Excellence. Responsibility. Innovation.

Q4 2014

Hermes EOS

Public Engagement Report

On the ground in Bangladesh – Hermes EOS' visit to garment manufacturers

This report contains a summary of the responsible ownership activities undertaken by Hermes EOS on behalf of its clients. It covers significant themes that have informed some of Hermes EOS' intensive engagements with companies in Q4 2014.

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

What is Hermes EOS?

Hermes EOS helps long-term institutional investors around the world to meet their fiduciary responsibilities and become active owners of public and private companies. Hermes EOS' team of engagement and voting specialists monitors its clients' investments in companies and intervenes where necessary with the aim of improving their performance. Hermes 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 41 clients and £134 billion* assets under advice.

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

The depth and breadth of this resource reflects our philosophy that 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 EOS has extensive experience of implementing the Principles for Responsible Investment (PRI) and other stewardship codes. Its 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 Hermes EOS to help signatories in meeting the challenges of effective PRI implementation.

How does Hermes EOS work?

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

The Hermes Responsible Ownership 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 dialogue. Some engagements involve one or two meetings over a period of months, others are more complex and entail multiple meetings with different board members over several years.

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

While we are robust in our dealings with companies, the aim is to deliver value for clients, not to seek headlines through campaigns, which can 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 generally contain specific details of our interactions with companies unless they are already public. Rather it explains some of the most important issues relevant to responsible owners and outlines Hermes EOS' activities in these areas.

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

Hermes EOS team

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Engagement professionals


Roland Bosch
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Darren Brady
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Sectors: Oil and Gas


Natacha Dimitrijevic
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Bruce Duguid
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Sectors: Oil and Gas, Utilities


Rochelle Giugni
Sectors: Consumer Goods and Retail, Financial Services


Tim Goodman
Sector lead: Oil and Gas
Sectors: Mining


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


Karin Ri
Sector lead: Utilities
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Sachi Suzuki
Sector lead: Industrials
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Sectors: Consumer Goods and Retail

Business and Client Development


Dominic Burke
Client Relations


Mais Hayek
ESG Integration


Bram Houtenbos
Operations


Amy Lunn
Head of Business and Client Development


James O'Halloran
Head of Operations


Nina Röhrbein
Reporting

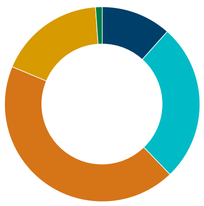

Lucy Saville
Client Relations

Engagement by region

Over the last quarter we engaged with 192 companies on 455 social, environmental, business strategy and governance issues. Hermes EOS' holistic approach to engagement means that we typically engage with companies on more than one issue simultaneously. The engagements included in these figures are in addition to our discussions with companies around voting matters.

Global

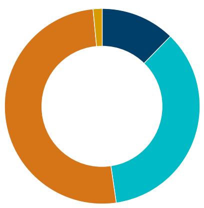
We engaged with **192** companies over the last quarter.



- Environmental **11.6%**
- Social and ethical **26.2%**
- Governance **43.5%**
- Strategy and risk **17.6%**
- Stewardship **1.1%**

Australia and New Zealand

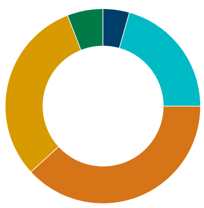
We engaged with **17** companies over the last quarter.



- Environmental **12.3%**
- Social and ethical **35.4%**
- Governance **50.8%**
- Strategy and risk **1.5%**

Developed Asia

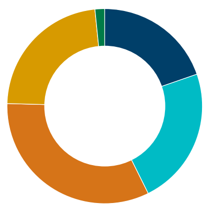
We engaged with **32** companies over the last quarter.



- Environmental **4.4%**
- Social and ethical **20.6%**
- Governance **38.2%**
- Strategy and risk **30.9%**
- Stewardship **5.9%**

Emerging and Frontier Markets

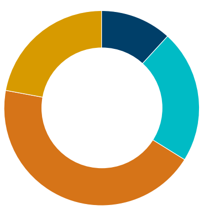
We engaged with **26** companies over the last quarter.



- Environmental **19.7%**
- Social and ethical **23.0%**
- Governance **32.8%**
- Strategy and risk **23.0%**
- Stewardship **1.6%**

Europe

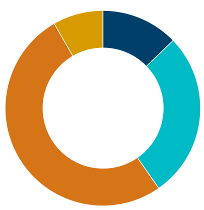
We engaged with **31** companies over the last quarter.



- Environmental **11.8%**
- Social and ethical **22.1%**
- Governance **44.1%**
- Strategy and risk **22.1%**

North America

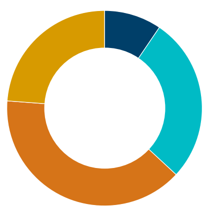
We engaged with **55** companies over the last quarter.



- Environmental **12.8%**
- Social and ethical **27.5%**
- Governance **51.4%**
- Strategy and risk **8.3%**

United Kingdom

We engaged with **31** companies over the last quarter.



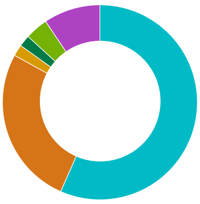
- Environmental **9.5%**
- Social and ethical **27.4%**
- Governance **39.3%**
- Strategy and risk **23.8%**

Engagement by issue

A summary of the 455 issues on which we engaged with companies over the last quarter is shown below.

Environmental

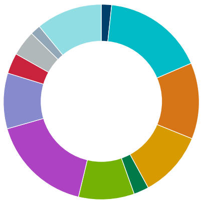
Environmental issues featured in **11.6%** of our engagements over the last quarter.



- Climate change/Carbon intensity **56.6%**
- Environmental management **26.4%**
- Forestry **1.9%**
- Oil sands **1.9%**
- Waste **3.8%**
- Water stress **9.4%**

Social and ethical

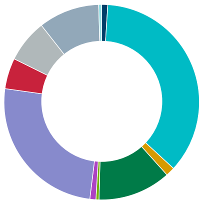
Social issues featured in **26.2%** of our engagements over the last quarter.



- Access to medicine **1.7%**
- Bribery and corruption **16.8%**
- Community relations **12.6%**
- Corporate culture **10.9%**
- Customer relations **2.5%**
- Employee relations **9.2%**
- Health and safety **16.8%**
- Licence to operate **9.2%**
- Munitions manufacture **3.4%**
- Operations in troubled regions **4.2%**
- Political risk management **1.7%**
- Supply chain management **10.9%**

Governance

Governance issues featured in **43.5%** of our engagements over the last quarter.



- Accounting or auditing issues **1.0%**
- Board structure **35.9%**
- Conflicts of interest **1.5%**
- Other governance **12.1%**
- Poison pill **0.5%**
- Related-party transactions **1.0%**
- Remuneration **25.3%**
- Separation of chair/CEO **5.1%**
- Shareholder communications **7.1%**
- Succession planning **10.1%**
- Voting rights – not 1 share 1 vote **0.5%**

Strategy and risk

Strategy and risk issues featured in **17.6%** of our engagements over the last quarter.

