HERMES | Equity Ownership Services

Q1 | Public Engagement Report 2014

This report contains a summary of the responsible ownership activities undertaken by Hermes Equity Ownership Services (EOS) on behalf of its clients. It covers significant themes that have informed some of EOS' intensive engagements with companies in Q1 2014.

The report also provides information on its voting recommendations and the steps EOS has taken to promote global best practices, improvements in public policy and collaborative work with other shareholders.

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 and private companies. EOS' team of engagement and voting specialists monitors its clients' investments in companies and intervenes where necessary with the aim of improving their 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 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 37 investors with around $171bn* in assets under stewardship.

Hermes has the largest stewardship resource of any fund manager in the world. Our 26-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 with 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 Principles for Responsible Investment (PRI) and other stewardship codes. EOS' 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 EOS to help signatories in meeting the challenges of effective PRI implementation.

How does 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 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 engagement 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 around 400 companies 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 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 for clients, not to seek headlines through campaigns, which can often 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 does not contain specific details of our interactions with companies. Rather it explains some of the most important issues relevant to responsible owners and outlines EOS' activities in these areas.

We would be delighted to discuss EOS with you in greater detail.
For further information please contact:
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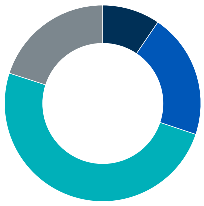
* as at 31 March 2014

Engagement by region

Over the last quarter we engaged with 153 companies on a range of 325 social, environmental, business strategy and governance issues. Our 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.

Global
We engaged with 153 companies over the last quarter.

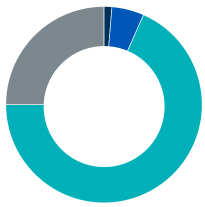


- Environmental **9.5%**
- Social and ethical **20.6%**
- Governance **49.8%**
- Strategy and risk **20.0%**

Australia and New Zealand
We engaged with eight companies over the last quarter.

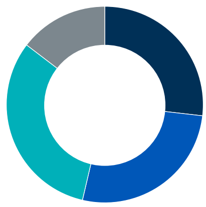
- Environmental **26.7%**
- Social and ethical **20.0%**
- Governance **53.3%**

Developed Asia
We engaged with 43 companies over the last quarter.



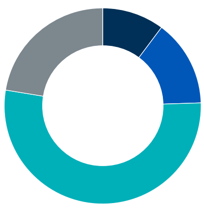
- Environmental **1.3%**
- Social and ethical **5.3%**
- Governance **68.4%**
- Strategy and risk **25.0%**

Emerging and Frontier Markets
We engaged with 19 companies over the last quarter.



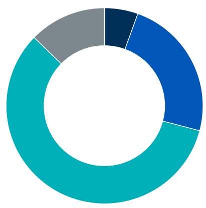
- Environmental **26.8%**
- Social and ethical **26.8%**
- Governance **31.7%**
- Strategy and risk **14.6%**

Europe
We engaged with 25 companies over the last quarter.



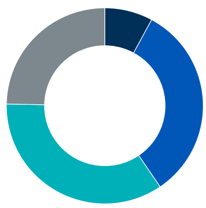
- Environmental **10.2%**
- Social and ethical **14.3%**
- Governance **53.1%**
- Strategy and risk **22.4%**

North America
We engaged with 27 companies over the last quarter.



- Environmental **5.5%**
- Social and ethical **23.6%**
- Governance **58.2%**
- Strategy and risk **12.7%**

UK
We engaged with 31 companies over the last quarter.



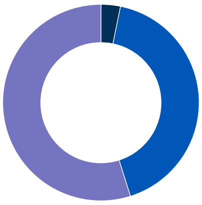
- Environmental **7.9%**
- Social and ethical **32.6%**
- Governance **34.8%**
- Strategy and risk **24.7%**

Engagement by issue

A summary of the 325 issues on which we engaged with companies over the last quarter is shown below.

Environmental

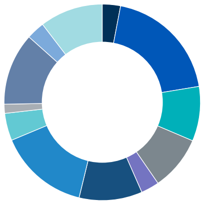
Environmental issues featured in 9.5% of our engagements over the last quarter.



- Biodiversity **3.2%**
- Climate change/carbon intensity **41.9%**
- Other environmental **54.8%**

Social and ethical

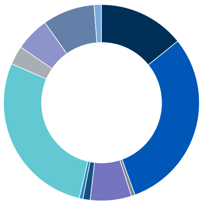
Social issues featured in 20.6% of our engagements over the last quarter.



- Access to medicine **3.0%**
- Bribery and corruption **19.4%**
- Community relations **9.0%**
- Corporate culture **9.0%**
- Customer relations **3.0%**
- Employee relations **10.4%**
- Health and safety **14.9%**
- Licence to operate **4.5%**
- Munitions manufacture **1.5%**
- Other social and ethical **11.9%**
- Political risk management **3.0%**
- Supply chain (inc child/other labour issues) **10.4%**

Governance

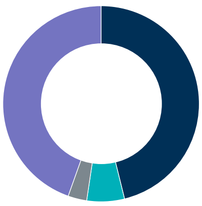
Governance issues featured in 49.8% of our engagements over the last quarter.



- Accounting or auditing issues **14.2%**
- Board structure **30.2%**
- Conflicts of interest **0.6%**
- Other governance **6.8%**
- Poison pill **1.2%**
- Related-party transactions **0.6%**
- Remuneration **27.8%**
- Separation of chair/CEO **3.1%**
- Shareholder communications **5.6%**
- Succession planning **8.6%**
- Voting rights – not 1 share 1 vote **1.2%**

Strategy and risk

Strategy and risk issues featured in 20.0% of our engagements over the last quarter.



- Business strategy **46.2%**
- Reputational risk **6.2%**
- Returns to shareholders **3.1%**
- Risk management **44.6%**

Value for money? – the hidden costs of nuclear energy

We have engaged with several nuclear power plant operators on their business plans and safety mechanisms since the world of nuclear energy was thrown into turmoil in 2011.

