

Public engagement report

Q4
2012

Q4

This report contains a summary of the responsible ownership activities undertaken by EOS on behalf of its clients. It covers significant themes that have informed some of our intensive engagements with companies in Q4 2012. The report also provides information on our voting decisions and the steps we have taken to promote global best practice, improvements in public policy and collaborative work with other shareholders.

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What is EOS?

Hermes Equity Ownership Services (EOS) helps institutional shareowners around the world to meet their fiduciary responsibilities and become active owners of public companies. EOS' team of engagement and voting specialists monitors its clients' investments in companies and intervenes where necessary with the aim of improving performance. EOS' 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 resources with other like-minded funds to create a stronger and more representative shareholder voice, our joint company engagements can be more effective. We currently act on behalf of 32 investors, with roughly US\$120bn¹ in assets under stewardship.

Hermes has the largest stewardship resource of any fund manager in the world. Our 32-person team includes former CEOs and other board members of public companies, as well as senior strategists, corporate governance experts, investment bankers, fund managers, lawyers and accountants.

The depth and breadth of this resource reflects our philosophy that ownership 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 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.

Hermes has extensive experience of implementing the United Nations' Principles for Responsible Investment (UN PRI). EOS' Chief Executive Colin Melvin chaired the committee that drew up the original principles and we are actively engaged in a variety of work-streams, through the clearinghouse and in the revision of the PRI reporting framework. This insight enables EOS to help signatories to meet the challenges of effective PRI implementation.

¹ as at 30 September 2012

How does EOS work?

EOS uses a proprietary screening process to determine which companies will benefit from intensive engagement. The first element of this screen looks at the companies' ability to create shareholder value by comparing the weighted average cost of capital with cash returns to investors. We then apply further screens across a range of other metrics including environmental and social issues. Finally, we assess the prospects for engagement success.

The Hermes Responsible Ownership Principles set out our basic 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 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 involvement with companies over time depending on the nature of the challenges they face and the attitude of the board towards our intervention. 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 there are many companies included within our engagement programmes, meaning that significant additional resources are dedicated to these situations. All of our engagements are undertaken subject to a rigorous initial assessment and ongoing review process, ensuring we are focusing 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 to clients, not to seek headlines through campaigns. These can often undermine the trust which would otherwise exist between a company and its owners. We aim to be honest and open with companies about the nature of our discussions and will seek to keep such discussions private. Not only has this proved the most effective way to bring about change, it also acts as a protection to our clients, so that their position will not be misrepresented in the press.

For these reasons, this public report does not contain specific details of our interactions with companies but aims to bring clarity on some of the most important issues relevant to responsible owners today and EOS' related activities in these areas.

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

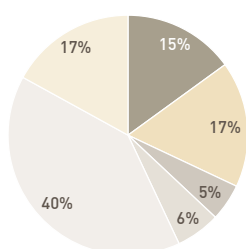
For further information please contact Colin Melvin on +44(0)207 680 2251.

Engagement by region

Over the last quarter we engaged with 201 companies on a range of 397 social, environmental and governance issues. EOS' holistic approach to engagement means that we will 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.

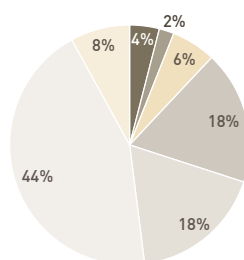
North America

We engaged with 39 companies on a range of 78 issues over the last quarter.



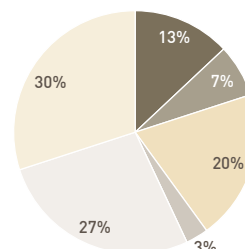
Asia

We engaged with 25 companies on a range of 50 issues over the last quarter.



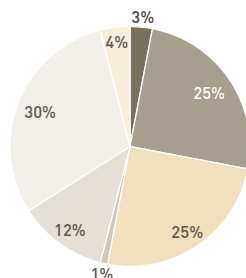
Australia & New Zealand

We engaged with 16 companies on a range of 30 issues over the last quarter.



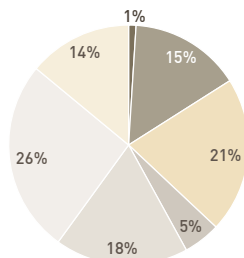
Emerging & Frontier Markets

We engaged with 36 companies on a range of 73 issues over the last quarter.



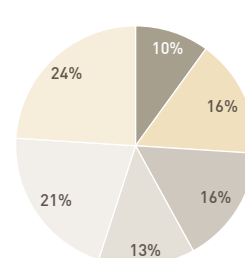
Europe

We engaged with 50 companies on a range of 94 issues over the last quarter.



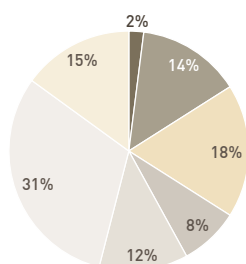
UK

We engaged with 35 companies on a range of 72 issues over the last quarter.



Global

We engaged with 201 companies on a range of 397 issues over the last quarter.

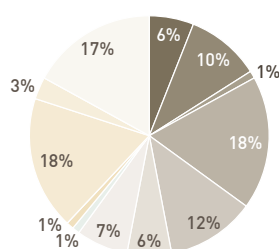


Engagement by issue

A summary of the 397 issues on which we engaged with companies over the last quarter is shown below.

Social and ethical

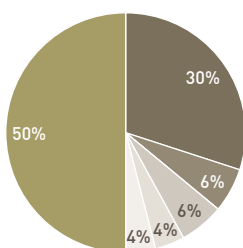
Social and ethical issues represented 18% of our global engagement issues over the last quarter.



Employee relations
Community relations
Customer relations
Health and safety
Supply chain (inc child/other labour issues)
Operations in troubled regions
Corporate culture
Munitions manufacture
Access to medicines/clinical trials
Bribery and corruption
Licence to operate
Other social & ethical

Environmental

Environmental issues represented 14% of our global engagement issues over the last quarter.



