Hermes Equity Ownership Services

Public engagement report

Q3 2011

HERMES

Q3

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

Contents

What is EOS?

Hermes Equity Ownership Services (EOS) helps institutional shareowners around the world to meet their fiduciary responsibilities and become active owners of public companies. EOS' team of engagement and voting specialists monitors its clients' investments in companies and intervenes where necessary with the aim of improving performance. EOS' activities are based on the premise that companies with informed and involved shareholders are more likely to achieve superior long-term performance than those without.
As the largest pension fund in the UK, Hermes' parent the BT Pension Scheme (BTPS), has substantial interests across international markets. Through pooling resource with other like-minded funds to create a stronger and more representative shareholder voice, our joint company engagements are more effective.

Hermes has the largest stewardship resource of any fund manager in the world. Our 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 and the BTPS have extensive experience of implementing the United Nations' Principles for Responsible Investment (UN PRI). EOS' Chief Executive Colin Melvin chaired the committee that drew up the original principles, and the current chair is a trustee of the BTPS. This insight enables EOS to help clients who wish to become signatories or have already achieved signatory status to meet the challenges of the PRI.

How does EOS work?

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

The Hermes Principles set out our basic expectations of companies in which our clients invest. These cover business strategy, communications, financial structure, governance and management of social, ethical and environmental risks. The Principles and their regional iterations guide our intervention with companies throughout the world. Our approach is pragmatic and company and market specific, taking into account individual company circumstances.

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

At any one time there are many companies included within our engagement programmes, meaning that significant additional resources are dedicated to these situations. All of our engagements are undertaken subject to a rigorous initial assessment and ongoing review process 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 to clients, not to seek headlines through campaigns. These can often undermine the trust which would otherwise exist between a company and its owners. We aim to be honest and open with companies about the nature of our discussions and will seek to keep such discussions private. Not only has this proved the most effective way to bring about change, it also acts as a protection to our clients, so that their position will not be misrepresented in the press.

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

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

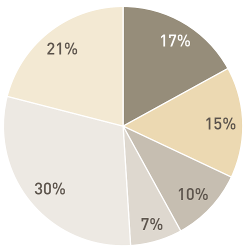
For further information please contact Colin Melvin on 020 7680 2251.

Engagement by region

Over the last quarter we engaged with 188 companies on a range of 378 social, environmental and governance issues. EOS' holistic approach to engagement means that we will typically engage with companies on more than one issue simultaneously. The engagements included in these figures are in addition to our discussions with companies around voting matters.

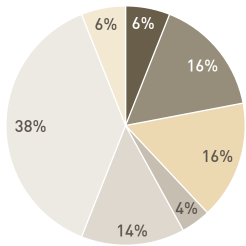
North America

We engaged with 40 companies on a range of 94 issues over the last quarter.



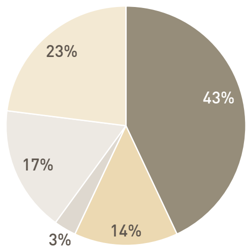
Asia

We engaged with 31 companies on a range of 51 issues over the last quarter.



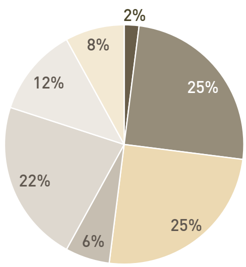
Australia & New Zealand

We engaged with 19 companies on a range of 35 issues over the last quarter.



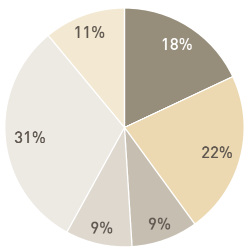
Emerging & Frontier Markets

We engaged with 23 companies on a range of 52 issues over the last quarter.



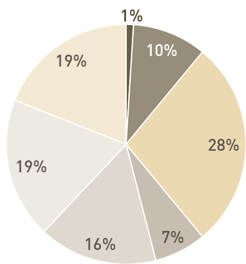
Europe

We engaged with 36 companies on a range of 65 issues over the last quarter.