- Business strategy **46.3%**
- Capital structure **2.5%**
- Reputational risk **1.3%**
- Returns to shareholders **5.0%**
- Risk management **45.0%**

Stewardship

Stewardship issues featured in **1.1%** of our engagements over the last quarter.

- Reporting/disclosure **60.0%**
- Stewardship code **40.0%**

Environment

Not a waiting game – Why stranded assets need to be addressed now

Hermes EOS engages with companies in the extractives industry and with policy-makers on climate change.

Setting the scene

Climate change has been fast rising up the agenda for institutional investors. Since Mercer published its *Climate Change Scenarios – Implications for Strategic Asset Allocation report in 2011*, an increasing number of investors have tried to address climate change in their assessment of risks and opportunities and asset allocation. For Hermes EOS, an important part of the engagement on climate change with companies in the extractives sector is about stranded assets. According to the Intergovernmental Panel on Climate Change, the power and industry sectors together account for about 60% of total CO_2 emissions. With this in mind, to remain below 2°C global warming, which policy-makers are still trying to achieve at the COP21 climate change conference in Paris in 2015, 60-80% of today's reserves of coal, oil and gas will become unburnable and therefore "stranded." However, company valuation and credit ratings methodologies do not typically inform investors about their exposure to these stranded assets. But with many institutional investors heavily exposed to fossil fuel companies, it is imperative to understand where the biggest risks lie. Overall, Hermes EOS engaged with 42 companies on climate change in 2014 and with many of them specifically on stranded assets and climate change scenario modelling.

Definition

Stranded assets are assets that have suffered from unanticipated or premature write-downs, devaluations or conversion to liabilities, according to the University of Oxford's Smith School of Enterprise and the Environment. They can be caused by a variety of risks, including climate change or the degradation of natural capital, a change in resource landscapes such as the evolution of shale gas, new government regulations such as carbon pricing or air pollution regulation, a fall in clean technology costs, for example, for solar and onshore wind, evolving social norms such as fossil fuel divestment campaigns and changes to fiduciary duty or litigation.

Debate drivers

Initially, climate change legislation – and the potential for a global carbon price – were the main drivers behind the stranded assets debate.

Some companies we have engaged with on stranded assets have tried to push back on the risk presented by climate change legislation. This is due to the uncertainty surrounding it and because they believe that the continuance of a carbon-based world is likely. But the recent climate deal struck by the US and China demonstrates the speed at which changes to the status quo can arise.

The stranded asset debate has also been boosted by the drop in oil price over 2014. This is despite the long-term view of mainstream research that it will continue to rise on the back of growing energy demand. Renewable energies are now also becoming more commercially viable. Concerns by asset owners and fossil fuel divestment campaigns have also added to the pressure on companies.

Affected sectors

The sectors most at risk from stranded assets are oil and gas and mining. Our focus has been less on coal companies, as coal has already begun to strand in the US as a result of the shale gas revolution and clean air regulations. Coal-fired power stations are closing in favour of less dirty gas-fired power plants, therefore resulting in a drop in the price of coal and an increase in the number of US coal producers seeking to export the fossil fuel. This trend is set to continue in the US following the China-US climate agreement on cutting greenhouse gas emissions, with predictions of peak coal occurring in China earlier than expected.

However, the trend has begun to reverse in Europe, where due to cheap coal prices and the phasing out of nuclear power by several countries, coal use by utilities has actually been on the rise. UK utility Centrica, for example, sold three of its combined cycle gas turbines following operating losses as a result of cheap global coal which made the stations too expensive to run.

Corporate and public policy engagement

Hermes EOS has sought to address concerns in relation to carbon and stranded assets. Through the Carbon Asset Risk Initiative, a project by the Institutional Investors Group on Climate Change (IIGCC) and sustainability leadership organisation Ceres, we have engaged with global carbon-intensive companies to understand and address their exposure to climate change risks.

In our engagement, we have challenged companies on their exposure to stranded assets. We have asked them whether they have put a shadow carbon price into their business planning process, pressed them on the future scenarios they are planning for and questioned the extent to which their boards have been discussing stranded assets and stress-testing against different scenarios.

Leaders and laggards

Based on our engagement, miners appear to be the most advanced in addressing the risk of stranded assets. This may reflect the fact that large mining companies are generally less exposed to changes in fossil fuel demand than other fossil fuel extractive companies such as oil and gas players and can exploit alternative opportunities in other commodity types.

In our opinion, the most advanced readiness has been demonstrated by a dual-listed miner, which has a large exposure to coal, iron ore and copper. The company has a clear view on the threat of stranded assets, has engaged with investors on the issue and assessed its diversified portfolio against five scenarios based on the scientific projections of the Intergovernmental Panel on Climate Change (IPCC). Four of these are based on a central case which takes into account the expected levers of US economic recovery, the progressive development of China and India, the integration of developing economies into multi-polar economic environments where global power has shifted as well as action on climate change. Each scenario has a range of inputs and outputs which are applied each year to all assets to see how they will perform over the next 20 years. An additional high impact, low probability scenario was created in 2014. But across all the scenarios, even in the face of a strongly coordinated global cooperation on climate change, the business remains robust thanks to its diversified portfolio.

The company will also focus on three areas of lower carbon technology, namely high-efficiency, low-carbon transportation, fuel efficiency and collaborative work on transport emissions.

In addition, its work on fugitive methane emission technology will continue, as the company has a significant fugitive emissions profile from its coal and petroleum assets. It hopes to improve reporting and measuring of these. As for many of the other extractives companies, carbon capture and storage (CCS) is also of interest and the company is looking for regions where regulatory policy supports CCS investment and where there are appropriate carbon sinks for long-term storage.

Another mining company was equally keen to disclose its scenario work and how a changing energy market could affect its strategy. However, oil and gas companies, particularly those with exposure to capital-intensive operations have been less forthcoming, especially on the details of their scenario planning. Nevertheless, we have had useful conversations with some of these companies, gaining a greater understanding of the risks posed to their business models, the shadow carbon prices they apply and the scenarios which they use to test future plans.

Carbon capture and storage

CCS is viewed by many heavy CO2 emitters as the solution to tackling climate change and stranded assets. According to the IPCC's Fifth Assessment Report, without CCS, the cost of limiting global CO2 emissions to 450ppm could increase by 138%. The International Energy Agency meanwhile says that CCS has the potential to deliver 17% of the required mitigation by 2050.