Setting the scene

Since the magnitude nine earthquake and subsequent tsunami struck the northeast coast of Japan in March 2011, damaging nuclear power facilities, including the reactors at the Fukushima Daiichi power plant, nuclear policy has come under scrutiny worldwide. However, the response has been inconsistent. While Belgium, Germany and Switzerland have begun to phase out nuclear power and Italy voted to remain nuclear free, China and other developing economies have initiated or restarted their nuclear power programmes. Japan intends to do the same. Nuclear power remains the primary source of energy in France and in 2013, the UK renewed its support in agreeing to build the first of several planned nuclear power stations at a strike price of £92.50 for every megawatt hour of energy produced. This was almost twice the then wholesale cost of electricity.

Assessment of different fuel sources

Fuel source	Investment cost	Time to market	Generation cost	Carbon footprint	Reliability	Flexibility	Space requirement	Infrastructure requirement	Risk
Nuclear	High	Long	Low	Very low	High	Low	Low	Medium	High
Coal without CCS*	Medium	Medium	Medium	High	High	Medium	Low	Low-medium	Low
Coal with CCS*	Very high	Very long	High	Low	Unclear	Medium	Low-medium	Low-medium	Medium
Gas / CCGT**	Low	Short	Medium	Medium	High	High	Low	Low	Low
Hydro	Medium	Short	Low	Very low	Medium	Low	Low-medium	Medium	Low
Oil	Medium	Short	High	Very high	Medium	Medium	Low-medium	Low	Low
Onshore wind	Medium	Short	Short	Very low	Low	Low	High	High	Low
Offshore wind	High	Medium	Medium	Very low	Low-medium	Low	High	High	Low-medium
Solar PV	High	Very short	Very short	Very low	Low	Low	High	High	Low
Solar CSP	High	Short-medium	Short-medium	Very low	Low	Low-medium	High	High	Low
Marine / Tidal	High	Very long	Unclear	Very low	Medium	Low-medium	High	High	Unclear
Geothermal	High	Medium	Low-medium	Low-medium	High	Medium	Medium	High	Medium

**CCS = Carbon capture and storage
**CCGT = Combined cycle gas turbine
Source: CA Cheuvreux 2011

Few issues are as polarising as nuclear power. It has been widely acknowledged as a solution to rising carbon emissions and climate change, which is why it seems paradoxical or perhaps appropriate that it was the force of nature that has altered the path of nuclear policy.

But there is less agreement over the true cost of nuclear energy. Opponents of renewable forms of energy highlight their high costs and dependency on subsidies. While the generation costs of nuclear power are indeed relatively low, there is a need to account for the extra costs that have become apparent in recent years. At present, energy sources get selected primarily on the basis of their generation costs, contribution to supply, reliability and measures such as government mandates and regulatory targets such as climate change, according to research firm Cheuvreux.

Post-Fukushima world

Following the Fukushima disaster, the safety and security of nuclear operations is a higher priority globally. While the risk of nuclear accidents is low, the impact of such tail risk events is vast. More stringent safety requirements imposed by regulators have led to delays in operations and spiralling costs, particularly for utilities with a large proportion of nuclear power generation in their portfolios and for those whose profit plans and targets depend on the resumption of certain nuclear plant operations.

The soaring costs of safety – an estimated inflation-linked increase of two to three times over the last 30 years – which includes the decommissioning of old reactors and the clean-up of sites, make it difficult for nuclear plant operators to assess future capital costs and revenues. In turn, this has a negative impact on their share price.

Clean-up costs and compensations awarded for damages caused by its nuclear plants and radiological contamination have soared for the Japanese power facility most affected by the Fukushima disaster, Tokyo Electric Power Company (Tepco), to an estimate of just under JPY5 trillion ($49 billion). To ensure the smooth running of future decommissioning, a further JPY1 trillion has been allocated over the 10 years starting from 2013, primarily aimed at the costs associated with water decontamination and stabilisation measures. It will be accompanied by cost-cutting and a reduction in research and development. The company expects to recover the decontamination costs through the sale of the company's shares and the payment of the equivalent portion of the profits into the national treasury.

Engagements

Governments' stakes in and control over nuclear plant operators, as well as the sometimes unclear responsibilities between the state and listed companies, can make engagement difficult.

In our discussions with the boards of nuclear power companies we have raised the issue of safety, in the context of business strategy, risk and crisis management and corporate governance, emphasising that the right expertise is crucial in overseeing safety and promoting a corporate culture of responsible operating practices.

Fukushima reinforced the urgent need for utilities to introduce an effective system of checks-and-balances. For example, during our engagement, we were pleased to note that Tepco has switched from its management framework to a committee governance structure, reduced the board size to 11 with a majority of external directors, appointed an independent chair and in an effort to improve risk management, introduced various bodies, including a nuclear reform monitoring committee, a nuclear reform special task force and a social communication office.

In our dialogue with companies, we have focused on the lessons learned from Fukushima and asked the boards to demonstrate an adequate understanding of potential changes in the regulatory and social environment and their impact on strategy and business plans. Safe and stable operations of nuclear power plants are critical to maintaining supply capacity, protecting the environment and ensuring the companies' financial stability, which is a key investor concern.

In response to our engagement, as well as increased regulatory requirements, political pressure and public concern, companies have provided detailed assessments of key risks associated with each of their nuclear power plants, current and enhanced risk and crisis management procedures, contingency plans and the capacity mix for power generation in the event of an accident. In Japan, we also pressed for a mid-to-long term roadmap towards the decommissioning of one company's reactors, its commitment to compensation for nuclear damage and an estimate of costs.

We have commended the publication of the results of nuclear stress tests for each facility after EU-wide and national calls for such tests, which focus on operators' responsiveness to events such as earthquakes, floods, extreme weather conditions, failure of the emergency power supply or cooling systems.

Future

Japan's lack of energy resources makes a move away from nuclear power unlikely, and the country already faces rising costs relating to the fossil fuels – mainly gas – it imports to bridge the gap caused by the disruption to nuclear plant operations. While most of its nuclear infrastructure is old and would need to be replaced for cost and safety reasons, Japan cannot call for an end to nuclear power and instead must reassess its entire energy policy.

The country has announced a stronger move towards renewable energy – however, building the required infrastructure will take decades. In addition, while renewables, like nuclear power, produce relatively little carbon, they are generally intermittent sources of energy that need backing-up.

The development of other types of reactors that are deemed to have greater safety benefits, for example those running on thorium rather than uranium, may curb the costs of nuclear power plants. By turning more nuclear waste into fuel, new reactors may also address the issue of storage and introduce additional economies. But the technology is still in development and it will be some time before it can operate at scale.