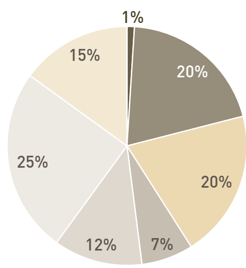
UK

We engaged with 39 companies on a range of 81 issues over the last quarter.



Global

We engaged with 188 companies on a range of 378 issues over the last quarter.



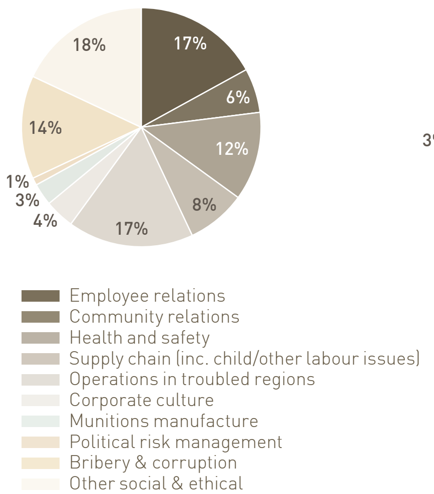
Shareholder communications
Environmental
Social and ethical
Risk management
Business strategy
Governance
Remuneration

Engagement by issue

A summary of the 378 issues on which we engaged with companies over the last quarter is shown below.

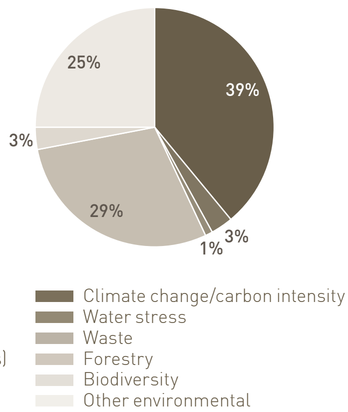
Social and ethical

Social and ethical issues featured in 20% of our global engagements over the last quarter.



Environmental

Environmental issues featured in 20% of our global engagements over the last quarter.



Other engagement

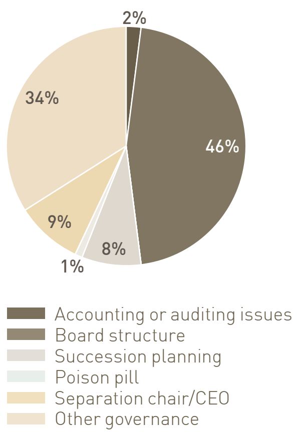
Shareholder communications featured in 1% of our engagements over the last quarter.

Risk management featured in 7% of our engagements over the last quarter.

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

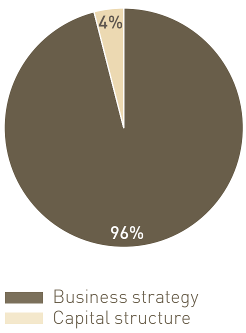
Governance

Governance issues featured in 25% of our global engagements over the last quarter.



Business strategy

Business strategy issues featured in 12% of our global engagements over the last quarter.



Business strategy and board structure

Strategic engagements

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

Statistics	
Number of companies engaged with on strategic matters this quarter:	90
North America	23
Asia	14
Australia and New Zealand	4
Emerging and Frontier Markets	13
Europe	14
UK	22

Number of significant steps forward in strategic/governance engagements this quarter:	8
North America	1
Asia	1
Australia and New Zealand	1
Emerging and Frontier Markets	0
Europe	1
UK	4

Overview

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

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

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

Highlighted sample engagements

We spoke with a large retail company in **North America** to discuss a range of governance issues. We raised concerns in relation to the way that the company seems to be making a habit of ignoring shareholder wishes. Again this year a shareholder proposal regarding the right to act by written consent received significant - although not majority - shareholder support, having received close to 50% support in 2010. While the company is not required formally to implement any changes as a result of these votes, we believe that it should nevertheless proactively engage with shareholders given the voting results. We are further concerned as this is not the first time the company has been slow to react to shareholders' concerns as expressed through their significant support of proposals aimed at enhancing rights: two years ago this was also the case with a shareholder

proposal seeking to reduce the threshold to call special meetings from 25% to 10%. We emphasised that these examples of lack of accountability are the main reasons for our decision to withhold our support from the members of the governance committee. We strongly encouraged company steps to gain a better understanding of the changes shareholders seek and to make necessary changes. We agreed to a follow up conversation with the company secretary ahead of next year's AGM to discuss progress on the proposed changes.

