operations that have been appointed from the company's global pool as well as externally. We discussed the specific risks of drilling in the region with the head of health, safety and environment for Alaska, in particular how trivial incidents can escalate into serious ones because of the harsh climate and remoteness of the location and felt the company has learned from its previous mistakes. We also visited the offices of Superior Energy Services, a contractor responsible for the Arctic Containment System venture. The Arctic Containment System venture is the third layer of response to a potential spill after the blowout preventer and the capping stack, which was eventually used to stop BP's 2010 Gulf of Mexico oil spill. We were able to watch the simulators used for training and rehearsal as well as interact closely with the staff.

We then travelled to Barrow, the largest native community on the coast of the Chukchi Sea in the Arctic Circle. We met some of the elders of the community who negotiated the historic land settlement between the indigenous Alaskan peoples and the US government. Alaska's indigenous peoples have managed to negotiate a far better settlement with the US government than other native Americans and as a result have significant economic clout. We also met the next generation of the political leadership of the region and some of the directors of the

Arctic Slope Regional Corporation, the company created out of the land settlement that is owned by the entire community. The extractive company and Arctic Inupiat Offshore, one of its subsidiaries, have an agreement in principle to create a joint venture which will provide an income stream to the community in exchange for the development of an onshore pipeline from Barrow to deliver oil to the Trans-Alaska pipeline.

While the community has a spectrum of views on the prospect of significant oil and gas development offshore, the community's tribal, political and economic leadership is in favour of the exploration work as it is the only means by which the community's living standards can be maintained. The community leadership is also considering establishing an NGO to support the development as it is concerned that the majority view is not heard. The community is reliant on food from the sea and is very worried about the prospect of an oil spill but believes that the extractives company can manage its development safely and responsibly. However, we will follow up with a global indigenous peoples' organisation to seek dialogue with members of the community that have different views to hear their concerns and raise them directly with the company.

Board refreshment

Lead engager: Hans-Christoph Hirt

Following the limited advancement on the key objectives of our engagement and a settlement over the rigging of interbank rates, we spoke at the AGM of a European bank. We publicly raised our concerns about the bank's lack of progress on cultural change and its handling of pending litigations and investigations. We believe the bank's overall unsatisfactory delivery on targets set under its current strategy has contributed to the poor share price development and total shareholder return since its two co-CEOs took over three years ago. Moreover, valuable time and credibility was lost by the management board's late recognition that changes to the bank's structure and business model are required to create value sustainably in a changed regulatory environment. In April 2015, the bank announced the next phase in its strategy but had at that stage not yet provided enough details to allow shareholders a robust assessment of the new plan.

At the AGM, we once again queried the suitability of the co-CEOs to lead the cultural change given their long tenure in key leadership positions. We also shared our strong concerns about the findings of US and UK regulators which were published when the bank settled investigations into its involvement in the manipulation of interbank rates. The statements of the key regulators involved indicate that

the levels of the fines reflect the severity of the misconduct of the bank's employees but also its slow response to the investigations and inadequate cooperation. The quality of the responses to the questions we asked was mixed but positively, the chair seemed critical about the performance of the management board to date. Given our concerns, we voted against the so-called discharge of the management board, thus expressing our lack of confidence in its members. We also urged the bank's supervisory board to review the composition of the management board, taking into account its new strategy and performance over the last three years. Almost 40% of the shareholders present at the AGM voted against the discharge of the members of the management board, thus delivering a strong message to the supervisory board that further refreshment of the management board was required. Just weeks after the AGM, the company announced that the two co-CEOs were stepping down. We welcomed the news, as it facilitates the necessary refreshment of the management board, as well as the appointment of a new CEO.