Overall, we are positive about the progress and efforts nuclear plant operators have made in risk management and governance. However, the rising costs associated with decommissioning, clean-up and damages mean that substantial concerns about their businesses and financial positions remain.

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Paying the price – dealing with the after-effects of pharma scandals

Engagements with pharmaceutical (pharma) companies are crucial as they deal with increasingly hefty fines and damage to their reputations.

Setting the scene

Controversies seem to have accompanied the pharma sector for decades. The thalidomide scandal of the 1950s and 1960s anticipated further high profile controversies in recent years, including corruption, product recalls, a lack of availability of drugs in developing countries and public concern over poor governance practices, particularly with regard to remuneration. Many pharma companies need to implement reforms to avoid fines and litigation costs becoming part of substantial regular business expenses and to avoid value destruction and subsequent lower shareholder returns.

Bribery and Corruption

Each year billions of dollars are siphoned from the world's health spending into private hands in both emerging and developed countries. And the problem just keeps growing.

While between 1977 and 2011, the healthcare sector accounted for 12% of all international bribery enforcements brought by the US Foreign Corrupt Practices Act (FCPA), according to Trace, in 2012 the pharma and medtech sectors made up around half of all US settlements under the same legislation.

As regulators step up their efforts to crack down on malpractice, and tougher legislation such as the UK Bribery Act has come into force, the level of fines imposed on pharma companies has skyrocketed. In 2012, the FCPA regulator handed out the sector's biggest fine to date – $3 billion – to GlaxoSmithKline for the promotion of drugs for unapproved usages, failure to report safety data and payments of kickbacks to doctors.

Other pharma companies have also been investigated for paying bribes to officials and healthcare professionals in China. The steep increase in fines and falling sales in countries where alleged offences have been committed all jeopardise the financial returns of pharma companies, and we believe there is significant value to be added through engagement on this issue.

EOS encourages the implementation of global policies and adherence to the standards set out by the FCPA, the Physician Payment Sunshine Act and the Bribery Act. In addition, 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 their employees across all of their operations.

Although 35% of the world's pharma sector is headquartered in the US, it is a global industry, so the appropriate management of geopolitical risks is crucial. In this context, we have pressed companies to implement robust policies and management mechanisms to mitigate emerging market risks. We also urge companies to demonstrate their ability to cope with changing regulatory environments and reduced state healthcare budgets. As new allegations of corruption and bribery continue to emerge we will probe and monitor the processes in place to ensure anti-corruption policies and programmes are rolled out across all sites and operations.

Product development and risk

Product recalls have blighted the pharma industry but there are also risks in research and development (R&D) and the marketing of products. Mispriced, counterfeit, off-label and poor quality medicines frequently enter companies' distribution channels because of bribery. Product recalls meanwhile signal a lack of quality control and oversight of operations at a regional and global level, and are sometimes linked to poor due diligence around M&A activity.

In our engagements, we promote a robust and ethical pipeline development programme. Our objective is to ensure sufficient diversification and the timeliness of new product development. To mitigate product recalls and associated litigations, we seek better disclosure and management of risks related to product safety, including the introduction of effective anti-counterfeiting mechanisms. Clinical trials ought to adhere to the highest ethical standards – the principles of the Declaration of Helsinki and local good clinical practice guidelines – and appropriate training needs to be given to relevant members of staff.

Access to medicine

Unfortunately, access to medicine (ATM) is often considered as a purely philanthropic exercise to alleviate poverty, when in fact it should be incorporated into business strategy. This is because, in addition to supporting companies' licences to operate, ATM programmes pave the way for participating fully and sustainably in new high-growth emerging economies. But while some pharma companies have a desire to tap into markets such as China and India, there can be a disconnect between policy and implementation. Developing markets may, for example, favour generics, leading pharma companies to fear the loss of their intellectual property.

As new allegations of corruption and bribery continue to emerge we will probe and monitor the processes in place.

We advocate the allocation of adequate resources to R&D. In particular, we encourage companies to shift from a pure focus on developed market diseases and newer versions of existing drugs to the development of new drugs for currently under-researched diseases. We have been successful in encouraging a number of pharma companies – those open to participation in the programme – to incorporate ATM as part of their business strategy. As a result of our engagements, the position of certain companies on the ATM index has significantly shifted upwards and we continue to benchmark their performance against the ATM index, where appropriate.

Corporate culture

The increase in the number of complexities, geographies and risks in the pharma sector requires the right board composition, skills and understanding. Therefore, EOS pursues appropriate board diversity and attributes, including expertise in risk management, as an important engagement objective.

Executive pay ought to be properly and effectively linked to company and individual performance. We therefore encourage the use of metrics that promote improved corporate behaviour and culture and enhanced transparency of pay policies and practices. As part of this, we promote the *Remuneration Principles for Building and Reinforcing Long-term Business Success*, which we produced with the UK's National Association of Pension Funds and other investors. This is particularly pertinent given the time it takes to bring a new drug to market.

As best practice, we encourage the adoption of clawbacks for violations of healthcare codes and regulations and misconduct to recoup pay. This practice should not exclusively apply to financial misstatements. As a result of our engagement – which at times took place in collaboration with other investors – such policies were introduced at several companies. Holding periods of variable pay schemes were also extended at AstraZeneca and GlaxoSmithKline.

Poorly structured remuneration schemes for sales staff meanwhile have driven negative behaviour in pharma companies and been a key force behind payments of bribes. Higher variable pay linked to individual sales quotas, which has been the traditional way of compensating such staff, can, without adequate controls, indirectly incentivise the use of inappropriate influencing strategies.

As part of our engagement with pharma companies, we urged them to make use of other performance metrics – such as customer satisfaction, quality of service and client retention – in the assessment of their sales force. The initial fear that top sales people would leave companies if such reward structures were put in place turned out to be unjustified. Instead staff have welcomed the move as it lessens the pressure on them.

Engagements with boards

As the pharma industry has grappled with the issues mentioned above, we have also engaged with companies on the structure of their boards. The right skills on the board and regular refreshment are crucial in the enforcement of anti-corruption policies as well as in maintaining oversight of their pipelines. It is essential that boards have a clear understanding of what is required to take a drug from its first stages of development to wider commercialisation.

For a strong leadership structure, we encourage the appointment of independent directors as well as a separate CEO and chair structure. Some companies have appointed individuals with emerging markets expertise to the board to help with their understanding of local markets and their subsequent launch of operations in these countries. We will continue to engage with companies on these issues.