Climate change/carbon intensity
Water stress
Oil sands
Forestry
Biodiversity
Other environmental

Other engagement

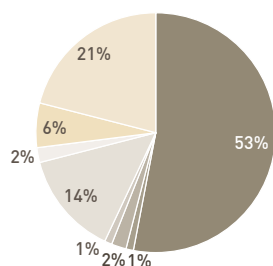
Remuneration featured in 15% of our engagements over the last quarter.

Risk management featured in 8% of our engagements over the last quarter.

Shareholder communications featured in 2% of our engagements over the last quarter.

Governance

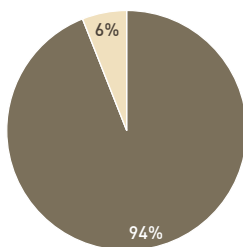
Governance issues represented 31% of our global engagement issues over the last quarter.



Board structure
Committee structure
Related party transactions
Conflicts of interest
Succession planning
Poison pill
Separation chair/CEO
Other governance

Business strategy

Business strategy issues represented 12% of our global engagement issues over the last quarter.



Business strategy
Capital structure

Business strategy and board structure

Strategic engagements

Many of EOS' most successful engagements combine discussions of business strategy and structural governance issues.

Statistics

Number of companies engaged with on strategic matters this quarter:	49
North America	5
Asia	9
Australia and New Zealand	0
Emerging and Frontier Markets	9
Europe	17
UK	9
Number of significant steps forward in strategic/governance engagements this quarter:	18
North America	8
Asia	2
Australia and New Zealand	0
Emerging and Frontier Markets	2
Europe	4
UK	2

Overview

EOS' holistic approach to engagement combines discussions on business strategy and risk management, including social and environmental risks, with structural governance issues. Our engagements fill the gap left by the investment industry's tendency to focus on the short term. The result of this tendency is that corporate management too often goes unchallenged in its approach to the long-term future of a business and there is minimal pressure for change. EOS assesses and engages with underperforming companies from a long-term perspective, asking questions which encourage management and boards to think afresh, to overturn long-running periods of underperformance. This approach is frequently successful in adding value or ending the destruction of value.

Business strategy is also a key feature of other engagements, examples of which are highlighted elsewhere in this report. We are generally most successful in achieving change on environmental, social and other matters where we lead the conversation from a business perspective and focus on these issues as risks to the company's strategic positioning. Companies can become locked into historic patterns when their boards are overdue for refreshment and need new perspectives. Injecting new thinking at the head of the company – an independent chair or change of CEO – is frequently the key to unlocking change and driving renewed operational performance, which can create long-term value for shareholders.

Engagements on governance and business strategy may require a series of meetings over months and years. It takes time for board changes to generate the business and strategic changes which improve long-term performance.

Examples of recent engagements

We met with the CEO and CFO of a **North American oil and natural gas** explorer, developer and producer, in order to discuss strategy and governance. The company claims leading capital efficiency and achieves a high return on investment. The company's substantial monthly dividend imposes a significant capital discipline on management, though it does not stop the acquisition of more development land. The company claims to be highly risk-averse, so we challenged the CEO to demonstrate how he reduces risk compared to his competitors. We talked through the management of exploration risks, the hedging strategy, the use of proven extraction technologies and the low debt-to-equity ratio. We also tested the decision of the board to promote the previous CEO to the position of chair, and asked about the role of the lead director (who had previously been chair). We also tested the decision to retain a director who seems over-committed.



We met with a **Japanese electronics company** to continue our dialogue on business strategy and governance. We appreciated that the profitability of its TV business, a big contributor to last year's large-scale loss, has improved slightly thanks to structural reforms and welcomed the company's determination to take more radical steps if the business fails to reach break-even soon. We were also pleased to learn that there has been a clear change in corporate culture and that the speed of decision-making has increased. However, we remain unconvinced that the three core businesses the company aims to strengthen are sufficiently focused or that the plan for recovering their profitability is viable. We also queried the rationale for a new joint venture and how this will benefit the company and its shareholders in the long term. While board composition, including the level of independence, appears better than that of most other Japanese companies, we probed the board's effectiveness and contribution to the improvement of the company's performance. We continue to press the company to provide clearer plans and more concrete targets with regards to its core businesses.

On the back of a letter setting out our concerns and recommendations, we met with members of the board and senior executives of a **Chinese chemical producer** to continue our engagement about various aspects of the company's corporate governance – concerns which had also fuelled a high-profile proxy fight earlier in the year. We welcomed the apparent truce in hostilities and sought assurances that the board is now functioning well, having added representatives of the dissident shareholders. We also strongly welcomed plans to add an independent director to the board in 2013, and that shareholders will be able to vote for individual directors rather than just a single slate. We pressed again for more transparency regarding investment decision-making processes, the establishment of an investment committee composed of a majority of independent directors and the employment of an independent financial adviser to provide an objective opinion on major investments. Overall, many of the controversies seem to have been resolved and the company seems to be actively listening to proposals, but we will continue to monitor developments.

We met with a senior executive of a **European electronics and engineering company**, further to our meeting with the chair in September. We expressed our disappointment about the planned, limited supervisory board refreshment at the last AGM and the lack of a clear plan on succession. We also raised our concerns about the apparent lack of focus in strategy, which seems to have contributed to the disappointing operational performance relative to competitors over recent times, without any apparent prospect of sustained improvement in the near future. We tested what improvements to the remuneration report will be made in the forthcoming annual report and communicated our strong concern about the supervisory board's role in setting targets and exercising discretion. We agreed that we will take up these issues and concerns with the chair again and urged actions to address the main points before the next AGM.