At a CCS seminar of one oil major, we discovered that, despite being viewed as an interesting business venture, CCS is unlikely to be rolled out across operations in the future without changes to carbon policy. According to this company, a $60-80 per tonne carbon price is needed to make CCS economically attractive. So while CCS could be a game changer, this will only happen if the cost of carbon outweighs the costs of creating a CCS grid. Another challenge is finding appropriate reservoirs for storage. Transportation of the emissions needs considerable expansion to reach heavy carbon emitting operations such as steel, cement and power plants. But from a safety perspective, the technology appears to be relatively low risk. Extractive companies are stating the need for more regulatory support, particularly in operational and capital expenditure aid to develop large scale test sites to prove the concept. However, without meaningful carbon taxation CCS will not be viable.

Positive steps

Encouraging extractive companies to disclose their future energy scenarios and learning how they see themselves affected by climate change is the first step to understanding how their assets are exposed to stranding.

However, the oil majors and their host countries are playing a waiting game to avoid first mover disadvantage. We will encourage oil and gas companies to use a wide range of possible carbon pricing and oil and gas pricing scenarios in their strategic and project planning. Additionally, we will continue to support public policy initiatives during the run-up to the 2015 climate change conference in Paris – such as the EU 2030 Climate and Energy Package – to push for meaningful country and international public policy action to reduce the first mover disadvantage.

Positively, there have been notable changes from some of the big players in the oil and gas sector. A previously strong climate change denier, for example, has started to engage with investors on climate change, while a company with significant oil sands operations believes CCS will become viable, particularly once a material carbon price is in place. By wanting a more meaningful carbon price of $40 or higher, the company and the oil sands industry is ahead of policy in Canada.

The next step will be for companies to explain where they see their businesses in 10 to 20 years and how their capital expenditure plans for 2020 and 2050 are aligned with these future business models. We will continue to work with extractive firms to understand their exposure and also with other investors and relevant organisations to further develop our thinking on stranded assets.

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Social

Apparel everywhere – On the ground in Bangladesh

Hermes EOS took three asset owners on an engagement trip to visit four garment manufacturers in Bangladesh and met a number of key stakeholders while there.

Setting the scene

Bangladesh has a long tradition of producing clothes for global retailers. But it was only when the eight-storey Rana Plaza building on the outskirts of its capital Dhaka collapsed in 2013 – killing more than 1,100 garment workers and injuring thousands more – that the world took note of the plight of these workers. In the wake of the disaster, two initiatives were set up, the Alliance for Bangladesh Worker Safety, which was founded by North American retailers and brands, and the Bangladesh Accord on Fire and Building Safety, which mainly has Asian, Australian and European company signatories.

Both initiatives set out binding, five-year undertakings that aim to improve safety in ready-made garment factories in Bangladesh by inspecting and auditing them.

Due to the strong relationship Hermes EOS has been able to build with global retailers, our requests to visit some of their Bangladesh-based garment manufacturers to find out what has happened in the industry since Rana Plaza were granted.

In search of the workers' voice

Shortly after our arrival in Bangladesh, we were greeted with a billboard advertising the first ever Dhaka Apparel Summit. This was the first sign of many illustrating the sheer scale and influence of the garment industry in the country.

The Apparel Summit was attended by a number of different stakeholders with over 1,000 delegates, including Hermes EOS. But the voices missing from the conference were those of worker representatives. The views of workers are crucial to advancing safety standards in the garment manufacturing industry and these could be further included in the collaboration between buyers, producers, donors and NGOs to help mitigate future disasters. This is particularly important as trade unions are absent from the country.

One of the retail brands we visited arranged for Hermes EOS to speak to a representative of the factory's worker participation committee to understand the workers' perspective. However, under the glare of the supervisors and owner, we were unable to speak frankly with the individual. This raised some questions about how open employees can be on the committee in putting forward any concerns, particularly those relating to their supervisors.

We also visited a helpline set up by the Alliance for Bangladesh Worker Safety. Speaking with the call centre workers gave us an insight into how the information is documented to protect the interests of the workers. It helped ease our reservations about the anonymity of the helpline and whether workers could report to it without fear of reprisal. Encouragingly, fewer safety concerns are now being raised. Instead more calls relate to a lack of payment. The helpline is an important tool, as it allows concerned workers to by-pass management and contact someone independent about any concerns. But we found that overall, more needs to be done on worker welfare.

Factory visits

Due to a shortage of space, factories in Bangladesh are often multi-storey. Therefore they face a unique set of health and safety challenges, which Hermes EOS aims to address through its engagements. Hermes EOS visited the factories of four major suppliers. We had pushed for mid-level range, not best-in-class, factories but generally found their conditions to be satisfactory.

Following the Rana Plaza disaster, the audit system of factories supplying to international retail brands in Bangladesh has been enhanced. We wanted to understand whether or not this has also been accompanied by the necessary behavioural and cultural changes across factories. One factory contracted by a leading brand is solely audited by the Accord and its findings are transferred to Alliance member brands to avoid duplication, which is a common feature of the audit process. It also has a training school and employs approximately 1,000 disabled people, some of whom we met. Based on visual evidence, everything appeared orderly and satisfactory.

Our visit to another factory employing around 10,800 workers, and used by a company with an international reputation for responsible sourcing, proved useful too. In addition to abstaining from production in risky locations such as residential areas, shared buildings and basement production lines, the retail brand assesses the attitude of factory management as part of its initial due diligence. We were surprised to learn that neither training on the retail brand's code of conduct nor testing of how well it is adhered to take place on the ground – something we will raise at our next engagement meeting with the company. To avoid sub-contracting and ensure that the factory is not overbooked, the company explained that a management system calculates the time it takes to produce a garment. Generally the factory, which included a canteen, crèche, pharmacy and children's complex, was in good condition. We also visited the production office of this particular brand which employs a number of people tasked with ethical sourcing.

The investment in health and safety at the two-year old factory of a third brand was reflected in the 97 fire doors that it was equipped with at a cost of $1,500 dollars each. However, we discovered that some fire doors were used as normal exit doors which over time could reduce their effectiveness.

For a fourth retail brand, it was the first time it had taken an investor group to Bangladesh and positively it resourced the trip with key experts. Representatives at the factory it took us to assured us that its employees' work shifts do not exceed 10 hours, even if this means it is unable to fulfil client orders on time.

Optimising resource efficiency in factories is a common issue in Bangladesh with two of the brands we met targeting a resource efficiency rate of 50% rather than the Bangladesh average of 40%. However, the target date and method of reaching this higher efficiency rate often remains opaque. One company explained that its factory could improve its efficiency by increasing automation and providing middle management with training on identifying faults in garments.

Neglected issues

The audits undertaken by the Alliance for Bangladesh Worker Safety and the Bangladesh Accord on Fire and Building Safety initiative have clearly improved safety standards at garment manufacturers in the country. This was confirmed through our visits and meetings with experts from NGOs, embassies and other organisations during the trip. However, some issues seemed to be lower priority.

Environmental issues, for example, appeared to be an afterthought at many factories although at one we saw efforts being made to better manage energy, water and waste. We visited the water treatment plant of another factory and noted strong policies on environmental management.