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Governance

The leaders of the pack – more countries follow in the footsteps of the UK Stewardship Code

EOS has engaged with regulators in various jurisdictions to help draft their respective stewardship codes and encourage their implementation, thereby promoting a greater appreciation of the rights and responsibilities of investors globally.

Setting the scene

When international law firm Freshfields Bruckhaus Deringer concluded in 2005 that the integration of environmental, social and governance (ESG) factors into financial analysis was not only permissible but actually part of fiduciary duty, it challenged the then widespread opinion that undertaking ESG and stewardship activities may be in breach of the responsibilities of institutional investors. Most recently, the UK Law Commission's preliminary consultation paper on the fiduciary duties of investment intermediaries cemented the Freshfields view, effectively overruling the Cowan vs Scargill case from 1985, which had implied that institutional investors should invest to maximise financial returns regardless of the long-term impact of their investment decisions. The integration of ESG factors into fiduciary duty is reflected in the UK Stewardship Code and its various international counterparts, which aim to enhance the quality of engagement between asset managers and companies in order to improve shareholder returns over the long term.

UK

Following its publication in July 2010, the UK Stewardship Code quickly became a global trendsetter. The UK already had a corporate governance code, but this new comply-or-explain code issued by the Financial Reporting Council (FRC) specifically addressed institutional investors and suggested that part of their fiduciary duty was to behave as a good owner of companies. Because it asks for an explanation in case of non-compliance, it forces asset managers and owners to reflect publicly on their activities, promoting an investment market response to the quality of stewardship of fund managers. Changes to the Stewardship Code made as part of its 2012 revision clarified the respective stewardship responsibilities of asset managers and owners, including those stewardship activities that they have chosen to outsource. The amendments also call on investors to explain more clearly how they manage conflicts of interest, the circumstances in which they will take part in collective engagement and the use they make of proxy voting agencies. Another amendment encourages asset managers independently to verify the processes that support their stewardship activities in order to provide greater assurance to their clients.

EOS has actively supported the Stewardship Code from its inception and is one of its numerous signatories. However, the code is still in its relative infancy and behavioural change will take time. There have been signs that more engagement on a wider range of issues is taking place between large companies and their major shareholders and that there is a growing demand from asset owners for their investment managers to apply a meaningful approach to stewardship. Investors are increasingly expected to aspire to the same levels of transparency they expect of the companies in which they invest. However, to date, many statements on compliance with the UK Stewardship Code give little insight into investors' actual practices.

Netherlands

The Netherlands was one of the first countries to introduce guidance similar to the UK code, with the *Best practices for engaged ownership* developed by the Dutch corporate governance forum Eumedion. The code, which consists of 10 best practice provisions, is directed at all of Eumedion's domestic and international participants and is based on a voluntary apply-or-explain basis. The statement on the degree of compliance must be shown in the annual report or placed on the website of the institutional investor. Eumedion participants, including EOS which also holds a board position, believe that responsible use of shareholder rights strengthens the checks and balances on listed companies, which are key to creating long-term value for companies and stakeholders. The June 2011-adopted code has gained plenty of traction, with more than 70 Eumedion participants.

South Africa

The Code for Responsible Investing in South Africa (CRISA) works on an apply-or-explain basis and consists of four principles. It differs from other stewardship codes in that it explicitly states that institutional investors should incorporate environmental, social and governance (ESG) factors into their investment analysis and activities, as part of their delivery of superior risk-adjusted returns to the ultimate beneficiaries. CRISA was developed after regulators realised the latest version of the King Code of Corporate Governance (King III) in 2009, like its predecessors, had failed to adequately address institutional investors. Although the final version of King III did refer to institutional investors as part of the governance system, the South African Institute of Directors set up the CRISA committee to develop the code, which was published in 2011. CRISA has been hailed by many as a great example of a code that goes beyond governance to include the full set of ESG principles, but there have been suggestions that application of the CRISA principles to date could have been stronger.

Switzerland

In response to growing political pressure, umbrella organisation economiesuisse, institutional investors, proxy advisors and regulatory authorities joined forces in 2011 to develop the *Guidelines for institutional investors governing the exercising of participation rights in public limited companies*. Alongside the Swiss Code of Best Practice for Corporate Governance, which addresses listed companies, the 2013-launched guidelines supplement the existing self-regulation instruments on good governance. The guidelines consist of five principles and again are based on a comply-or-explain approach. But unlike other stewardship codes, this is focused on voting and does not refer to dialogue or engagement.

Further, Switzerland became the first country to introduce a binding say-on-pay following the backing by the Swiss electorate of the Minder initiative against excessive remuneration. This means that with effect from 2015 Swiss pension funds will have to vote annually, and in the interests of their members, on the compensation of the board of directors, executive board and advisory committee of all of their domestic shareholdings. They will also have to disclose their votes at least once a year.

Italy

The Italian Stewardship Code, which was published in late 2013, leans heavily on the *European Fund and Asset Management Association (EFAMA) Code for External Governance*, which in 2011 provided a framework of six high level principles and best practice recommendations for asset managers to follow when engaging with investee companies. The Italian investment management association Assogestioni adopted the *Stewardship principles for the exercise of administrative and voting rights in listed companies* in order to stimulate discussion and collaboration between management companies and listed issuers. There is reason to be optimistic about this development as previous corporate governance efforts in Italy – such as the requirement for full disclosure of governance data and AGM minutes, the country's comply-or-explain corporate governance code and the Corporate Governance Committee – have led to an improvement in company behaviour, transparency, controlling mechanisms and attendance at shareholder meetings.

Japan

Japan is in the final stages of developing and implementing the *Principles for Responsible Institutional Investors*, also known as Japan's Stewardship Code. We responded to the public consultation on the draft version and largely agreed with the proposed principles and comply-or-explain approach. We were particularly supportive of the notion that the stewardship responsibilities of institutional investors should go beyond voting to also include proper monitoring of and constructive dialogue with investee companies. However, we suggested that Japan's Financial Services Agency develop practical guidance for the disclosure and implementation of key principles. The development of the code represents a switch from a traditionally rules-based corporate culture to one based on principles and is a significant step forward in responsible investment and ownership activities in Japan. With a new government in place, Japan looked at ways to foster sustainable, longer-term growth, and, taking the UK as an example, set about doing so with the new code. Institutional investors have until the end of May 2014 to join the initial list of signatories.