New AGM intervention

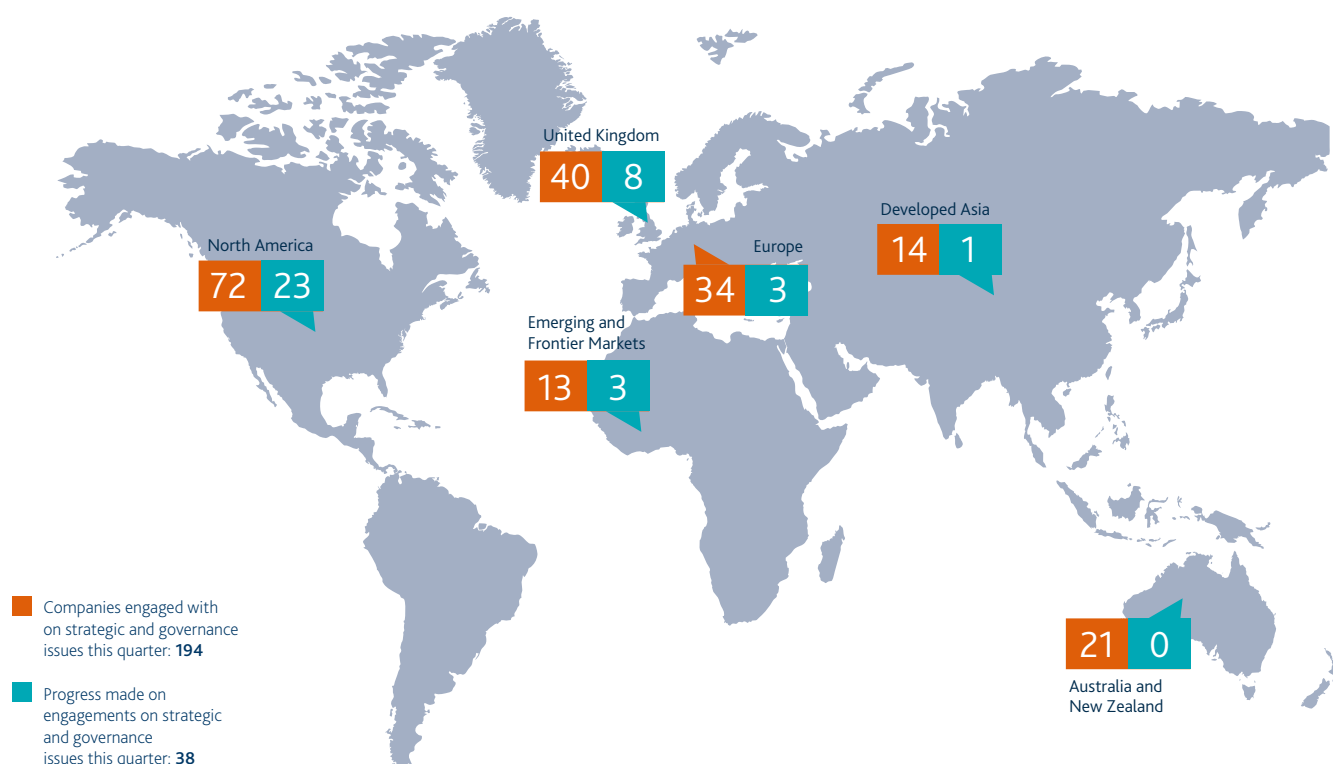
Lead engager: Hans-Christoph Hirt

We continued our intensive engagement with an Asian electronics manufacturer through our intervention at its AGM. We welcomed the enhanced transparency on the company's strategy and long-term objectives, including the launch of a dedicated website, and generally improved communications. We also recognised the company's commitment to address human capital management and environmental issues more effectively in its forthcoming sustainability

report. We have engaged and made specific suggestions on all of these issues, which is why we are pleased with the impact our engagement has had. Given the company's capital position, we also welcomed the significantly increased dividend payment. However, we continue to push for more transparency and explanation about the company's diversification strategy and increasing competitive pressures in its core business. Therefore, we raised a number of questions on these topics which the chair/CEO spent a long time answering. He was able to describe the company's efforts more effectively than in the past, including on the key issue of working conditions. We accepted written responses to our queries on board composition and succession planning. We also used the AGM to invite the chair's adviser, with whom we have had constructive dialogue since the beginning of the year, to our Client Advisory Council. We were pleased that the chair agreed to this request and that our clients will have a unique opportunity to interact directly with this important company.

Meeting the chair/CEO's adviser and the head of investor relations the day after the AGM, we were pleased to be reassured that its 2014 sustainability report will address some of our key concerns and suggestions. Earlier in the quarter, we obtained some valuable insights into the company's efforts towards automation of its factories at an on-site meeting with the general manager for automation technology, who reports directly to the chair/CEO. Automation principally addresses the industry's need to become ever more effective and is one of the company's responses to the challenges of human capital management in a sector dominated by long hours of monotonous work.