We met the chair of a **UK bank** this quarter, as well as its finance director. With the chair we discussed board succession, its recent regulatory difficulties, and risk management. We examined the criteria identified for new appointments, while we were in broad agreement with the attributes identified for new members. We were also reassured that he is alive to keeping the board as small as possible, whilst presenting a reasonable case for having a number of executives on the board and planning considerable overlap of tenure between retiring and new directors. We discussed executive succession plans. Whilst on the surface the meeting was reassuring we will continue to engage with the bank on its risk profile.

Integrated Reporting

A new destination or a better road map?

The International Integrated Reporting Council (IIRC) will publish its draft framework on 16 April 2013. Whether it helps to improve corporate reporting depends largely on whether investors help ensure that it focuses on evolution, not revolution.

“Investors need better information so they can properly understand and judge the Board’s role and effectiveness.”



Overview

Well-functioning markets rely on good information. If capital markets are to facilitate long-term value creation then the information disclosed to investors needs to be a lot better than it is now. This is why one of Hermes EOS' focus areas for our policy and best practice work is "honest reporting". But while criticisms of current corporate reporting practices are abundant and some of the solutions are clear, the momentum for meaningful change has been in relatively short supply. IIRC seeks to address this by encouraging the integration of material long-term risks and opportunities into companies' standard annual reporting.

On 17th December 2009, His Royal Highness The Prince of Wales called for the establishment of an organisation to oversee the development of an international connected and integrated approach to corporate reporting. The call to action was made on behalf of the Global Reporting Initiative (GRI), the International Federation of Accountants (IFAC), and the Prince's Accounting for Sustainability (A4S) initiative. The IIRC was soon born, and counted amongst its members senior representatives from International Organization of Securities Commissions (IOSCO), International Accounting Standards Board (IASB), International Federation of Accountants (IFAC), United Nations Principles for Responsible Investment (UNPRI), International Corporate Governance Network (ICGN), World Economic Forum (WEF) and others.

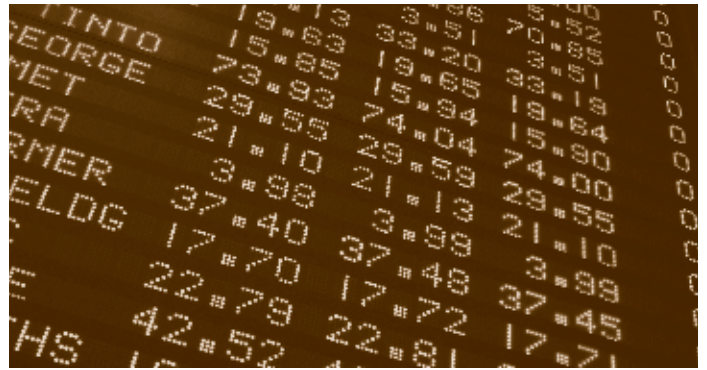
The IIRC consists of many of the organisations whose insight and support is essential if meaningful changes to corporate reporting are to occur. And while the IIRC is not an investor-led initiative, its mandate is clearly targeted at investors and the process includes, among others, APG, Aviva, BlackRock, Hermes EOS, La Caisse de dépôt et placement du Québec, PREVI, Railpen Investments, Standard Life Investments and UBS.

This article provides an overview of why Hermes EOS believes that the IIRC is an important initiative worthy of support; it also outlines our concerns to ensure its likely success.

The IIRC's mandate is ambitious and success is uncertain. To succeed, four things need to happen: two of these relate to the integrated reporting (IR) Framework and two relate to the IIRC process.

Integrate this

The engineering axiom "you can't maximize two variables at once" is applicable to corporate reporting: one report cannot serve equally two audiences. Unless the primary audience for a



company's sustainability report is the same as for their annual report and accounts, these two reports should not be combined. Integrated reporting will fail if companies think that this means a combination of their annual and sustainability reports.

The IIRC has made clear that the "primary" audience of an integrated report is investors. For investors who are inclined to read it, an annual report and accounts should demonstrate how the company plans to create and sustain value to a time horizon consistent with their investment strategy. Because different investment strategies operate across different time horizons, the report must therefore address the short-, medium- and long-term horizons. This requires the integration of a broad range of information, including on marketplace, strategy, risks, operations, financial and non-financial factors. An excellent example of an integrated report is provided by Johnson Matthey, the FTSE100 company which won awards for best annual report and best sustainability and stakeholder relations at the 2012 ICSA-Hermes Transparency in Governance Awards.

The Board is the Word

The Board of Directors of a company should have the information, expertise and insights needed to oversee the identification, management and reporting of material information on strategy, operations, risks and performance. The Board also has the responsibility to act in the interests of the company and as representatives of its investors. Great care must be taken over any change that would reduce the primacy of the Board of Directors' role in determining materiality. While corporate disclosures can serve the interests of other stakeholders or policy objectives, those in the report and accounts should be primarily intended to explain value-creation to investors. Integrated reporting will fail unless it leads to a greater focus on the board and its responsibility for reporting as well as for leading the company.

If the objective of integrated reporting is to communicate the company's value-creation strategy, then it must provide more insights into the thinking of the ultimate owner of the corporate strategy. This is the role of the board. And the board needs to be held accountable for the direction it sets and also for the efficiency with which it achieves its objectives. Investors need better information so they can better understand and judge the Board's role and effectiveness, and so call them to account for their delivery.

The root cause

One of the IIRC's challenges is trying to re-engineer corporate reporting guidance without having a consensus view on the root cause of the current deficiencies. The key question is: why don't we already have integrated reporting? If any group was well-placed to answer this question then surely it is the IIRC, which includes representatives of the institutions responsible for mandating and guiding corporate disclosures.