We spoke with an investment holding company in the **Asia** region regarding governance matters. We expressed our concerns about the overall board structure, especially an apparent lack of genuine independence on the remuneration and nomination committees. While we acknowledged differences in cultural context, we also stressed that a tenure of over 20 years should be considered excessive in any market. The company understood our concerns about the issuance of shares without pre-emption rights, and we encouraged it to provide shareholders with explanations in advance of any such proposal. We agreed to continue our communication.

We held a meeting with a large exploration company in the **Australia and New Zealand** regions with both the SID and CEO. We noted that while we welcomed the ambitious investment in organic growth, the growth in the payout to shareholders was substantially below the significant growth in profits. The company responded that it has a progressive dividend policy and it aims never to disappoint the market with a dividend cut; we argued that the message it was sending to the market through the conservative cushion between what is currently paid and what might be available for shareholders was that this cushion was less substantial and less long-lived than it appeared. We believe our views were taken on board by the company. We also discussed staff turnover challenges and how the company can mitigate the cost increases and turnover which arise from the current active market for experienced staff: we pressed for the company not simply to act as a recipient of these market conditions but to be proactive, and gained some agreement as to actions which can be taken. We also talked through the challenges of managing such a large business and discussed possible ways to simplify it structurally as well as the cultural challenges involved in moves to standardise and streamline management structures.

We spoke with a large food processing company in the **Emerging Markets** region about the issues of corporate governance. We again raised concerns about the combined chair and CEO roles and the apparent dominance of the family, which accounts for a third of the board (including the chair and CEO) and holds nearly half of the company's issued shares. We pointed out that an unspecified payment to one of the board members from the family raises significant concerns, causing us to vote against the resolution on related party transactions at the last AGM. We also reiterated our concerns about the need to protect shareholders from dilution through a tougher approach on protecting pre-emption rights. Lastly, we encouraged disclosure of the level of audit fees as well as non-audit fees to enable shareholders to gauge the independence of the auditor. We agreed to explore the possibility of arranging a meeting with a non-executive director as well as a site visit later in the year.

We met with the vice-chair of an energy company in **Europe**, to discuss a range of governance issues, particularly board composition and effectiveness and the combination of the roles of chair and CEO. We focussed particularly on the joint roles and urged the company to consider addressing this, at the retirement of the current incumbent if not before. We also pushed that the company ensure that it appoints a lead independent director with a clearly defined set of powers in relation to the operation of the board so as to mitigate the risks of concentration of power in the hands of a single individual. These comments appeared to be well understood. We agreed with the vice-chair that the current board is excessively large (with 22 members) and that its scale needs to be reduced over time. We also agreed that next year offers an opportunity to deliver this with some board elections due, and that this also provides an opportunity to improve the diversity of the board, both in terms of gender and geographical knowledge, and we talked through the board evaluation process to ensure in particular the contribution of those directors with significant commitments are questioned on a regular basis.

We met with the senior independent director of this storage services company in the **UK** regarding concerns about the level of independence on the board. We talked through the strategic challenges in the current economic environment, and welcomed the focus on increasing occupancy levels and poaching customers from failing competitors, rather than continuing to build its own facility network or acquiring competitor's stores. We gained some assurance from the SID that despite the presence of founders on the board, including the executive chair, there is a reasonable degree of challenge from independent directors. We did not however receive assurance in regard to the chair of the audit committee, who was previously the partner on the company's audit, and has a pre-existing relationship with the company's current signing partner. We agreed with the SID to arrange meetings with other non-executive directors, to explore board dynamics further. We also provided feedback to the SID regarding our concern at the audit committee chair's affiliation with the external audit firm, and encouraged the company to put the audit back out to tender.

Banking Remuneration

Engaging with the banking industry on banking remuneration

Following the 2008 financial crisis, there is now widespread agreement that remuneration policies which promote short term revenue and profit targets can incentivise bankers to pursue risky decisions. If companies remain unchallenged by less interested and engaged shareholders this can allow a culture of rewards for failure to emerge. EOS has had long standing dialogues with large and high-profile banks across the world, to ensure that they have gone far enough to address the risk issues which they face and ensure that the structures in place favour long term shareholders' interest.