We also visited a vocational college run by Save the Children which several retailers support. But despite retail brands having such initiatives in place, we felt some cultural issues – such as gender equality and sexual harassment – were largely ignored.

As 80% of the employees in Bangladeshi garment factories are women, but their supervisors are predominantly male, sexual harassment can be a problem. However, this topic remains taboo and is not being documented. One retail brand previously had training programmes in place to deal with sexual harassment in factories but, as this was not seen as an essential part of the company's overall supply chain strategy, the training was stopped. Although one retail brand is financially supporting the advancement of its female factory workers, it is still extremely unusual for women to hold senior positions.

Child labour is often cited as a significant problem in developing countries as desperately poor families seek any available source of additional income. However, children are frequently exposed to low-paid and sometimes hazardous work. The factories we visited ensured that they avoid child labour by asking for evidence – such as dental records – to verify an employee's age.

A visit to the slum of Mirpur allowed Hermes EOS to experience the harsh living conditions of workers in the garment industry and understand the benefits of a fair living wage. One brand is promoting its fair living wage in the region and has a roadmap in place to ensure its targets are met. We encouraged it to collaborate with peers and collectively put pressure on the Bangladeshi government to set a fair living wage.

As the mandates of the Accord and Alliance run for only five years, there is uncertainty over the future safety of workers and buildings after the terms of the initiatives end. It was widely agreed that the Bangladeshi government needs to have trained and deployed its own inspectors by this time. In addition, machinery safety is not covered by the Accord and Alliance audits. This is the responsibility of the individual brands and the Bangladeshi government.

Lessons learned

Based on the experiences of our trip, it is clear that much has been achieved on building and fire safety since the Rana Plaza tragedy. Now the focus needs to be on investment in education for workers, factory owners and the industry on health and safety. Over the next few months, we will provide feedback on our observations to the boards of the retailers whose factories we visited. We will also use what we learned in our engagements with other retailers more broadly.

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Governance

Advances in audit – regulatory developments help asset owners in their engagement on audit issues

Hermes EOS has intensified its dialogue with audit firms as these are required to meet stricter regulations.

Setting the scene

Audits are intended to provide the owners of a company with an independent opinion as to the truth and fairness of its financial statements. But the image of auditing firms was tarnished when the banks to which they had given a clean bill of health collapsed during the global financial crisis. Audit firms were accused of lacking professional scepticism, which was partly attributed to the often lengthy relationships between auditors and companies. Because audit reporting was also opaque, it was difficult to understand how auditors were fulfilling their responsibilities to shareholders. Since then, the profession has been working to regain the trust of investors and the public.

Controversy

In 2014, the UK's largest retailer – supermarket chain Tesco – was hit by controversy when it emerged it had overstated its profits by over £250 million due to issues with commercial income recognition. This was even more surprising as the auditors had identified this as a key area of focus for them and had not reported any related issues to shareholders. The UK's Financial Conduct Authority, Financial Reporting Council (FRC) and Serious Fraud Office have since begun investigations into the matter.

This latest incident highlights the importance of good quality audits for companies and particular for investors. And there are some good audit reports being produced. BP's auditor report, for example, explains the level of interaction the audit partner had with Rosneft, which provides an insight into their concerns and ultimately helps the reader form a view on the quality of the audit. However, bland or boilerplate disclosures suggest the audit process may lack rigour, which signals a need for engagement.

The key aim of Hermes EOS' engagement with audit firms has been to ensure investors are at the forefront of auditors' minds and that this is reflected in the reporting they provide.

New rules

Recent changes in audit regulation have given further insights into the process.

The amendments made to the UK Corporate Governance Code in 2012 included requirements relating to the audit. The requirements ask audit committees, for example, to address any key issues raised by auditors in relation to the financial statements. Equally, the code emphasises the quality of the audit and the independence of auditors. The FRC, which sets the code, expects audit committees to explain how they have assessed the effectiveness of the external audit, how they ensure the auditor's objectivity and independence and how the appointment was made.

The introduction of ISA700 by the FRC a year later meanwhile mandates more meaningful reporting by the auditors, including the scope of the audit, the key risks assessed by the audit and the materiality of those risks.

Auditors' reports must now explain how the auditor applied the concept of materiality when planning and performing the audit, including the thresholds used for the materiality in financial statements. As auditors commonly tend not to audit 100% of a business – instead focusing on the key components of a company to reach the audit conclusion in a cost-efficient way – they also need to explain the scope of the audit. In addition, they now need to describe the most significant risks of material misstatement and how these were addressed.

Although the UK took an early lead in the debate on audit, Europe has been catching up.

In April 2014, the European Parliament adopted a new framework seeking to improve the quality of audit and reinforce the independence of statutory auditors across the EU. It requires audit reports to be more detailed and informative and include meaningful data for investors. Strict transparency requirements will be introduced for statutory auditors with stronger reporting obligations via regulators. The work of auditors will be closely monitored by strengthened audit committees. In addition, the new rules will allow 5% of the shareholders of a company to initiate an action to dismiss the auditors.

Rotation and tenure

According to Exane BNP Paribas, more than a quarter of European companies have not changed statutory auditor for at least 20 years. This is a problem as the ensuing close relationship between auditor and company could damage the independence of the former.

Under the new EU rules, companies will need to change their auditor after 10 years. Member states can choose to extend the 10-year period by up to 10 additional years if tenders are carried out and by up to 14 additional years in the case of joint audits.

Audit firms will also be prohibited from providing certain non-audit services to the companies they audit, such as tax advice and services linked to the financial and investment strategy of the audit client. The aim is to limit the risk of conflicts of interest. The EU also introduced a 70% cap on the average fees generated for non-audit services to companies in relation to audit fees for the last three consecutive financial years.

EU member states must transpose the rules into national law by June 2016.

Challenges

While we welcome the new legislation seeking to improve the audit process and the transparency around it, there are some ensuing challenges. One trend we have witnessed recently is that, because of the high costs of submitting a bid and the perception that they are unlikely to win, incumbent auditors may not reapply for tender. Some companies do not invite the incumbent auditor to participate in the tender process for similar reasons. With four global firms dominating the audit landscape, this means the company is often left with a choice of only three audit providers.

And specialisation in certain areas by some audit firms means that, for many, the choice is fewer than four to begin with. This is further compounded by the number of non-audit services that are now not able to be provided by a firm's auditor. Hermes EOS would like to see an increase in competition in the audit market, and so we worry that some of the rules on retendering and rotation could result in the perverse outcome of reducing competition. However, joint audits may present an opportunity for smaller firms to gain a bigger share of the audit market.

Engagement with audit firms

The disclosures arising from the new rules present an opportunity for investors to read and use them. Positively, more investors have started to engage with companies on the audit process and taken action where necessary.