Current reporting standards do not serve a broad range of investors because investors, and asset owners in particular, currently do not play a meaningful role in the institutions that define corporate disclosure. If information is power, then one should expect a battle for control of the bodies that set disclosure requirements. One must consider: why did it take so long for the United States Securities and Exchange Commission (SEC) to issue guidance on the disclosure of climate risk? Why did IOSCO's experts group on conflicts of interest in private equity not include any asset owners? Why is the IIRC process composed primarily of consultants, auditors and accountants?

Long-term pools of capital – such as pension funds, insurance companies and sovereign funds – are asset-rich, but time-poor. They do not have the capacity to allocate staff to participate actively in the development of accounting or disclosure standards. If a process is staffed by agents rather than principals, then the outcome will better serve the needs of agents. That is the root cause that must be addressed. With some prompting from APG, Aviva, EFFAS, Hermes EOS and Railpen Investments, the IIRC is now tackling this problem by creating an Investors Testing Group (ITG) to enable investors to provide meaningful input through a process that is better-suited to their resource constraints. It is now up to investors to take advantage of this opportunity.

Dial "S" for Stability

Credit for the creation of the IIRC belongs to the sustainability community, whose ongoing efforts (and frustration) were essential. But to succeed, the IIRC and its stakeholders must focus not on environmental or social sustainability, but on financial stability and market efficiency. In our view, we do not need a new destination in corporate reporting, what we need is a better road map for getting there – and this road map must provide both technical guidance and political momentum. While the IR Framework will provide technical guidance, the IIRC must seek a lever for political momentum and make its case in a way that reflects the priorities of the Financial Stability Board and the G20.

The key insight behind the UK government's encouragement of an effective UK Stewardship Code is the conclusion that capital markets are more stable where they benefit from a meaningful proportion of active owners. Active owners require different information than active traders. If the IIRC can help investors to be more active owners, then it will contribute to the G20's financial stability agenda. It will also contribute meaningfully to long-term sustainability, even if it does so in a different way than its creators originally intended.

Corporate political and lobbying expenditure

Seeking enhanced transparency and appropriate governance of a still obscure form of corporate spending.

Best practice in the disclosure and governance of corporate political donations and lobbying expenses has improved only marginally during the last three years, with many companies still failing to demonstrate how political donations are an appropriate use of corporate funds. This article provides an overview of Hermes EOS' approach to the issue.

“The increasing reputational risks associated with political contributions and lobbying activities call for greater scrutiny by investors.”



Overview

Shareholder proposals relating to corporate political and lobbying spending have been the most popular type of resolutions filed at companies' shareholder meetings during the last two years in the United States [US]. Also, a petition filed with the US Securities and Exchange Commission (SEC) in 2012, calling on the agency to initiate a rule-making consultation process regarding corporate political spending, has received an unprecedented 300,000 comments. However, it took until the end of 2012, following record-breaking corporate contributions to the US political campaigns, for this topic to begin to resonate with the SEC, as evidenced by recent comments made by some of its senior representatives.

While a few companies have taken the lead in improving disclosures regarding the funds they allocate to political spending, several large contributors still have significant work to do. Very few are as transparent regarding their lobbying expenditures, and an even smaller number have robust policies in place to ensure adequate governance of these processes, and in particular that such donations are in companies' best interests.

This article sets out our approach to engagement on corporate lobbying and political expenditure both at policy and company levels. Given that the US market is where this topic has been most relevant in recent years, the focus of our engagement has been with the US regulator and with issuers within this market. We have now also started to engage with companies within the United Kingdom (UK) and Europe that have operations in the US and which have channelled funds into the country's political processes.

Our global public policy objective on political donations and lobbying are to enhance transparency and disclosure of political and lobbying expenses, and improve company policies, board oversight and accountability in this area. Accordingly, our latest US governance principles encourage companies to provide detailed disclosure of their political contributions and lobbying activities as part of their mainstream reporting. We believe that the increasing reputational risks associated with such practices call for investors to further scrutinise these expenditures to assess their material impact.



As part of our public policy plan for 2013, we will be writing to individual stock exchanges and their respective regulators calling for regulation regarding enhanced disclosure and appropriate governance of political donations and lobbying expenditures. We will continue to push for donations made anywhere in the world by European Union (EU)-domiciled or quoted companies to obey the strict rules for EU donations, which require shareholder approval in advance.

In our interactions with companies meanwhile, we continue to call for reports that provide details on payments intended to influence legislation, elections, and campaigns supporting or opposing candidates for public office. As a result, we tend to support relevant shareholder proposals that advocate such enhanced disclosure. We also expect companies to explain why such expenditure is in their best interest and that of their owners, as well as how it is an appropriate use of corporate funds. Moreover, we expect this disclosure to explain the governance process around such expenditure, including how the decisions are made and how the risk, including reputational, involved with donations is assessed and managed. Lastly, we seek an overview of the diligence conducted on the organisations to which donations are made and the use to which donations are put.

We have been engaging with a number of companies, both leading and lagging in this area. We are seeking to learn from those that exhibit best practices while pressing for the less progressive to make the necessary changes to improve. We have also joined efforts with 25 global investors, representing US\$970bn of assets, as part of a coalition focusing on engagements with key companies that operate within sectors in which the more prominent political donations and lobbying activity has recently been observed, such as healthcare, energy, banking, pharmaceuticals and technology. The increase in political donations and lobbying expenditures in these sectors is likely to be mainly due to the regulatory changes proposed as part the political debate that has taken place in the US around the presidential elections.

Through our work with the Center for Political Accountability (CPA) – a US organization specializing in gathering and analyzing company data regarding political donations and lobbying expenditures – we have identified a group of UK and European companies which have funded the political process in the US. As such, we have started to address this topic in our existing engagements with those companies, highlighting the potential reputational risks associated with these activities, particularly in light of their respective local markets' policies which differ substantially from those in the US.