Engagements on strategy and governance issues





Public policy and best practice

Protecting and enhancing value by promoting better regulation

Hermes EOS contributes to the development of policy and best practice on corporate governance, sustainability and shareholder rights to protect and enhance the value of its clients' shareholdings over the longer term.

Highlights

Call for methane emissions regulation

Lead engager: Tim Goodman

Together with investors representing \$1.5 trillion of assets, we signed an investor statement prepared by sustainability organisation Ceres in support of strong action by the US Environmental Protection Agency (EPA) to regulate methane emissions from the oil and gas sector. The statement was sent to the White House and the EPA. Reducing methane emissions is one of the most immediately effective measures to reduce greenhouse gases because, while its global warming effects do not last as long as those of carbon dioxide, methane has a much greater impact in the short term.

Changes to the German Corporate Governance Code

Lead engager: Hans-Christoph Hirt

We provided a detailed response to the consultation of the German Corporate Governance Commission, pushing for a recommendation that sets a limit on the supervisory board mandates an individual can hold before having to provide an explanation. Furthermore, we suggested that the Commission reviews the legal framework for dialogue between investors and supervisory boards, introduces a recommendation on reporting after a board evaluation and reflects upon how the consideration of strategy could be optimised in the German two-tier governance system.

While we had pushed for these more far-reaching changes, we welcomed the subsequently announced amendments to the German Corporate Governance Code. These included, for example, encouraging board candidates to consider the likely time commitment associated with board and committee work and a self-defined target maximum tenure.

Overview

We actively participate in debates on public policy matters to protect and enhance value for our clients by improving shareholder rights and boosting protection for minority shareholders. This work extends across company law, which in many markets sets a basic foundation for shareholder rights, securities laws, which frame the operation of the markets and ensure that value creation is reflected in value for shareholders and developing codes of best practice for governance, management of key risks and disclosure. In addition to this work on a country-specific basis, we address regulations with a global remit. Investment institutions are typically absent from public policy debates even though they can have a profound impact on shareholder value. Hermes EOS seeks to fill this gap. By playing a full role in shaping these standards we can ensure that they work in the interests of shareholders rather than being moulded to the narrow interests of other market participants – particularly companies, lawyers and accounting firms, which tend to be more active than investors in these debates – whose interests may be markedly different.

Inaugural forum of Stewardship Asia

Lead engager: Hans-Christoph Hirt

We were the only representative of foreign institutional investors to address the inaugural forum of Stewardship Asia, a Singaporean think-tank set up by Temasek, one of the local sovereign wealth funds. Stewardship Asia, which effectively is a re-launch of an earlier initiative, will look at corporate engagements as a way to strengthen companies and economies. This involves considering the role of boards and management, as well as key stakeholders, such as investors and employees.

Stewardship in Taiwan

Lead engager: Hans-Christoph Hirt

We gave the key note speech at an event on stewardship codes for institutional investors hosted by the Taiwan Stock Exchange. Having promoted stewardship over the last few years in Taiwan through numerous meetings with regulators and high-profile speeches, we are pleased that this topic now seems part of the corporate governance reform agenda led by the country's stock exchange. In our key note, we presented stewardship codes as the missing link in making corporate governance work and explained the reasons for the surge in interest in stewardship codes by institutional investors in Asia and Europe. We reflected upon adjustments to the role of institutional investors in Taiwan, where family ownership is widespread among listed companies and important cultural differences exist compared to western markets.

We also highlighted potential conflicts of interests between asset owners and fund managers, a topic that seemed new to many of the event's participants. We gave practical examples of the implementation and the impact of stewardship activities of institutional investors. Our ability to draw on in-depth engagement experience in Europe and several key Asian markets was particularly helpful. In the roundtable discussion that followed our speech, it was encouraging to see the apparent enthusiasm of local institutional investors for stewardship and the willingness of the stock exchange to take the initiative on developing related local guidance. We offered our help and support on this important project.