Hermes EOS has been intensifying its engagement with audit firms on how they are responding to the new rules. We met all of the largest audit firms in the UK as well as a number of the smaller firms in 2014. We pressed them for greater clarity on how materiality thresholds are set and how quality is ensured across the firms globally, as well as more willingness to report on key judgements and opinions rather than just process. In order to flag potential systemic risks, for example in the banking industry, we encouraged auditors in the US to report concerns to the regulators of financial services companies on an anonymised or aggregated basis.

Engagements with companies

In our engagements with companies meanwhile, we have and will continue to press for improved audit reporting.

One positive example is Rolls-Royce. Following a call from the regulator requiring it to change its accounting policies on revenue sharing arrangements with partner suppliers, its auditor – KPMG – commented not only on key risks and the work done to assess them but also provided its findings from the audit process.

A UK bank meanwhile sought our input on a decision relating to its tender in 2014. We discussed possible options and counselled against delaying the tender. Instead, we suggested additional transparency around how the audit tender is conducted to ensure that investors are clear about the process, whatever the outcome.

We have also pursued these themes in other fora. For example, at a US audit committee leadership summit, we called for increased dialogue between audit committee chairs and investors, which to date remains relatively rare.

We will continue to meet audit firms with a view to encouraging best practice. As disclosures improve, we envisage audit becoming an increasingly regular engagement topic for us, not only with the chairs of audit committees but also with the auditors themselves. Those meetings are a step in the right direction in bringing auditors and their underlying clients – the investors – closer together.

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Strategy

For and against – An overview of the 2014 voting season

Regulation, remuneration and shareholder proposals have all shaped 2014's proxy season.

Setting the scene

On behalf of its clients, Hermes EOS votes at all shareholder meetings of companies in their portfolios. Voting supplements our engagement programme with companies and can be used to send a powerful message to companies. Issues that cause us to initiate an engagement and led to votes against management, abstentions or votes by exception varied by country in 2014.

Brazil

Brazil's market regulator issued new guidance on the disclosure of candidates representing minority shareholders. Companies are now advised to release this information 30 instead of 15 days prior to an AGM. We hope to see more companies follow this advice in the future to help investors make decisions in a timely manner.

Europe

France introduced advisory say-on-pay votes in 2014. This was a result of a new recommendation set by the revised Corporate Governance Code a year earlier, under the auspices of the French Association of Large Companies Afep and the Movement of the Enterprises of France (Medef). We opposed remuneration proposals at 66 French companies because the quality of information provided was not robust enough to demonstrate a meaningful link between pay and performance. This was also the case at GDF Suez where – because of a lack of disclosure – we voted against the remuneration policy.

At the beginning of the year, we opposed the discharge of the supervisory board – a vote of confidence in its members – at **German** conglomerate Siemens, expressing our concerns about the performance of the board in the previous financial year. We escalated our engagement at the company's AGM, pressing in particular for further board refreshment and succession planning for the chair.

Italy's voting season was shaped by the country's treasury submitting proposals at many state-owned companies seeking stricter honourability requirements for directors in their by-laws. Honourability requirements essentially allow the ousting of directors charged with financial crimes before they are tried. We opposed these requirements – among others at Eni and Finmeccanica – as they may not have legal standing and may negatively impact the stability and continuity of the companies. The risk/benefit assessment associated with the proposed by-law amendments was also unconvincing. In a positive move, the minority shareholder representative at Eni was proposed by institutional investors, rather than the government and, with our clients' support, was successfully elected.

In the **Nordics**, the influence of foundations continued to be evident in the proposals of candidates to the board. While this is not a key concern for Danish institutional investors, we believe that it is an important one, as it contravenes international best practice. We therefore challenged companies on the independence of the candidates to contribute to the overall effectiveness to the board. However, we did not oppose any of the suggested candidates on this basis as they all possessed a diverse range of relevant skills.

Switzerland introduced the ordinance against excessive pay in 2014 as a result of the so-called Minder initiative although the legislation has come into force on a staggered basis. In 2014, annual board director elections, the election of the chair and compensation committee and the election of an independent proxy – an administrative function in the voting chain for shareholders voting by proxy in Switzerland – became mandatory for shareholders to vote on.

From 2015, shareholders will also be able to vote annually on the compensation of the board of directors, executive board and advisory committee at Swiss companies. However, this concerns only quantum, not the overall remuneration structure.

In the **UK**, remuneration continued to be a contentious issue, particularly with regard to the discretion companies claim to have to operate outside of their proposed policy. This was the case at oil and gas company BG Group where numerous investors refused to support the conditional share award for the incoming CEO. While we had no concerns about the ability of the candidate, we feared that approving such an award would set a worrying precedent, as it was out of line with the shareholder-approved remuneration policy. However, after a number of meetings, BG Group changed its plans. The incoming CEO will instead be granted an award of shares under the company's existing remuneration policy.

Japan

Japan continued to witness an increase in the number of independent directors appointed to company boards. Those appointed also tended to be genuinely independent candidates rather than in some way affiliated with the company. The trend towards independent directors was reflected at imaging and optical products manufacturer Canon, for example, which, for the first time appointed two independent directors after previously voicing strong opposition to doing so. Toray Industries was another Japanese company that appointed its first independent director in line with our engagement objective, while Nippon Steel & Sumitomo Metal appointed two outside directors to its board.

The trend towards independent directors has been helped by the country's stewardship code, the Principles for Responsible Institutional Investors, which was launched in spring 2014, and the country's move to adopt its own Corporate Governance Code. The enactment of Japan's recently amended company law could lead to further changes in the board structure of companies.

US

In the US, we noted an increase in the quality and quantity of engagement around the vote between companies and shareholders. A number of companies contacted us ahead of our vote submissions. In contrast, others were more aggressive in their efforts to persuade the Securities and Exchange Commission to omit shareholder proposals from their agendas and even took legal action against those who filed proposals. However, on the back of strong equity markets, fewer voting battles took place.

Still, the number of shareholder proposals filed remained high, with proposals on environmental and social issues for the first time surpassing those on governance matters, according to proxy advisory firm Institutional Shareholder Services. This was reflected at Duke Energy where, following a coal ash spill earlier this year, a campaign followed to vote against four board members.

However, almost one third of all shareholder proposals were withdrawn, mainly as a result of company action and/or ongoing dialogue, according to professional services firm EY. The proposals most commonly sought the appointment of an independent chair. The second most common proposal related to the disclosure and oversight of political spending. Pay-for-performance issues meanwhile remained the main driver behind shareholder opposition to executive pay in 2014.

At News Corp, we were pleased that our co-sponsored shareholder proposal requesting the elimination of the dual class share structure received an unprecedented 47% support from investors. This result is particularly notable given that 40% of the voting power is controlled by Rupert Murdoch and entities related to his family. When accounting for the non-independent votes, our proposal received close to 90% support from outside shareholders. This demonstrates a resounding desire of News Corp shareholders to see an end to the dual class share structure, which creates a disconnect between the economic interests and voting rights of the founding family, thus resulting in compromised accountability to independent investors. Based on this latest result, we now have some greater traction and will seek discussions with the board from a much stronger negotiating position.