We consider inadequate the current approach by certain companies, which attempt to justify the channelling of large amounts of corporate money to political donations and lobbying by asserting that it is in the best interests of the company and its owners. In addition, we fundamentally disagree with the rationale often proposed by companies that, given the nature of the US system, abstaining from involvement in and providing robust disclosure of political and lobbying expenses would place them at a competitive disadvantage. Two of the world's largest companies by market capitalisation, Apple and Microsoft, are good examples of how robust disclosure, strong governance policies, adequate board oversight and reasonable limitations in expenditures do not hinder a company's ability to remain competitive.

Therefore, as we expand the universe of companies we engage with on political donations and lobbying expenditures in 2013, we will continue to emphasize the implementation of robust policies that govern such processes and that foster appropriate board accountability, in addition to enhanced transparency and disclosure. We will press boards to outline clearly how such donations are effectively aiding companies' competitiveness and to disclose fully the end use of those contributions. In our experience from engaging with companies on the issue, this is particularly important given that most boards are generally unaware of the details of the recipients' agendas and how these may represent a potential reputational risk to the company.

Palm oil

Mitigating environmental and social risks: EOS visits a palm oil plantation

As part of our engagement on palm oil, we conducted a site visit to a plantation in Indonesia to further our understanding of a company's efforts to tackle environmental and social challenges faced in its operations.

“In order to carry out engagements more effectively, Hermes EOS has become an affiliate member of the Roundtable on Sustainable Palm Oil, a multi-stakeholder initiative.”

Overview

We started an engagement programme on palm oil in 2010 and have since had several meetings and discussions with companies in various sectors. Although it is a versatile and profitable commodity, the production of palm oil entails various risks in the environmental and social areas. Not only has it caused a large-scale deforestation, contributing to climate change and a loss of biodiversity, disputes with local populations over land ownership as well as working conditions, including health and safety, have been sources of concern for global investors as these issues pose reputational as well as supply chain security risks. One of the companies we have been engaging with intensively is a large-scale palm oil producer in Southeast Asia, which was targeted by an non-governmental organisation (NGO) and accused of contributing to deforestation and poor handling of community relations. Although its initial response appeared slow, the company has since been working closely with the Roundtable on Sustainable Palm Oil (RSPO), a multi-stakeholder initiative to promote the use and growth of sustainable palm oil, and they have set up a target of obtaining the RSPO certificate for all their plantations by 2015.

We have become affiliate members of the RSPO to be able to carry out our engagements more effectively. We have also been monitoring progress on the certification process and other issues at this company very closely. To escalate our engagement we paid a visit to one of its plantations in Indonesia in order to gather evidence of the company's commitments and progress towards resolving environmental and social issues.



We have intensified our engagement with this company following allegations that its operation of palm oil plantations was contributing to deforestation and causing damage to biodiversity, this led large-scale international buyers to suspend their businesses with this company and a UK bank to withdraw its investment. Since then, the company has set a target of achieving the RSPO certification for all its plantations by 2015. They have also been working proactively with NGOs towards achieving this target. We met and spoke with both heads of investor relations and sustainability on a number of occasions to test the progress being made and decided to visit one of the company's plantations and speak to those who work on the ground, to further our understanding of the issues and efforts made so far. In particular, we wanted to investigate the working environment on the plantation and its carbon management, as well as the community consultation process and integration with the local population.



We visited a plantation located in the Riau region of Indonesia, the journey to which included a one and a half hour flight from Jakarta followed by a further two and a half hours' drive. When we reached the plantation, we were welcomed by a small international team of site managers, who talked us through various challenges faced in the operations of the plantation and initiatives taken to address environmental and social issues. We learnt that the site itself had already been fully certified by the RSPO, even prior to the NGO allegations about other parts of the company's operations. It was also highlighted to us that there was a SGD\$2 (two Singaporean dollars) increase in the cost of production per tonne of palm oil due to the certification process, with most of this cost associated with audits. We were pleased that the company considers this increased cost acceptable – given our previous concerns that the cost of certification might be a major obstacle – and is working towards obtaining the certification for all its plantations by 2015. Since major buyers who had previously suspended trading with the company set their target of sourcing only certified oil for 2015, we again urged the producer to bring the target certification date forward. We understood, however, that this may prove challenging due to a lack of human resources.

We welcomed the company's effort towards minimising the environmental impact of its operations and to avoid the use of chemicals, where possible, by using natural- and organic fertilisation products produced from natural waste and using birds for rat control. Moreover, the plantation has its own power generation system, which relies on palm shells and palm fibre as fuel, with diesel only used for starting and shutting down. As a result, the greenhouse gas emissions from the plantation are far below the emission standard set by the International Sustainability and Carbon Certification, which is required by one of the company's major buyers. The company also has its own water treatment system in place and we were assured of the company's intention of achieving a high degree of self sufficiency and mitigating its environmental impact on the local areas.

On the social issues, the company explained how they have successfully completed the complicated process of acquiring land, and in particular how they deal with conflict with local residents. The company holds continuous meetings with local leaders to solve occasional issues together with the neighbouring community. This issue of land acquisition is inherent to the palm oil business, as well as other plantation businesses, due to the complexities surrounding land tenure and ownership. Indeed, a number of other plantation operators have been caught up in allegations involving disputes over land with indigenous populations. We were able to gain some assurance of this company's effort towards integration and harmonisation with the local community, particularly given that most of the nearly five thousand workers on the plantation are

hired locally.

During our tour around the plantation, we witnessed harvesting of the palm fruit, which was due to be separated into its constituent parts, sold and used for purposes including power generation and fertilising. Given our concerns about the potentially difficult working conditions and environment of the plantation, we were pleased to learn that workers are provided with relevant health and safety training and subsequent health and safety certification as well as regular health checkups. Discretion is permitted around working hours in order to encourage workers to work during the optimal conditions and avoid working during the hottest hours of the day. We gained further comfort by visiting various facilities designed for the welfare of plantation workers and their families, including the housing estate, hospital and schools. The local school was built by the company and the teachers' wages are paid by the company.