Statistics	
Number of companies engaged with:	30
Number of companies where substantive change sought:	22
Number of these showing progress so far:	7

Overview

Do remuneration practices at banks impact on the sustainability of the financial system? The crisis provided clear evidence that banks are a country's economic backbone whose collapse or misconduct can impact the entire world economy. The 2008 fallout gave rise to international standard setting bodies, politicians and investors around the world reassessing their position on remuneration in the banking industry and the risky behaviours that certain structures had encouraged. Events demonstrated that there needed to be more consistency of thought across the international capital markets with an international agenda being applied on pay more than any other industry. Critics claim that banks lacked sound corporate governance, particularly on risk management and remuneration which was one of the reasons behind the crisis.

Greater public scrutiny and sensitivity continues to surround banking pay meaning that global banks are now having to work harder to align pay with the long term risks of their business. As governments and taxpayers have invested heavily to recapitalise some banks - there is a greater need for banks to become transparent to allay concern on the circumstances surrounding the controversial use, for instance of guaranteed bonuses. But the issue is not only about bonuses but about pay more widely and the culture within banks that should be in place to discourage rewards for reckless behaviours. EOS discussions with companies to date indicate a willingness to make changes.

Issues and companies

Over many years EOS has undertaken a series of intensive engagements on banking remuneration, combining both discussions with companies in the financial sector and international regulators. A large number of regulatory reforms have been proposed in light of lessons learnt from the crisis; during this period of economic uncertainty EOS identified the need to provide direct clarity to banking remuneration committees on what investors expect on aligning pay structures to the interests of shareholders over the long term. Based on EOS' engagement experiences with financial institutions we developed the EOS banking remuneration principles which we have shared with our investee companies as part of our engagement programme. These outline a series of principles for remuneration committees to take into account when setting board level and senior management remuneration. Broadening the oversight on remuneration from board level members to key traders in investment banking is a crucial development as their activities can greatly impact the performance of banks.

The EOS Banking Remuneration Principles assist companies in formulating and instilling the correct behaviours and culture to drive their remuneration policies across their organisations and discourage the development of short termism and non-executives rubber stamping pay policies. It is clear from our engagements that a gap can exist between the culture which a bank aspires to and what exists in reality. Therefore ensuring the alignment of the corporate culture to ethical standards and effective managing risks is central to EOS' engagement committees to make a public statement on the type of culture they aim to promote.

Ensuring the correct leadership needed to achieve and sustain major cultural change is a very important. Lack of independence can lead to inadequate oversight of pay structures or too much power and status in the hands of one individual. EOS has therefore encouraged independent chairs to provide sufficient space for debate and discussion on pay and in the case of executive chairs that any performance targets for share awards have different performance targets and time frames from the executives. This minimises the risk of compromising the chair's ability to call management to account. EOS also aims to conduct shareholder dialogue via the remuneration committee so that past decisions can be understood and an informed dialogue on future arrangements can occur.

The approach and focus of EOS' engagement varies across geographical regions. In the US for instance we have focussed on the culture that permitted excessive risk taking in the past and ensuring that risk is fully integrated into pay and that of the remuneration committee's decision making. In addition, promoting the role of the risk or responsibility committee to oversee and agree the risk appetite and exposure of the remuneration arrangements along with the remuneration committee.

EOS presses for performance to be measured over longer periods to ensure pay reflects genuine returns particularly for individuals such as investment bankers who are often better paid than board executives and on occasions can have greater influence on the sustainability. We therefore promote the payment of bonuses for trading staff are rewarded over time periods greater than a single year so that pay is triggered by genuine and not short-lived profits. Having a longer perspective of at least three years is more likely to promote a cautious approach towards risk by moving away from annual performance measurements. Considering and managing the potential for longer term negative events is an aspect that some banks had neglected to take into account. EOS has found that deferral alone may not serve to reduce the perceived value of that element of reward and increase an individuals' attention to the annual cash element.