Malaysia

Like Japan, Malaysia has proposed its version of a stewardship code – *the Code for Institutional Investors* – and we have been actively involved in its development. The comply-or-explain code consists of a set of principles calling on institutional investors to discharge their stewardship responsibilities through proactive engagement and voting. We responded to the public consultation on its draft version by the influential, government-sponsored Minority Shareholder Watchdog Group (MSWG) and the Securities Commission of Malaysia. Although we supported most of the principles, we noted our concerns about some inappropriate or overly prescriptive guidance notes. We subsequently met the CEO and senior executives of MSWG and the Securities Commission and were pleased to hear that our concerns will be taken on board in the drafting of the final version. We will continue to participate in the finalisation, launch and implementation of the code in the market, which is scheduled for mid- 2014.

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Wind of change – why India's governance reform is blowing in the right direction

EOS has been engaging with regulators in India to help reform its corporate governance structures and standards.

Setting the scene

India has been undergoing a quiet revolution over the past months with regard to its corporate governance standards. New laws such as the *Companies Act 2013, the Lokpal Act and the Land Acquisition Act* have all come into force, while the new listing rules of the Securities and Exchange Board of India (SEBI) will take effect on 1 October 2014, just a few months after the country's general elections. To date, one of the biggest barriers to change has been the influence of society and in particular family on the way companies and their boardrooms are run. Customs, traditions, personal and family relationships all influence leadership structures and styles, in particular board composition, the choice of independent directors and succession planning. We have acknowledged these sensitivities in our engagement and are beginning to see the green shoots of a corporate cultural change.

EOS' engagement

EOS' relationship with regulators in India is a longstanding one. The corporate governance and related changes recently introduced to a large extent reflect what we have been pushing for in our dialogue with regulators. As part of our public policy work, we have lobbied several regulators and other important parties including SEBI, the National Stock Exchange, the Bombay Stock Exchange, the Confederation of Indian Industry (CII), the Ministry of Finance and the Ministry of Corporate Affairs (MCA). We have also included policy objectives in our engagements with companies, always conscious of the fact that governance is very much driven by social conventions in India.

The Lokpal Act

There has for a long time been widespread public concern about bribery and corruption in India following a series of scandals. One of the biggest corruption cases to date has been the alleged mis-selling of telecoms licenses by a former minister. The scandals that have befallen the country are reflected in the position in the Corruption Perceptions Index produced by Transparency International – India ranked 94th out of 177 countries in 2013. In response, India passed its anti-corruption bill – officially known as the *Lokpal and Lokayuktas Act* – at the end of 2013. The initial bill was tabled two years earlier but lengthy debates and deferrals slowed its introduction. It finally came into force on 16 January 2014.

The Companies Act 2013

The original Companies Act dates back to 1956, which is why an update was long overdue, and after five years of consultation, we are pleased that the Act finally has finally arrived. The new Companies Act provides greater clarity in a number of areas, such as limits on the number of directorships held by individuals and improvements in audit and accounting practices.

The SEBI Listing Rules

The passing of the Companies Act in turn spurred SEBI to draft new listing rules, as the old ones, given the corporate scandals that occurred in the country, were deemed insufficiently stringent. With the new rules, SEBI introduces significant mandatory changes to company structures. For example, it now requires companies to have a nomination and remuneration committee, which must consist of three or more non-executive directors. Independent directors need to make up at least half of the members in this committee.

After lobbying for such representation on this committee, we are particularly pleased that SEBI has included these requirements in its listing rules. We believe that this new structure facilitates greater transparency around decision-making and succession-planning, particularly at companies with a strong family influence.

In addition, SEBI introduced a board evaluation process that includes an assessment of the performance of directors. We had already encouraged companies to implement board evaluation results ahead of this mandatory change, under the leadership of the chair. This is particularly important where there are major shareholders – so-called promoters – who may enjoy close personal ties with certain board members.

We had also called for whistleblowing mechanisms to be introduced at companies with regard to related party transactions. These mechanisms are now compulsory under the new SEBI rules and allow minority shareholders to express any concerns by voting on a special resolution.

Board diversity

SEBI recognises that diversity, in all its aspects, serves an important purpose for board effectiveness. It has unexpectedly fast-tracked a quota for women on company boards, overtaking many developed companies and the EU in their approach to dealing with gender diversity issues. This means that larger listed companies must have a female director on their boards from 1 October 2014. We are supportive of initiatives to increase gender diversity, and in the same spirit encourage companies to ensure the appropriate diversity of skills and expertise on their boards.

Corporate Social Responsibility (CSR)

India's MCA first introduced the *Corporate Social Responsibility (CSR) Voluntary Guidelines* in 2009, which led to improvements in CSR reporting by some companies. These guidelines have now been incorporated in the 2013 Companies Act, meaning that larger companies have to spend on average 2-3% of their net profits from the last three years on CSR activities.

We have highlighted to the regulators that the success of this initiative lies in the companies' approach to the integration and understanding of environmental, social and governance (ESG) risks to their businesses. It is important that this money is used to ensure that these issues are incorporated into business-as-usual rather than simply to fund corporate philanthropy.

Land Acquisition Act

During many of our engagements, we have discussed land acquisition, which has received plenty of local and international interest. Until recently, the principal law was still based on the British enacted Land Acquisition Act of 1894, meaning a review was well overdue.

We therefore welcomed the *Right to Fair Compensation and Transparency in Land Acquisition, Rehabilitation and Resettlement Act of 2013*, which strives for a balance in addressing the concerns of farmers and those whose livelihoods depend on the land being acquired, as well as in facilitating land acquisition for industrialisation, infrastructure and urbanisation. The new law helps companies in dealing with community relations and greater harmonisation between local and state regulation.

Implementation

The latest rules and regulations seem robust. But despite our cautious optimism that these long-awaited improvements to governance will result in positive changes, we need to await their implementation and observe how companies will report to the regulators on the new requirements. Ahead of the SEBI rules coming into force, we have been encouraging companies to evaluate the impact of the new regime and move away from a traditional compliance-driven approach towards an understanding that ESG risks need to be assessed and managed or mitigated in the same way as any other risk the company faces. We will continue to engage with Indian companies and regulators in this regard.

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Strategy

Engagement on strategy

Many of the most successful engagements undertaken by EOS combine discussions of business strategy and structural governance issues.