This site visit provided us with an excellent opportunity to see the conditions of the plantation and speak with people who carry out the day-to-day work on the ground. We acknowledged the openness of the company and its willingness to engage with shareholders on important sustainability issues. We took this opportunity to urge the company to increase its efforts towards obtaining RSPO certification for its other plantations and that more detailed and concrete information about the certification process and the progress made should be communicated to shareholders. In addition, while we recognised the company's effort and initiatives for tackling environmental and social challenges, we reiterated that the management of sustainability risks should be ingrained in the corporate culture. In particular, we suggested that sustainability should form part of the formal board agenda and discussed as key issues with commensurate high priority given the significant implications on the company's core business operations.

“Base of the Pyramid” or “Inclusive Business” opportunities

Unleashing the commercial potential of low-income segments in emerging markets.

Building on our work on access to medicines as well as to telecommunications and nutrition, we are widening the scope of industries within which we consider the potential for business growth in emerging markets.

“One of the main challenges, both for the companies and for engagement, is that inclusive business ventures are often characterised by a move into “uncharted territory” and many risks will be unknown.”



Overview

The terms “Base of the pyramid” or “Inclusive Business” refer to the notion that businesses ought to seek to tap into the uncharted markets presented by the lower income portions of the populations in developing countries. Compared with the increasingly saturated markets targeting the “top of the pyramid”, these new markets may present significant business opportunities for new micro-consumers, new capacity for consumption and new micro-producers, an opportunities for innovation.

A company can seek to tailor any aspect of its business to the particular needs of this target audience, including its products, services, procurement, production, packaging, pricing, marketing, communication, location, transport or distribution. The key to success is partnering at the local level, both to address costs and provide the necessary access and knowledge of the market. By working with micro-entrepreneurs, small and medium businesses, local non-governmental organisations and the public sector, businesses can be locally responsive to the particular market environment.

It is important for the company to ensure its adaptability and capacity for low-cost experimenting, in order to build up its knowledge of the market, test partnerships and confirm the viability of the business model before scaling up investments. One of the biggest challenges is building up the market infrastructure, market expertise and legal systems – which hopefully will be rewarded with the competitive advantage of being among the first to position itself in the market.

However, the inclusive business approach also carries the risk of exposing immature markets and inexperienced consumers to harmful products. Tobacco, alcohol and highly processed food and drink are examples of such products which bring increased exposure to issues normally faced by developed markets, such as lifestyle diseases (diabetes, obesity and other non-communicable diseases). There is also the risk of non-adherence to the company’s own policies with the local partner, for example relating to safety, quality, marketing standards, bribery and corruption.



Building on our ongoing engagements relating to access to medicines, we initially chose to expand our focus to include companies with products and services relating to telecommunications, nutrition and consumer staples. This had mainly led to dialogue with European and American companies, as they present a wider and more developed range of case studies for consideration.

Within the telecommunications sector, our dialogue on inclusive business opportunities has formed part of engagements on a wider range of issues. It has included challenging the companies on the degree to which they place sufficient strategic importance on the integration of their ventures in markets like Morocco and India. Regarding access to nutrition in the consumer staples sector, we have been engaging on strategic integration as well as the particular risks arising from inclusive business ventures in countries such as China and India. The issues have included challenging companies on their preparedness for price restrictions and wage inflation as well as responsible sourcing of palm oil and cocoa. We had initially also identified access to finance as a key sector for engagement on the importance of inclusive business ventures, but in light of the challenges currently faced by banks, our engagements have instead focused on risk management and alignment of remuneration with appropriate performance criteria.

While we recognise that in some areas and sectors, such as pharmaceuticals, there is a particular and in fact crucial need for a company to consider the commercial implications of its positioning in emerging markets, we nonetheless find it valuable to expand the focus to additional industries which have an added exposure to emerging markets. These include enabling greater capacity for business through increased access to technology, communication, information, education, water, energy, sanitation, housing, construction, food, agriculture and consumer goods.

Recent examples from our dialogue with companies in other industries include increasing the shipping capacity of ports in India, Nigeria and Ghana, as well as joint ventures aimed at creating a new market for ethanol-based cooking stoves in Mozambique. We have also engaged on risk management, raising our concerns regarding a chemical producer's apparent push to sell products banned in the European Union in emerging markets.

In order to structure our approach to this diverse range of additional industries, we have sought to establish two more general objectives as potential points of departure, adaptable to the specific conditions of the particular company and its business.

The first objective addresses the strategic importance of growth opportunities in emerging markets and whether the company has developed a clear strategy and ensures sufficient integration. The company itself ought to be best placed to assess the commercial potential, and we consider the relevance of inclusive business opportunities in the context of its stated strategy. When dealing with sectors, products or business models where the need for positioning on emerging markets is not apparent, the company may provide sufficient assurances and reasoning for its decision not to embark on inclusive business projects. A related challenge is that a substantive move into emerging markets may require significant long-term investment for which the companies may justifiably not always have the appetite. Beyond the question of whether the company's approach is commercial as opposed to charitable, engagement on the strategic integration of such opportunities tests issues such as whether there is oversight and buy-in from senior executives and the board. We also look at its focus on innovation, development of a local network, long-term investment planning with targets and a timeline for scaling up projects, relevant expertise and efficient sharing of information across the company as well as adaptability to business drivers and potential changes in capacity, demand and competition.

Our second engagement objective is aimed at the management of risks arising from existing inclusive business ventures. These relate to environmental and social impacts, as well as other business risks, such as security of resources or distribution efficiency. The relevance of particular issues will inevitably vary greatly, depending on the company and business area, but include testing the company on sufficient risk assessments and engagement with stakeholders, ensuring adherence to the company's own standards and policies by local partners and supply chain, as well as preparedness for regulatory pressures with potential effects on pricing, costs, capital or potential for growth.