In other regions, we have had detailed discussions with remuneration committees on performance target setting and the risk assessment of a large number of employees in the tier down from the board. In Europe, at times, EOS has used a more public forum to address concerns at company AGMs to encourage the board to use pay structures that reinforce the intended corporate culture rather than undermine it.

Across the world EOS has also lobbied with regulators on behalf of investors for a 'Say on Pay'. This would allow a binding or advisory shareholder vote on executive remuneration. We continue to actively engage on remuneration with the banks to ensure their implementation of the EOS banking principles.

A few of the companies affected by these issue are:

Bank of America Merrill Lynch (US), Barclays (UK), Citi Group (US), Deutsche Bank (Germany), Goldman Sachs (US), JP Morgan Chase (US), Morgan Stanley (US), Nomura Holdings (Japan), UBS (Switzerland), BNP Paribas (France), Credit Suisse (Switzerland), HSBC (UK), ING Group (Netherlands), Mitsubishi UFJ (Japan), RBS (UK), Société Générale (France), Standard Chartered (UK), Banca Intesa (Italy), Banco Santander (Spain), BBVA (Spain), Mizuho Financial group (Japan), RBC (Canada), Sumitomo Mitsui Financial Group (Japan), Unicredit (Italy), Bank of Montreal (Canada), Bank of New York (US), CIBC (Canada), Commerzbank (Germany), Lloyds (UK), Mediobanca (Italy).

Board diversity

Encouraging companies to think about board composition

Board diversity is a key issue for HEOS. Often the debate around diversity becomes polarised around gender. However, when we talk about diversity, we do not only refer to gender but to diversity of ethnicity, background, age, tenure and skills and attributes appropriate for a company's particular situation. As the issue has become more of a focus for regulators around the world, we have stepped up our engagement efforts, raising this at a wide variety of companies around the world.

'The composition of most company boards still fails to reflect the plurality of backgrounds, approaches and viewpoints which, in our view, best support long-term business success.'

Overview

HEOS has long believed that well constituted boards are a key element of proper governance at the companies in which our clients invest. The key function of the board is to provide effective oversight of and challenge to management. To be able to do this, and steer the company towards strong performance over the long-term, companies need to have the right mix of skills and experience available to them. It is unlikely that individuals with broadly similar backgrounds will be able to provide this range of expertise. We are therefore engaging with a large number of companies to encourage them to consider diversity in every sense as part of their nominations process. This work is far-reaching and ongoing as we believe that every company will benefit from seriously and thoughtfully considering the composition of their board.

Issues and companies

We believe that company boards will be most effective if they reflect the diversity of their businesses and their stakeholders. Companies can only benefit from the inclusion of a variety of experience and perspectives around the boardroom table to assist in the process of guiding and challenging executives and in generating constructive debate and discussion. In our view, such diversity should include not only gender but also ethnicity, background, age, tenure and other attributes important for a company's particular situation such as a range of professional backgrounds and specialist skills.

There is a growing body of evidence that board diversity really does matter from the perspective of company performance.[i] One recent study by an asset management firm in the UK found that operational and share price performance was significantly higher over one and three years at companies where women made up over 20% of board members than those with lower numbers of women on the board.[ii]

The composition of most company boards still fails to reflect the plurality of backgrounds, approaches and viewpoints which, in our view, best support long-term business success. Many are narrowly constituted and do not properly reflect the company's customer base or employee mix, or the composition of the population in general. For example, while a company in the food industry certainly needs non-executive directors with a background in this industry, there are a range of other skills that could also serve the company well for example technology, marketing, banking and finance, academia or politics. And with so many companies now operating on a global basis, it is increasingly important to reflect this trend in board composition. If expansion into new markets is being considered, it makes sense to include individuals with detailed knowledge of those markets to assist in this process. Population and prosperity growth in the emerging markets is a key trend to which many boards today look poorly-equipped to adapt.