Overview

EOS adopts 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

Independent directors

We welcomed the appointment of the first two independent directors to the board at an information technology company, particularly as it had long appeared reluctant to embrace corporate governance reform and its combined chair/CEO was one of the most influential figures in the country's business federation, which had been a powerful opposing force to legislative reform. We probed the background to the nomination process. The company denied that it had been entirely opposed to the appointment of independent directors, stating that it had taken time to find appropriate candidates. We are also pleased that the company shares our view that its current board size of 21 members is too large to function efficiently. It will propose a reduction to 19 at the upcoming AGM and plans to decrease it further in future. We pointed out that its board, which consists solely of male nationals, lacks diversity for a company operating on such a global scale.

The company described its efforts to promote women to senior positions, highlighting the appointments of non-national senior executives and adding that it expects to appoint foreign nationals to the board in future. We queried how the succession planning for its powerful chair is going, not least given his long tenure. The company has a management school system, which trains selected candidates for senior management positions. We were also pleased to learn that the company has clear metrics in place to link executive bonuses to performance. We encouraged it to consider disclosing such details going forward.

Publication of candidates' names

We were pleased about the publication of the candidates' names ahead of the AGM of an emerging market energy company, as a number of investors, led jointly by EOS, had engaged with the company and other stakeholders to encourage the nomination of two director candidates to represent the interests of minority shareholders. A domestic investor nominated the incumbent preference shareholder representative, who with 13 years on the board is the company's longest-serving director and has clear links to the national government. Our group of investors nominated an experienced financial industry professional who has strong corporate governance credentials and is free of government ties. With regard to ordinary shares, our group of investors nominated the incumbent director as the representative for ordinary minority shareholders, who has been on the board for a year as the sole representative of this group. In addition, the investor group nominated the incumbent member of the body in charge of overseeing audit issues and his alternate to serve for another one-year term.

The disclosure of minority nominees alongside the other candidates increases the transparency of the election process and signals improvements in corporate governance practices in the country. EOS had been engaging with its regulator on this issue and we were pleased that the regulator recommended in its annual letter on regulatory issues that shareowner-nominated director candidates should be included in a company's AGM material together with the candidates proposed by a firm's controlling shareowners. We therefore decided to support all management resolutions and elect our slate. We believe the appointment of the candidates we nominated will bring greater independence and new perspectives to the company's board. However, while the company has made progress in improving the balance of its board during the last year with the appointment of an independent director and independent members to the body in charge of overseeing audit issues, governance remains a critical issue for the company. In particular, the opaque pricing policy for petroleum products has been detrimental to shareholders in recent years and this may hinder the company's ability to invest and grow over the longer term.

Succession planning

We spoke at the AGM of a European conglomerate, reiterating the concerns we had raised, together with a group of other investors, in a recent letter to the chair on the work of the supervisory board. We particularly challenged the way the CEO succession was handled in the summer of 2013 and the consequences for the reputation of the company following numerous press leaks and public acrimony on the supervisory board. In line with our intensive engagement over the past years, we also requested the right expertise on the supervisory board to support the company in its future development. We pressed for a timely succession planning for the chair and urged him to present a successor by the AGM in 2015 at the latest. Our statement was supported by a number of American and European investors and well received by the audience. A number of respected national institutional investors backed our analysis of the poor performance of the supervisory board. The company acknowledged our message and the chair now appears prepared to look for a successor in a timely manner and to leave before 2018.