One of the main challenges, both for companies and for engagement, is that inclusive business ventures are often characterised by a move into "uncharted territory" and many risks will be unknown. We will therefore continue to identify best practices and case studies for our analysts to use as a reference in their dialogue with companies in similar sectors or business environments where concerns exist regarding either the strategic approach or risk management. Ideally, this will provide a better foundation for testing the quality of a company's positioning on its potential for inclusive business, as well as enabling us to incorporate both additional sectors and a wider coverage of regions.

Public policy and best practice

Protecting and enhancing value by promoting better regulations

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

“Investment institutions are typically absent from public policy debates even though they can have a profound impact on shareholder value.”

Overview

We actively participate in debates on public policy matters to protect and enhance value for our clients by increasing 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 in 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, which are currently in the areas of accounting and auditing standards.

Investment institutions are typically absent from public policy debates even though they can have a profound impact on shareholder value. 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.

Highlighted sample activities

Islam & Responsible Ownership Paper

We launched a paper on stewardship and shareholding within an Islamic context. The purpose of this paper is to raise awareness among Middle Eastern investors on how issues which are core to Islam impact matters at investee companies, encouraging investors to take a stewardship approach through responsible ownership. There is often a perception that Middle Eastern investors wishing to invest beyond the Gulf would be unable truly to reconcile their investments with their Islamic heritage and beliefs. For such asset owners which are mindful of their Islamic heritage, this paper seeks to demonstrate that responsible ownership presents an opportunity to preserve Islamic social and commercial values within investment behaviour. It focuses on the principle that mankind should take action in the interests of good, with individuals being agents for change (Khalifa), exercised through 'Islamic Stewardship'. Our paper attempts to show how Middle Eastern asset owners can respond to this challenge by being active owners of companies and avoid being passive spectators of their investments. In the absence of applying a responsible investment philosophy, Middle Eastern investors may find it challenging to fulfil their duties as Khalifa.





Enhanced Disclosure Task Force: publication

The Financial Stability Board issued the final report of the Enhanced Disclosure Task Force, establishing higher best practice standards for bank risk reporting. The publication marks the end of six intensive months of activity for EOS and the handful of other investors who worked alongside large banks and audit firms to develop these best practice recommendations. Our key contributions included coalescing the investors into a united group following a particularly disappointing meeting when the banks seemed particularly negative and obstructive, and contributing key language, not least at the last minute when a late IOSCO contribution threatened to derail consensus. Thus far, the publication has been broadly welcomed by regulators and the industry and we will look to find ways to promote its application by the leading banks.

Collaboration in Spain – initial meeting of pension funds

Alongside a Spanish consultant, we were successful in leading the convening of an initial meeting of Spanish pension fund representatives to promote collaboration and information-sharing. Currently, Spanish institutional investors do not undertake responsible ownership activities, other than some voting on a very basic level. This is a symptom of various limitations in the pensions industry, including conflicts of interest, lack of funding and resourcing for dedicated activities, the strong influence of the unions, and a weak regulatory framework with regards to responsible ownership. Importantly, however, pension funds will be expected to put in place responsible ownership policies at the start of 2013, although the structure and implementation requirements remain extremely vague. We were therefore pleased to have secured the presence of the largest pension funds, as well as union representatives, at this gathering. We presented our practical experience in terms of working with shareholders in other parts of Europe and spoke of our desire to share insights about ESG issues in the Spanish market and gain local knowledge. We also highlighted the effectiveness of engaging in dialogue with companies outside of the proxy voting season. We invited a representative of Dutch institutional investor platform Eumedion to present on the practicalities of setting up a collaborative investor platform. Overall, we noted a high level of interest among the attendees, although we expect that any commitments will take time as the cultural shift required is significant.

S&P amended ratings methodology

We welcome the new ratings methodology recently announced by Standard & Poor's, the leading ratings agency. The new methodology now more fully incorporates ESG factors into the assessment of the management of key risks, making steps towards ensuring that longer-term factors are integrated more effectively in fixed income markets. This change reflects our

input over the last several months, and also a formal response that we made in April to a consultation on ways in which the methodology could be enhanced. The fact that this consultation occurred at all was, we believe, a reflection of the comments we have been making to key staff over recent times, and in addition to our own response we were also instrumental in other contributions, not least that from the UNPRI. The newly announced methodology specifically references the persuasive input that S&P received on these issues.

Other work this quarter included:

Promoting best practice

- We presented at the latest Asian Roundtable on Corporate Governance, on this occasion organised by the OECD in partnership with the Government of Japan. We took the opportunity to discuss and emphasise our call for a substantive Corporate Governance Code in Japan, and to suggest that policy-makers in Asian markets consider establishing a Stewardship Code aiming to encourage regional asset owners and managers to act responsibly.
- We responded to a consultation from Australia's Financial Services Council on a proposed governance standard for superannuation schemes. While the FSC only represents a narrow portion of the industry, there is scope for this proposal to become a basis for approaches elsewhere. Given that the proposal covered both the internal governance of schemes and their external ESG responsibilities, it may form the foundation of an Australian stewardship code.
- We met with ABRASCA, the Brazilian Association of Publicly Listed Companies. We discussed the growing influence of the President's office among Brazilian companies, a concern shared on both sides.
- We spoke at two conferences and two less formal gatherings in Taiwan on various corporate governance topics, focussing in particular on board nomination, composition and performance. We explained our expectations and talked about how we adjust them in dialogue with companies from around the world to account for differences in local markets.
- We delivered speeches at two major events for German non-executive directors, highlighting our expectations for the dialogue between investors and supervisory boards.
- We attended and presented at a conference on mandatory carbon reporting in the UK. We gained some helpful insights into the forthcoming changes to reporting, which we shall look to address with the government as part of our response to its current consultation on the legislation.