After bank JP Morgan Chase appointed two new directors with appropriate regulatory and risk management experience in response to over 40% opposition in the election of three members of its risk policy committee in 2013, we continued our – since our 2013 shareholder proposal – more positive engagement with the company, choosing not to file a shareholder proposal. At the 2014 annual meeting, all directors were elected with over 96% support. We supported the advisory vote on its compensation plans by exception, noting that in future we expect greater disclosure of the key performance and risk metrics that the compensation committee takes into account when determining pay, as well as greater disclosure of the compensation of high risk-takers. We also supported by exception the re-election of the lead independent director given the concerns we have been discussing with the company in relation to his role as part of the company's shareholder engagement programme.

Vote confirmation

Hermes EOS participated in discussions of the vote confirmation working group of the UN-backed Principles for Responsible Investment, which strives to improve transparency in the proxy voting chain. Improved transparency is likely to contribute to increased accountability and boost vote participation. We will take part in a vote confirmation pilot involving two UK and two Dutch issuers in the 2015 proxy vote season, which aims to work backwards from the receipt of the vote to its instruction.

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Engagement on strategy

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

Overview

Hermes 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

Improved shareholder communication

Karin Ri welcomed the much improved shareholder communication by a Japanese company and its efforts to enhance board composition through the appointment of an additional outside director. She discussed the relevant skills and experience of the outside directors. The company assured Karin about the participation level of these directors but agreed to undertake a further review.

In a subsequent meeting with the company's vice president, Karin welcomed the new mid-term management plan, which contained a clear policy on shareholder returns over the next three years. This marked a major change from the company's previously reluctance to countenance increasing shareholder payouts. It also stated an aim of at least 7% return on equity by 2016, an increase from the current 4.2%. Karin was assured about the company's commitment to achieving higher profitability and more efficient capital management. However, its strategy and restructuring plans left her unconvinced, especially those for the loss-making part of its business.

ESG reassurances in rare meetings

In an extremely rare one-to-one meeting with the president – CEO-equivalent – of an emerging markets extractives company, Hans-Christoph Hirt encouraged a more proactive management of sustainability issues, suggested the creation of a stakeholder committee to support the company's efforts in this regard and assessed the board's oversight of key challenges and risks. Hans also urged the company to establish a more transparent and robust nomination process and set up a dedicated board committee for that purpose. His suggestions were well-received.

Following queries from Hermes EOS and other investors, the company set up a project on sustainability and plans to reach out to stakeholders as well as environmental, social and governance research firms. Hans was equally pleased to hear that the board is considering setting up a nomination committee and delighted with the senior access he had and the commitments that have been made.

In other high-profile meetings with the company, Hans was assured about some of the measures taken following BP's accident in the Gulf of Mexico in 2010, for example, in relation to responsibility for operations on exploration sites, enhanced risk management techniques and technologies and emergency response capacity. Together with its local peers, the company set up an off-shore emergency response centre. Positively, it has also started to measure and publish key performance indicators on health, safety and the environment. Nevertheless, Hans pressed for more focus on specific and challenging objectives, using benchmarking, as well as examples to bring the existing materials to life.

At his visit to the company's headquarters, its regional office and some of its operating sites, Hans found a genuine emphasis on the management of health and safety issues evident from the detailed briefings and mini-examinations that take place before anyone, including visitors, can enter operation sites. The company also seemed to enforce the use of protective gear and strictly managed access to particularly sensitive areas. In addition, it provided straightforward responses to all of his questions and much of the company's equipment and technology is provided by Western firms that provide support in installation and maintenance.

Board refreshment

After engaging with a pharmaceutical company over the past two years, the company made the changes to its board and the compensation committee that Hermes EOS had called for. A new chair was appointed in the summer of 2013 and the board and compensation committee were subsequently refreshed. The refreshment of that committee in particular was a necessary step towards rebuilding shareholder trust.

In response to domestic regulations, the company also chose to put forward a binding vote on compensation at its next AGM, thereby meeting another of Hermes EOS' engagement objectives. But Roland Bosch urged the adoption of a longer performance period in the proposed executive committee compensation plan as the industry has a long product lifecycle, far beyond the three years proposed within the company's two long-term performance plans.

Encouragingly, the company's culture is among the chair's priorities. He has introduced a shareholder engagement programme and convincingly described his board role, talked about how he works together with the executive team and explained the impact of some of the structural changes he has made at the board level, such as the introduction of a dedicated committee for research and development. This provides the board with more visibility on this crucial function and increases the accountability of its executives.

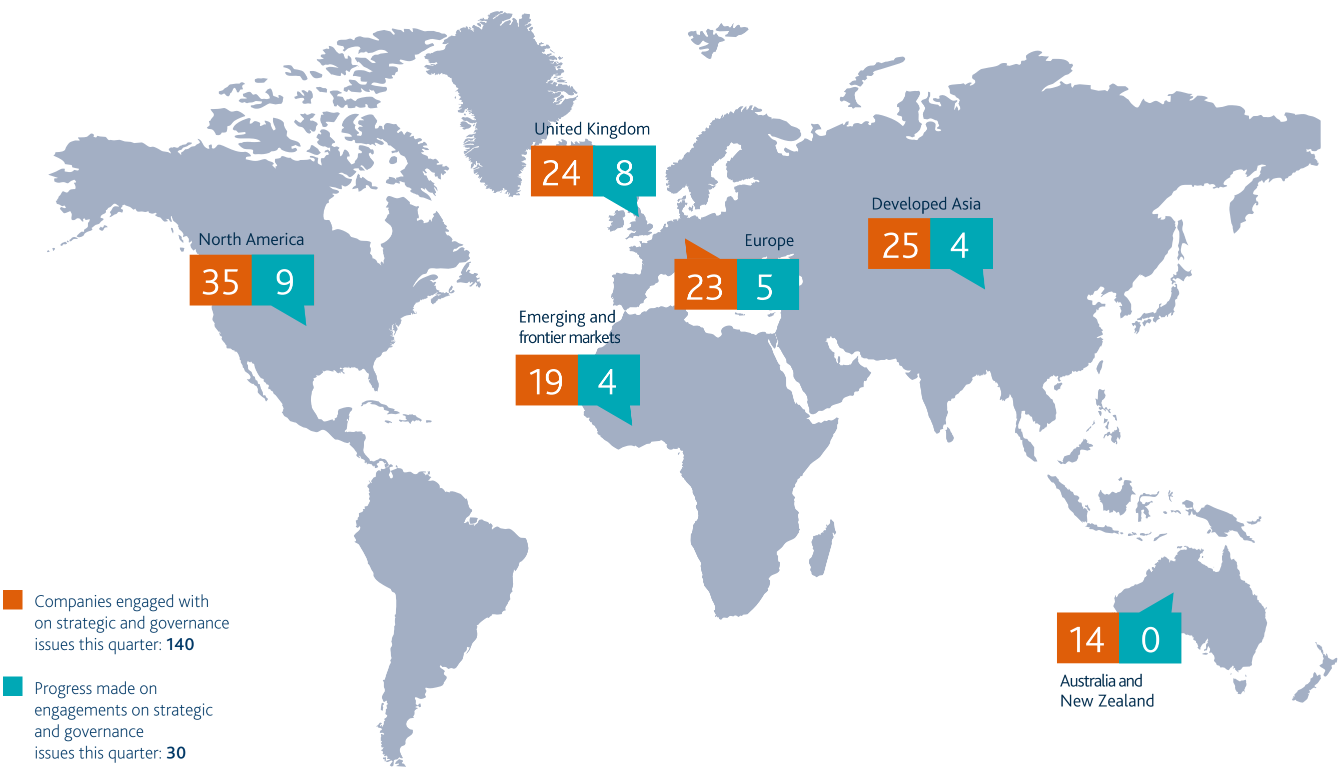
Overall, the company has done a significant amount of work and continues to make an effort to interact with shareholders to jointly identify what is in the best interest of the company. Hermes EOS looks forward to monitoring the success of the new board, the company's progress on key initiatives and further dialogue on remuneration.