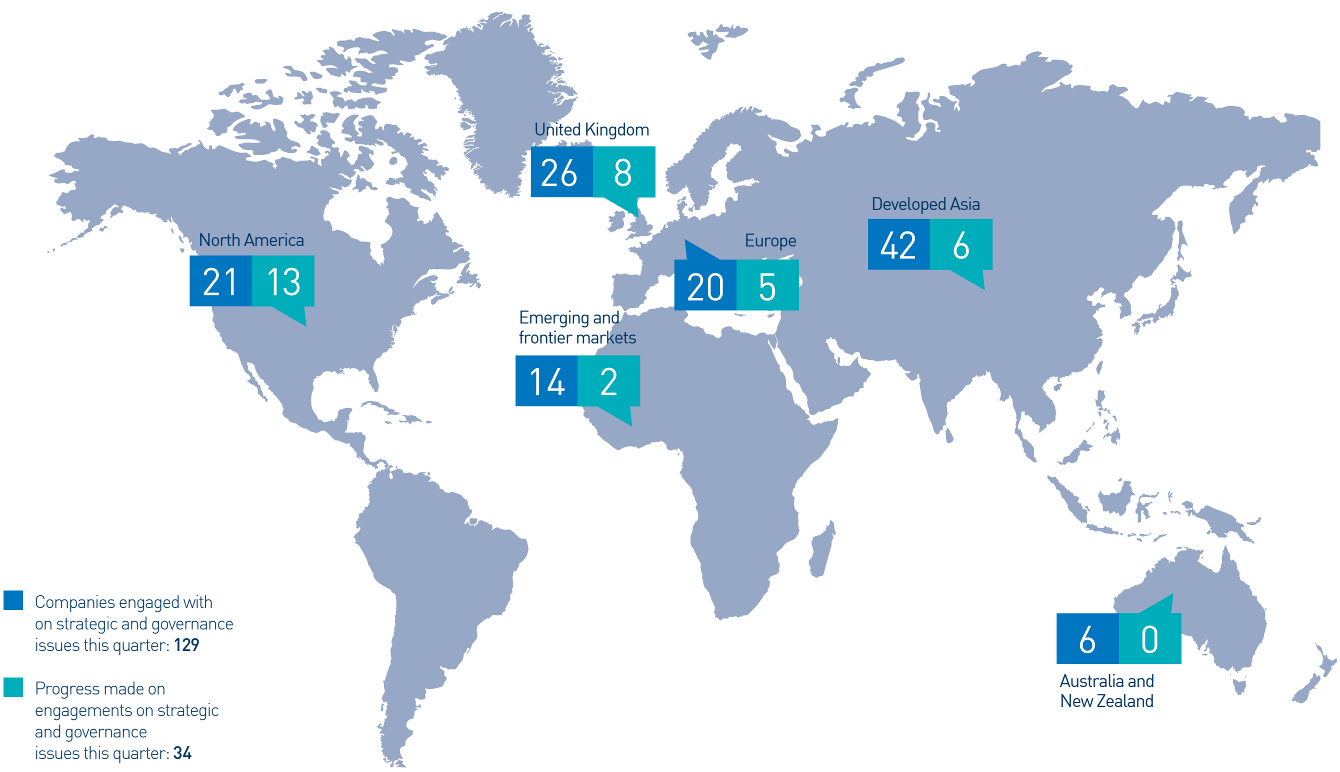
New chair and CEO

We were pleased with the announcement of a new CEO and chair at a North American company. Having expressed our view to the lead independent director that the board should encourage the founder to step aside from the chair in favour of an independent director, we are delighted that the former lead independent director is now in this role. We believe that the assignment of new duties to the former chair may be an elegant solution to his continuing board presence, but much will depend on the support the new CEO receives from the new chair and the rest of the board, as well as the conduct of the former chair and former CEO. We had an encouraging introductory call with the new chair to discuss his appointment and that of the new CEO. We learned that it was the CEO's track record of success within the company, together with his experience in the business area, which outweighed the advantages of an appointment of an external candidate. We were assured that both the chair and the CEO are capable of standing up to the founder and that it was the CEO who had requested the founder's assistance, leading to his new role. We made it clear that we did not want the chair to step down and his role to be recombined with the CEO's after an interregnum and were strongly reassured that this would not be the case. We also stated that the chair's external responsibilities should include meeting investors on governance matters, although we agreed that other external commitments for the company should be undertaken in agreement with the CEO. We were encouraged by how the chair described his role otherwise, in particular his role to mentor and counsel the CEO. We made it clear that the former CEO should retire from the board and we expect this to be the case before too long. We were pleased to hear that the board is planning its own refreshment and suggested possible attributes to consider in candidates. We also received some reassurance about the role of an early investor in the company who had been on the board for a prolonged period. The new chair appears mindful of the company's recent problems and is focused on improving performance. We will follow up with the company to reconfirm the points that we made. Thereafter, we will wait until the CEO announces his strategy before considering our next steps.

Remuneration

This UK company published its annual report, which confirmed the changes we had encouraged in relation to remuneration. It has now added clawback, a penalising malus clause and extended holding periods to its variable pay schemes, meaning we were able to conclude our remuneration objective with the company. While we will continue to push for structures that take into account a longer-term view of performance, however, we believe that the amendments the company's remuneration committee has made satisfy our initial concerns. The success of the implementation of these structures will be demonstrated in part by the response to the bribery and corruption difficulties the company is experiencing in China, which we will continue to monitor. We will also press for firm accountability, including in pay, if required.

Engagements on strategy and governance issues



Public policy and best practice

Protecting and enhancing value by promoting better regulations

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.

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, 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.

Highlights

Stewardship Codes in Asia

As discussed on pages 8-9, we welcomed the draft of Japan's Stewardship Code, which is officially known as the Principles for Responsible Institutional Investors, and subsequently signed up to it. We will continue to work closely with the regulators and domestic institutional investors to share best practices in implementing the code. Similarly to the Stewardship Code in the UK and Japan, the newly proposed Code for Institutional Investors in Malaysia will consist of a set of principles and operate on a comply-or-explain basis. We were assured that our concerns about some overly prescriptive guidance notes will be taken on board in the drafting of the final version.

New SEBI listing rules

After lobbying the Indian regulators to make enhancements to corporate governance requirements over the last five years, we were pleased to note that many of our recommendations have been incorporated into the new listing rules by the Securities Exchange Board of India (SEBI). We believe that these new company structures facilitate greater transparency around decision-making and succession-planning, particularly at companies with a strong family influence. SEBI also agreed to share with us its board meeting minutes on the outcome of the 2013 consultation, which will give us some insights into how decisions were taken, particularly on the rationale not to pursue a stewardship code in India.

IIGCC in Germany

We had a series of meetings with senior German government officials, together with other members of the Institutional Investors Group on Climate Change (IIGCC). Germany has committed to increasing the proportion of renewables in its energy mix and is keen to resolve some of the paradoxes resulting from the increase in gas prices, such as the preference for cheap coal over more climate-friendly gas, which led to a 2% rise in the country's emissions in 2013.

The investor group demonstrated its clear support for ambitious renewables targets, adding that it sees a 40% cut in greenhouse gas emissions as a minimum reduction target. We reiterated our support for a strong Emissions Trading Scheme, pointing out that to date it has not had an impact on energy costs. Overall, this was a good opportunity to present the joint IIGCC position on the 2030 climate framework and to explore any potential obstacles to European legislation and an international climate deal prior to the UN's climate summit in September 2014.

Other work in this quarter included

Promoting best practice

- We met with senior executives of the Bursa Malaysia stock exchange to discuss the proposed stewardship code, enforcement of the local corporate governance code and a planned ESG index due to be launched this year. We were pleased to hear that Bursa executives are closely involved in the development of best practice in corporate governance and stewardship activities. We discussed the role domestic and foreign institutional investors should play in this regard and the likely implications of the proposed stewardship code.
- Through the Company Reporting and Auditing Group, we met representatives of the largest six audit firms in the UK to discuss a number of topics. We exchanged views on the new audit reports required under IAS700 and provided some thoughts on areas where best practice in the industry could be helpful to demonstrate, such as independence and due diligence during the tender process and procedures for managing deteriorating relationships between a company and its auditor.
- We met with the chair of Brazil's securities exchange commission (CVM) to continue our dialogue on governance. The chair showed his appreciation for our recommendations on related party transactions and the nomination and election of directors. He said CVM is producing a circular aimed at clarifying some points in its rules that are currently open to interpretation. It will also nudge companies towards better practice in the nomination and election process of directors.
- We spoke about corporate engagement alongside French pension funds and the UK Sustainable Investment and Finance Association (UKSIF) at a seminar organised by the French Social Investment Forum, comparing UK and French practice. We made concrete suggestions for fostering corporate engagements and board accountability in France, such as a legal status for the lead independent director and the separation of the roles of chair and CEO.
- We participated in a call and survey conducted by Hugessen Consulting on governance and pay issues. We expressed support for broadened use of management pay ratios and vertical pay benchmarking in Canada. We agreed that pay-for-failure was a problem that needed attention in Canada although we are somewhat sympathetic due to the nature of Canadian employment law.
- We responded to the consultation by the Principles for Responsible Investment (PRI) on the draft scope for the PRI Governance Review. While agreeing with much of the draft scope, we encouraged that the review also explicitly consider a single rather than a multiple governing bodies' structure.
- We met with the conference board and representatives from Indian blue chip companies, including Infosys and Reliance Industries. The purpose of the event was to exchange frank and open views on how companies can develop their environmental, social and governance practices, in light of Indian reforms, such as the introduction of the 2013 Indian Companies Act, revised listing rules and voluntary guidance on sustainability reporting.
- During a meeting with senior executive directors of the Tokyo Stock Exchange (TSE) we again called for a Corporate Governance Code in Japan and urged TSE to take leadership in this regard. We would welcome the development of the Principles of Corporate Governance for Listed Companies published by TSE into a practical framework or Code on Corporate Governance in Japan to ensure that its high-level principles become widely accepted best practice.