Public policy and best practice continued

Public Policy

- We had a wide-ranging discussion with three members of the International Accounting Standards Board. We took the opportunity again to press for a rapid conclusion to the proposals for impairment – something which has been acknowledged as a necessary reform since the financial crisis, but which remains unresolved.
- Ahead of a crucial US discussion about auditor reports hosted by the local regulator the Public Company Accounting Oversight Board, we were in touch with a leading member of its Standing Advisory Group which is discussing these proposals.
- We responded to the Toronto Stock Exchange consultation on proposed amendments to its Company Manual to improve the accountability of boards to shareholders. We supported the proposals to require companies to elect directors individually instead of as an entire slate, adopt a majority voting policy, and require full disclosure of proxy vote results.
- Ahead of its publication of a report on corporate governance practices in Japan, the Ministry of Economy, Trade and Industry sought our views on key issues, particularly relating to board practices.
- We met with the vice chair of the Korea Exchange and a senior manager of its Listing Regulations Division to discuss the development of governance policy and practices in South Korea.
- We were invited to comment on the requirements for a new listing segment being created by the Moscow Stock Exchange. The Exchange is currently establishing a new market structure called Novy Rynok, which is a premium listing segment with higher corporate governance and transparency requirements.
- We were one of only two investor representatives to take part in a roundtable on materiality in financial reporting hosted by the European Securities and Markets Authority, which brings together the EU's national financial regulators.
- We participated as an expert in a working group session of the German Corporate Governance Code Commission considering the issue of remuneration.
- We met with the UK's Financial Services Authority to discuss bank risk reporting and ways in which it can be enhanced. We shared areas of concern and of focus most specifically highlighting the need for disclosures of gross derivative positions as well as net ones.
- We were pleased to provide input into and support a response via the Institutional Investors Group on Climate Change to the Environment Department's consultation on new carbon reporting regulations.

Working with other shareholders

- We spoke on a Council of Institutional Investors (CII) conference call to present our views on the necessary next steps in terms of banking reforms, ranging from remuneration to regulation, to the CII membership, the US's largest investment institutions.
- We participated in a call with other members of the Asian Corporate Governance Association to discuss various corporate governance matters in Asia. We talked through the recent discussions within a group of investors around Japanese corporate governance and how to communicate clear messages to companies.
- We met with the largest pension funds in Brazil (Previ, Petros, Fundacao CESP) to discuss governance, shareholder rights and the potential for partnerships.
- We are delighted that following our recommendation to the OECD to develop a network of Middle East institutional investors who can encourage active ownership and stewardship in the region, it agreed to launch a project to this effect.
- We presented at the biannual international investors conference held by DSW, the German association of retail shareholders. Our topic was the Kay Review, and we took the opportunity to share perspectives regarding the level of intermediation in the financial markets and routes to address the negative implications of this, not least seeking ways to discourage a trading mindset and to encourage an ownership and a stewardship approach.
- We presented in a Carbon Disclosure Project webinar for companies in support of its carbon action initiative. We offered the investor perspective on the imperative for carbon action and promoted the business benefits of carbon reduction initiatives.

Hermes votes at general meetings wherever practicable. We take a graduated approach and base our decisions on annual report disclosures, discussions with the company and independent analysis. At larger companies or those where clients have a significant stake, we seek to have dialogue ahead of voting against or abstaining on any resolution. In most cases of a vote against we follow up with a letter explaining our concerns. We maintain a database of voting and contact with companies and if we believe further intervention is merited, we include the company in our main engagement programme.



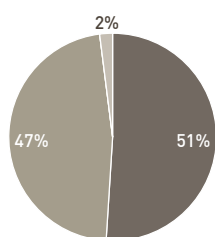
Hermes votes at company meetings all over the world, wherever its clients own shares.

Overview

Over the last quarter, we voted at a total of 1,418 meetings around the world, analysing 9,110 resolutions. At 595 of those meetings we opposed one or more resolutions and we abstained at 16 meetings. We voted with management by exception at 14 meetings, while we supported management on all resolutions at 793 meetings.

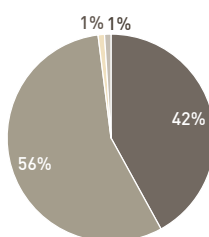
North America

We voted at 419 meetings
(2,761 resolutions) over the quarter.



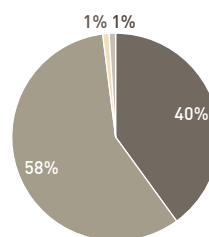
Asia

We voted at 137 meetings
(889 resolutions) over the quarter.



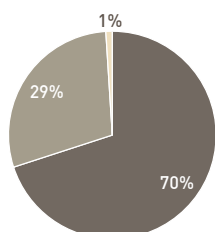
Australia & New Zealand

We voted at 293 meetings
(1,537 resolutions) over the quarter.



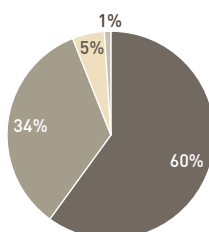
Emerging & Frontier Markets

We voted at 276 meetings
(1,860 resolutions) over the quarter.



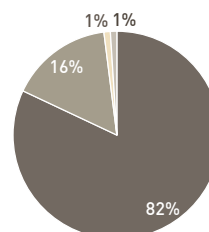
Europe

We voted at 133 meetings
(749 resolutions) over the quarter.



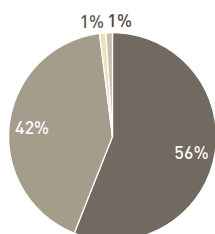
UK

We voted at 160 meetings
(1,314 resolutions) over the quarter.



Global

We voted at 1,418 meetings
(9,110 resolutions) over the quarter.



- Total meetings voted in favour
- Meetings where voted against (or voted against AND abstained)
- Meetings where abstained
- Meetings where voted with management by exception

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| Hermes Equity Ownership Services

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