Strong lead independent director

Tim Goodman concluded a Hermes EOS' engagement objective with a US bank on the need to have in place a strong lead independent director. In a positive meeting, the bank's lead independent director described how the strategy and better governance and controls have reduced the bank's risk profile and are improving its culture. He particularly highlighted the quality of the board and its committee chairs. The bank has strengthened its technology expertise with its recent appointment and the lead independent director feels that there are no obvious major gaps. Nevertheless, he is keen to have more diversity, including of nationalities, on the board.

Tim discussed how the culture of doing the right thing is being strengthened, not least through public terminations and wide-ranging clawbacks of variable pay. He also challenged how risk is factored into the overall variable pay pool and at individual unit level. It was agreed that the retention requirement of 75% of all shares until retirement creates a strong long-term alignment with Hermes EOS clients. Tim obtained a sense of the robust evaluation process for management and succession planning. He was impressed by the tough, active and engaged lead independent director and believes that the board is led effectively.

Engagements on strategy and governance issues



Public policy and best practice

Protecting and enhancing value by promoting better regulations

Hermes 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. Hermes EOS seeks to fill this gap. By playing a full role in shaping these standards we can ensure that they work in the interests of shareholders rather than being moulded to the narrow interests of other market participants – particularly companies, lawyers and accounting firms, which tend to be more active than investors in these debates – whose interests may be markedly different.

Highlights

Institutional Investors Group on Climate Change

Hermes EOS and Hermes Investment Management supported several investor announcements made at the New York climate change summit, such as the Global Investor Statement, which was backed by 360 signatories with $24 trillion in assets under management. The statement voiced an international ambition to accelerate investment in low carbon assets, carbon foot-printing and portfolio decarbonisation. The Institutional Investors Group on Climate Change (IIGCC), of which Hermes EOS is a member, met members of the European parliament in Brussels, Strasbourg and Paris, held engagements with French and Polish representatives and met individually with the UK's permanent representative in Brussels on the EU Emissions Trading Scheme. This was supported by a detailed update on the EU 2030 Climate and Energy Package, which sets the framework for the next 16 years on the EU's policy approach to greenhouse gas emissions reductions, renewable energy and energy efficiency targets. Now the IIGCC will follow progress made on climate change ahead of the December 2015 summit in Paris.

Japan's Corporate Governance Code

After calling for the introduction of a Corporate Governance Code with Japanese regulators over the past few years, Hermes EOS welcomed the published draft of the code. Prior to the draft's publication, on behalf of Hermes EOS, Karin Ri discussed the necessity of a framework that is embedded in local practices as well as the importance of including best practice and meaningful explanations in the comply-or-explain approach with the participants of the Corporate Governance Code Council. In particular, Karin highlighted the expectations for independent outside directors to demonstrate their relevant skills and expertise to oversee and add value to board discussions on strategy, capital policy, risk management and governance issues. As such, the code should encourage board training and regular board evaluations. Hermes EOS believes that the code ought to play a constructive role in promoting a more productive and positive dialogue between Japanese companies and their shareholders, including encouraging board level access. Hermes EOS has also worked closely with the Asian Corporate Governance Association to promote best practice. Karin was pleased that many of the key points that Hermes EOS suggested were included in the proposed draft of Japan's Corporate Governance Code.

Modern Slavery Bill

Hermes Investment Management – along with investors totalling £940billion in assets under management – co-signed a letter backing the UK government's commitment to include proportionate supply chain reporting requirements in the Modern Slavery Bill. According to the Global Slavery Index, an estimated 35.8 million men, women and children are trapped in modern slavery today and subject to forced labour, poor working conditions and other forms of bonded labour. Hermes EOS recognises that complex supply chains can leave businesses vulnerable to association with human rights abuses. Supply chain mismanagement can cause serious damage to profitability, shareholder and fund value as well as reputation in the short and long term. Companies that understand and address the complexities of the risks in their supply chains are better placed in managing their reputation and disruptions to their operations. The government's decision to introduce corporate supply chain reporting within the Modern Slavery Bill is welcome, as it gives companies an opportunity to increase their transparency and disclosure on how their actions address important social risks, such as forced labour.