Other work in this quarter included

Promoting best practice

- The **Carbon Disclosure Project's (CDP) water team** presented to the Water Stress Collaborative Engagement Initiative by the Principles for Responsible Investment on the latest insights from its 2014 water report and the future agenda for water reporting. The CDP believes that investors have woken up to water risk. However, companies are lagging this awareness, with only 58% of the Global 500 companies in the CDP survey responding.
- In a meeting with us, Greenpeace explained its view of the nature of the risks involved in **Arctic drilling**, including the heightened risk of a major incident due to the hostile conditions and lack of industry experience, as well as the difficulty of mitigating the impact of a spill.
- At a meeting of the **Carbon Asset Risk group** by the Institutional Investors Group on Climate Change, we shared experiences of how best to achieve a positive response from companies on climate change risk mitigation. The focus was on portfolio asset resilience and the need for companies to ensure that assumptions about the oil price up to 2035 are communicated as part of the stress-testing of various climate change scenarios.
- We participated in the launch of the second **Mercer report on integrating climate change into asset allocation and investment strategies**. The 'Investing in a Time of Climate Change' report applies different scenarios for tackling climate change over the period to 2050 to a range of investment portfolios and asset classes. Among the key findings are that, regardless of the climate scenario, climate change will have an impact on investment returns and that industry sector investments are most sensitive. While a 4°C scenario has a negative return on investment, a 2°C scenario does not have a negative return for a long-term diversified portfolio over the period to 2050. The findings of the report have important implications for the appropriate response to asset management and portfolio construction by asset owners.
- We participated in the annual conference of the **German Corporate Governance Code Commission**, which focused on the interplay between legislation and self-regulation. The topic was highly relevant given the criticism the Commission has faced for not addressing critical issues decisively enough, which resulted in legal rules on moves from the management to the supervisory board and a 30% gender quota.
- At a lunch hosted by professional services firm PwC for investors, we argued that company **quarterly reporting** should be discouraged as it can lead to short-term investor and company behaviour. From a company point of view, the necessity of having to produce a quarterly report may foster a short-term mindset, be a distraction for management and encourage actions which benefit short- over long-term performance. We added that quarterly reporting drives short-term trading rather than long-term investing.
- We discussed how Hermes EOS can support the **Aiming for A coalition** of investors to advance the climate change theme on the boards of companies at risk from global warming in the UK and continental Europe.
- We were pleased to accept an invitation by the Minority Shareholder Watchdog Group, a government-sponsored organisation overseeing Malaysia's stewardship code, to join the country's **Institutional Investor Council**. Following the launch of the country's stewardship code in 2014, in which we participated, the body will promote corporate governance and stewardship in this market.

Public policy

- We met the Spanish regulator CNMV to discuss the changes it made to the **Spanish Corporate Governance Code**. We were pleased to see a number of positive additions to the Code – such as extending the duties of directors to include tax-related responsibilities, restrictions on board size, introduction of a minimum independence level of 50% for the board and reducing the maximum terms for directors from six to four years – against which companies will have to report from 2016.
- We stated our views on the **hedging and pledging of shares by directors and employees** of quoted companies to the US Securities and Exchange Commission. We responded to its consultation on the disclosure of the hedging of shares – the act of insulating against a lack of financial rewards at times of underperformance. We argued that there should be a ban of this practice by all directors and senior employees to ensure that their ownership of shares is aligned to the experience of long-term investors. We also pushed for greater disclosure of the practice. We widened our response to include the pledging of shares, the act of using shares as a security for other financial transactions. We argued for disclosure of all pledging by directors and senior management, while accepting that on occasion temporary pledging of limited numbers of shares may be permissible.
- In a meeting with senior executives at the Securities and Futures Commission (SFC) in Hong Kong, we obtained a better understanding of the background to the consultation on **Principles of Responsible Ownership**, the local version of a stewardship code. The SFC's initiative seems to have been triggered by the development of stewardship codes in Japan, Malaysia and most recently Singapore. We discussed applying the guidance to retail investors and possible problems that may arise from the code concerning access to management and board members and the fundamental principle of equal treatment of shareholders. We subsequently replied to the SFC consultation, generally in support of the principles.
- We were reassured that **Canada will stick by its pledge to reduce national greenhouse gas emissions by 30% by 2030** compared with 2005 levels. The Canadian assistant minister for climate change underlined that Canada's Prime Minister is a pragmatist, not a climate sceptic. The key difference between today's and Canada's 1997 Kyoto commitment, on which it subsequently reneged in 2011, is that the carbon-intensive industries have been included in the process this time and are committed to delivering.
- In a private meeting with its executive secretary at the Business and Climate Summit, we were encouraged by the confidence of the UN Framework Convention on Climate Change (UNFCCC) that an **international deal on climate change** will be achieved at the end of this year. We identified a number of focus areas for engagement to best support a strong global deal. Investor engagement on public policy is seen as influential and should focus on achieving a long-term goal for decarbonisation. The UNFCCC welcomed the investor letter to G7 finance ministers calling for this long-term goal, which we helped to draft.
- We jointly signed a letter to the EU vice president and commissioner, encouraging the **Capital Markets Union Action Plan** expand its existing fourth principle to include full disclosure of the exposure to material environmental, social and governance risk. We also called on them to set up a high-level commission to investigate and report on the materiality of climate risk to capital market stability.