Public policy

- We attended a roundtable on Brazil's new anti-corruption law – the Clean Companies Act – which came into effect on 28 January 2014. There has been widespread public support for and political commitment to developing anti-corruption structures in Brazil following high-level cases of endemic corruption. This law represents a shift in the way bribery and corruption is dealt with in the country and potentially is a strong tool to combat these crimes.
- After some months of gestation, the Shareholder-Investor Exchange engagement protocol, to which we have been contributing, was launched this week with considerable interest from the financial media. We have received a number of inquiries from pension funds and investor organisations about the initiative, which we believe will help encourage more and better quality engagement between US directors and investors.
- At a meeting of the Canadian Coalition of Good Governance's (CCGG) Public Policy Committee, of which we are a member, the latest initiative of Industry Canada, a consultation paper outlining possible amendments to the Canada Business Corporations Act was discussed. The committee agreed to focus mainly on shareholder rights issues and, in connection with our discussion on proxy access, we recommended that the CCGG response press for the elimination of all constraints on shareholder communications.
- Together with other investor members of the Asian Corporate Governance Association (ACGA), we visited the Financial Services Agency of Japan to exchange views on the implementation of Japan's new Stewardship Code. We stressed the need for a Corporate Governance Code in Japan, which we believe is essential for building consensus around standards and for setting aspirational targets for companies.

Working with other shareholders

- We participated in a call with other members of the Asian Corporate Governance Association (ACGA) to discuss various issues and initiatives in Asia. In our discussion about its strategy for Korea, we suggested addressing the issue of bribery and corruption from a governance angle. To raise common issues such as the approval of unaudited financial statements at AGMs, we co-signed letters to Korean companies and regulators.
- We met with the Carbon Disclosure Project's (CDP) head of Brazil and Latin America to discuss partnership and potential joint projects, as well as the current state of carbon reporting in the region and the key objectives for 2014.
- As the only buy-side investor representative, we participated in a roundtable with politicians, NGOs, small exploration and major oil and gas companies to explore what responsible fracking in the UK might look like. As the industry representatives felt unfairly targeted in the media and by an ill-informed public, we encouraged the industry to realise that it had to embrace stakeholder concerns and be seen as a willing participant in dialogue and in regulation. We also called on the industry to better explain the climate change benefits of replacing coal with responsibly fracked gas.

EOS 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 at a company in which our clients have a significant holding 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.

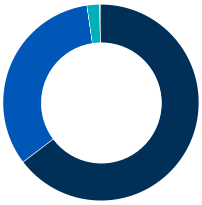
Hermes votes at company meetings all over the world, wherever its clients own shares.

Overview

Over the last quarter we voted at 1,316 meetings (10,317 resolutions). At 435 of those meetings we opposed one or more resolutions. We voted with management by exception at three meetings and we abstained at 27 meetings. We supported management on all resolutions at the remaining 851 meetings.

Global

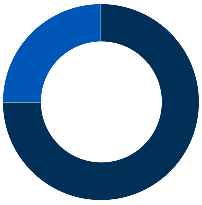
We voted at 1,316 meetings (10,317 resolutions) over the quarter.



- Total meetings voted in favour **64.7%**
- Meetings where voted against (or voted against AND abstained) **33.1%**
- Meetings where abstained **2.1%**
- Meetings where voted with management by exception **0.2%**

Australia and New Zealand

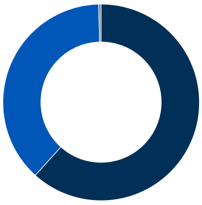
We voted at 24 meetings (106 resolutions) over the quarter.



- Total meetings voted in favour **75.0%**
- Meetings where voted against (or voted against AND abstained) **25.0%**

Developed Asia

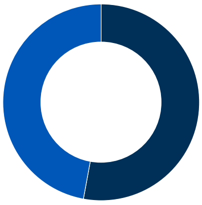
We voted at 483 meetings (2,956 resolutions) over the quarter.



- Total meetings voted in favour **61.7%**
- Meetings where voted against (or voted against AND abstained) **37.9%**
- Meetings where voted with management by exception **0.4%**

Emerging and Frontier Markets

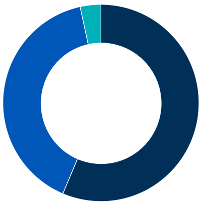
We voted at 225 meetings (1,715 resolutions) over the quarter.



- Total meetings voted in favour **52.9%**
- Meetings where voted against (or voted against AND abstained) **47.1%**

Europe

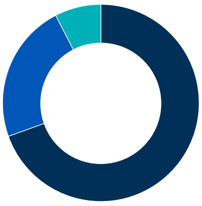
We voted at 174 meetings (2,195 resolutions) over the quarter.



- Total meetings voted in favour **56.3%**
- Meetings where voted against (or voted against AND abstained) **40.2%**
- Meetings where abstained **3.4%**

North America

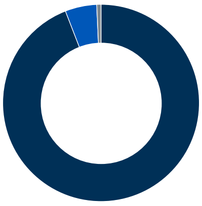
We voted at 275 meetings (2,032 resolutions) over the quarter.



- Total meetings voted in favour **69.5%**
- Meetings where voted against (or voted against AND abstained) **22.9%**
- Meetings where abstained **7.6%**

UK

We voted at 135 meetings (1,313 resolutions) over the quarter.



- Total meetings voted in favour **94.1%**
- Meetings where voted against (or voted against AND abstained) **5.2%**
- Meetings where voted with management by exception **0.7%**

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