Other work in this quarter included

Promoting best practice

- Leon Kamhi provided the perspective of an engager at a roundtable discussion hosted by the UK's accountancy member association ACCA on the merits of **investor divestment from fossil fuels**. He argued that the stronger the economic case for carbon reductions, the more likely companies and fund managers are to transition to making fewer and lower carbon investments. To be compelling, the economic case needs to be considered over a 10-15 year timeframe, as demonstrated in property refurbishments and the capital expenditure project decisions by some extractives companies. In addition, government regulators and industries have a role to play by introducing a carbon price, removing fossil fuel subsidies and encouraging investment in renewables.
- Hans-Christoph obtained an update on the progress of the **Global Initiative for Sustainability Ratings** (GISR) and as a member of its steering committee contributed to some of its ongoing initiatives. In 2014, GISR made significant progress towards achieving its main objectives of enhancing transparency, driving improvement and expanding the global market of sustainability ratings. It also started to publish some useful tools for users of such ratings.
- Naheeda Rashid learned about the **International Finance Corporation's work in Bangladesh** and exchanged observations about the garment industry. In particular, she discussed the issues of sub-contracting and child labour and how these could be detected. Naheeda also explored how female factory workers could be encouraged and assisted to become supervisors because, although 80% of factory workers are women, few of them hold supervisory positions. Harassment of women in the workplace is an issue that is not being reported as necessary.
- Freddie Woolfe attended the **launch of the Investor Forum**, a key recommendation of the UK's Kay Review on building a culture of long-term equity investment. While a number of the parameters remain to be ironed out, the forum will play an important role in coordinating major engagements in the UK on big strategic issues.
- Tim Goodman began Hermes EOS' dialogue with Albertan and Canadian national government officials on climate change and the province's oil sands operations. He is pushing for a **meaningful carbon tax in Canada**, as called for by the country's oil and gas industry.
- Hans-Christoph Hirt was delighted to share Hermes EOS' experience with stewardship codes and regulation in Europe and Asia with a group of senior executives of the Financial Supervisory Commission and Taiwan's Stock Exchange. Positively, the **introduction of stewardship guidance** is now firmly on the agenda of the two key regulators and part of the Corporate Governance Roadmap, a formal programme to improve the country's regulatory framework and practice.
- Karin Ri was pleased to hear that the Hong Kong Exchange plans to upgrade its current requirement for **sustainability reporting** from a voluntary to a comply-or-explain approach. This is in line with what Hermes EOS has been seeking since it first responded to a consultation in 2012.
- Naheeda Rashid visited **a school in Dhaka operated by Save the Children**, which offers pre-technical and vocational skills training to prepare young people for apprenticeships and in the end lead them to a safe job. The school targets vulnerable children and youth who are at risk of getting into hazardous work or not being offered future opportunities. Naheeda spoke with graduates from the apprenticeship scheme, one of whom had started her own businesses while others – after gaining skills – were now employed by garment factories.
- Leon Kamhi presented the delivery of the 2014 projects of **UNEP FI's Investment Commission**. He lauded its ground-breaking work to demonstrate the financial returns that have been achieved through energy efficiency retrofits in properties and the development of a robust methodology for real estate sustainability data. On the Commission's future plans, Leon was supportive of the global review of fiduciary duty to empower asset owners to consider material sustainability data in their decision-making. Hermes EOS also endorsed a project looking to identify how to reward long-term investors across asset classes. At the same time, Leon expressed caution not to develop complex solutions which may have unintended adverse consequences.

Public policy

- Hermes EOS co-signed a letter calling on the EU to strengthen and harmonise its **regulation of conflict minerals** with that of the US to enable more consistent risk management and disclosure of the issue. This will help companies and investors better manage this human rights risk.
- On behalf of Hermes EOS, Sachi Suzuki welcomed the passing of the **Singapore Companies Act**, which will allow the appointment of multiple proxies. The existing act only allows a maximum of two proxies to attend and vote at a general meeting, unless the company's articles specify otherwise. This has often prevented shareholders who hold shares through a nominee company or custodian bank from exercising their voting rights. Hermes EOS lent its support to this change, which was proposed three years ago, as it will increase the protection of shareholder rights. Disappointingly, the amended act had removed the rule of one-share, one-vote, thus allowing a structure with dual-class shares, which Hermes EOS opposes.
- Hermes EOS responded with a number of concerns to the UK Prudential Regulation Authority's **consultation on new remuneration rules**. Hermes EOS agrees with the intentions behind the proposed changes, which aim to more closely align risk and individual reward to discourage excessive risk-taking and short-termism. However, Hermes EOS has concerns about the complexity of the system proposed, specifically, the lack of flexibility.
- Hans-Christoph Hirt was pleased to learn that **Taiwan's Financial Supervisory Commission** issued an official letter addressed to the country's government funds and financial institutions advising them to disclose their investment strategies. This includes the consideration of corporate governance factors, the monitoring of their investee companies' performance and the reporting of the results of these activities. Hans was encouraged by this significant step towards introducing a full stewardship code.
- Karin Ri wrote to the Hong Kong Exchange to express Hermes EOS' strong **opposition to the introduction of weighted voting rights**, commonly known as dual-class shares. Since 2013, Hermes EOS has participated in discussions by the Asian Corporate Governance Association (ACGA) on this matter. In the letter, Hermes EOS endorsed the conclusion and opinions that ACGA had submitted. Multiple-class share structures disenfranchise minority shareholders and often increase the power of one or a few shareholders for a disproportionate financial stake. As a matter of principle, Hermes EOS opposes the misalignment of interests of the controlling shareholder with a company's other shareholders, especially minority shareholders, due to differential voting rights or other control structures.
- Hermes EOS provided comments on the **draft amendments to the OECD's Principles of Corporate Governance**. Hermes EOS is generally supportive of the proposed amendments to the Principles. However, Hermes EOS would have liked to have seen more emphasis placed on the role of shareholders in the board nomination process. In addition, there should have been more coverage of the interaction between board members and shareholders for information and accountability purposes, with specific reference to the importance of effective engagement and open channels of communication between both parties.

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

Overview

Over the last quarter we voted at 1,173 meetings (8,252 resolutions). At 418 of those meetings we opposed one or more resolutions. We voted with management by exception at three meetings and we abstained at two meetings. We supported management on all resolutions at the remaining 750 meetings.

Global

We voted at **1,173** meetings (**8,252** resolutions) over the last quarter.

- Total meetings voted in favour **63.9%**
- Meetings where voted against (or voted against AND abstained) **35.6%**
- Meetings where abstained **0.2%**
- Meetings where voted with management by exception **0.3%**

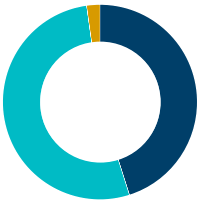
Australia and New Zealand

We voted at **251** meetings (**1,381** resolutions) over the last quarter.

- Total meetings voted in favour **66.5%**
- Meetings where voted against (or voted against AND abstained) **33.1%**
- Meetings where abstained **0.4%**

Developed Asia

We voted at **91** meetings (**549** resolutions) over the last quarter.



- Total meetings voted in favour **45.1%**
- Meetings where voted against (or voted against AND abstained) **52.7%**
- Meetings where voted with management by exception **2.2%**

Emerging and Frontier Markets

We voted at **269** meetings (**1,919** resolutions) over the last quarter.

- Total meetings voted in favour **63.2%**
- Meetings where voted against (or voted against AND abstained) **36.8%**

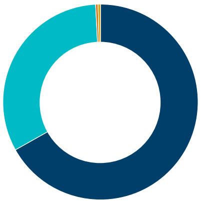
Europe

We voted at **162** meetings (**1,191** resolutions) over the last quarter.

- Total meetings voted in favour **47.5%**
- Meetings where voted against (or voted against AND abstained) **52.5%**

North America

We voted at **229** meetings (**1,555** resolutions) over the last quarter.



- Total meetings voted in favour **66.8%**
- Meetings where voted against (or voted against AND abstained) **32.3%**
- Meetings where abstained **0.4%**
- Meetings where voted with management by exception **0.4%**

United Kingdom

We voted at **171** meetings (**1,657** resolutions) over the last quarter.

- Total meetings voted in favour **83.0%**
- Meetings where voted against (or voted against AND abstained) **17.0%**

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

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