Hermes EOS makes voting recommendations at general meetings wherever practicable. We take a graduated approach and base our recommendations on annual report disclosures, discussions with the company and independent analysis. At larger companies and those where clients have a significant interest, we seek to have dialogue before recommending a vote against or abstention on any resolution.

In most cases of a vote against at a company in which our clients have a significant holding or interest, we follow up with a letter explaining our clients' concerns. We maintain records of voting and contact with companies and, if we believe further intervention is merited, we include the company in our main engagement programme.



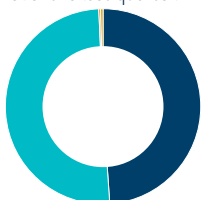
Hermes EOS makes voting recommendations at company meetings all over the world, wherever its clients own shares.

Overview

Over the last quarter we made voting recommendations at 6,086 meetings (70,344 resolutions). At 3,065 of those meetings we recommended opposing one or more resolutions. We recommended voting with management by exception at 27 meetings and abstaining at 19 meetings. We supported management on all resolutions at the remaining 2,975 meetings.

Global

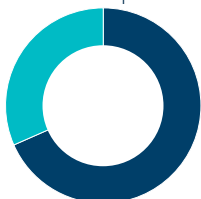
We voted at **6,086** meetings (**70,344** resolutions) over the last quarter.



- Total meetings voted in favour **48.9%**
- Meetings where voted against (or voted against AND abstained) **50.4%**
- Meetings where abstained **0.3%**
- Meetings where voted with management by exception **0.4%**

Australia and New Zealand

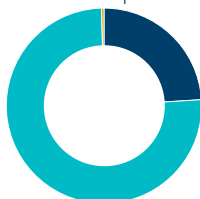
We voted at **57** meetings (**268** resolutions) over the last quarter.



- Total meetings voted in favour **68.4%**
- Meetings where voted against (or voted against AND abstained) **31.6%**

Developed Asia

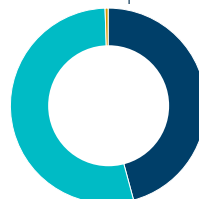
We voted at **1,059** meetings (**12,527** resolutions) over the last quarter.



- Total meetings voted in favour **24.0%**
- Meetings where voted against (or voted against AND abstained) **75.6%**
- Meetings where voted with management by exception **0.4%**

Emerging and Frontier Markets

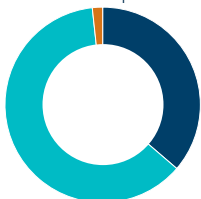
We voted at **1,095** meetings (**12,226** resolutions) over the last quarter.



- Total meetings voted in favour **45.8%**
- Meetings where voted against (or voted against AND abstained) **53.7%**
- Meetings where voted with management by exception **0.5%**

Europe

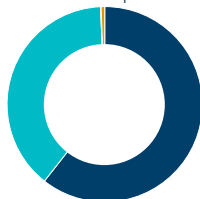
We voted at **1,030** meetings (**14,884** resolutions) over the last quarter.



- Total meetings voted in favour **36.3%**
- Meetings where voted against (or voted against AND abstained) **62.0%**
- Meetings where abstained **1.7%**

North America

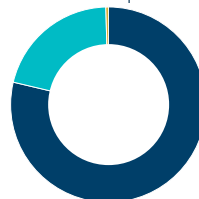
We voted at **2,390** meetings (**23,844** resolutions) over the last quarter.



- Total meetings voted in favour **60.6%**
- Meetings where voted against (or voted against AND abstained) **38.7%**
- Meetings where abstained **0.1%**
- Meetings where voted with management by exception **0.6%**

United Kingdom

We voted at **455** meetings (**6,595** resolutions) over the last quarter.



- Total meetings voted in favour **78.7%**
- Meetings where voted against (or voted against AND abstained) **20.9%**
- Meetings where voted with management by exception **0.4%**

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