Regulators around the world are responding in a variety of ways. Some countries have introduced quotas for the number of women on corporate boards, notably Norway which took the plunge in 2004. France, Italy, Spain and the Netherlands have also moved in the same direction with quotas due to come into effect over the next few years. In the UK, the Davies Report earlier this year noted the slow progress in appointing more women to boards and called for FTSE 350 companies to set targets for 2013 and 2015 and for FTSE 100 companies to aim for a minimum 25% female representation by 2015. Australia's recently revised Corporate Governance Principles and Recommendations require companies to report certain information in relation to gender diversity from the beginning of 2011. And in the US, the SEC has said that companies must include a "disclosure of whether, and if so how, a nominating committee considers diversity in identifying nominees for director."

We would strongly prefer that this situation be addressed satisfactorily through best practice initiatives. However we understand that should a best practice or self-regulatory approach fail then the introduction of quotas for board diversity in those countries that have not yet gone down this route may be necessary.

On behalf of our clients as long term shareholders, we will strongly challenge companies that appear to be failing properly to address diversity issues. Below we have set out a number of areas that we believe are particularly important for boards to consider.

i. Board composition and evaluation

We encourage boards to undertake a regular and thorough analysis of their composition to ensure that the interests of all relevant stakeholders are effectively represented. This should be part of the annual board evaluation process, which is required or promoted by the corporate governance codes in many countries. We expect that boards will set their own targets regarding diversity and seek to implement necessary changes as part of the process of board renewal. Where boards appear to lack sufficient diversity, we will question the extent to which such analyses and evaluations are being properly carried out.

ii Recruitment of non-executive directors

When considering possible candidates for membership, boards should take account of diversity in its widest sense and as this applies to the individual company. Attracting a suitably broad set of candidates may require looking beyond the mainstream recruitment agencies. We welcome and encourage the trend towards advertising board vacancies in national and international media. Where recruitment agencies are used, boards should ensure that they are given a specific mandate to seek out candidates from non-traditional backgrounds. We will challenge boards where candidates for non-executive directorships appear to have been drawn from a narrow pool. This includes, for example, candidates who serve on other boards with existing board members or who are otherwise already well known to them, former advisers to the company or candidates with a large number of existing board positions. We expect the chair of the nominations committee to be able to explain clearly to shareholders why a proposed candidate was deemed suitable.

iii Development of senior personnel

In order to ensure that sufficient high quality candidates with diverse backgrounds are available to serve on boards, companies should also take steps to ensure that in considering internal promotion or external appointments their human resources policies do not inadvertently discriminate against certain groups. We encourage companies to make their senior personnel, particularly the cadre of executives immediately below the board, available to serve as non-executive directors at other companies. This assists in those individuals' personal development and also in deepening the pool of talented potential non-executives for other companies.

i. *Women Matter: Gender diversity, a corporate performance driver* McKinsey & Co 2007 *The Bottom line: Corporate Performance and women's representation on boards* Lois Joy, Nancy M Carter, Harvey M Wagener, Sriram Narayanan, Catalyst 2007
ii. *Companies with a better track record of promoting women delivery superior investment performance* Bhogaita M, New Model Advisor, 2011

Aligning the investment chain

EU and others consider principal/agent problems more broadly

The EU Green Paper on corporate governance covers much more than the governance of the corporation. Its focus on the investment chain reflects a growing global trend which we believe is overdue and will continue for some time.

"There is a widespread perception in the pension world that the investment industry is perverse in one crucial sense: its food chain operates in reverse, with service providers at the top and clients at the bottom. Agents fare better than principals."

Overview

Only a relatively small portion of the EU Green Paper on Corporate Governance was directed at the governance of the corporation, covering issues such as separating the roles of chair and CEO, diversity in the boardroom, risk management and remuneration. The bulk of the consultation covered such matters as whether EU rules stand in the way of long-term investment, whether the investment chain effectively serves the interest of the end asset owners, whether stewardship activities are carried out appropriately and how improvement can be encouraged in this respect, and whether investors are playing their appropriate role in making comply or explain approaches to governance work. We welcomed this focus and supported it in our full and lengthy response to the consultation.

These agenda items are closely allied with a number of initiatives around the world in the area of long-term investment, fiduciary duty and stewardship codes, and around fund manager accountability and mandates. These developments are welcome and seem set over time to lead to rules which more effectively serve the interests of the underlying asset owners, and so enable the markets to focus more on the long-term success of investee companies.

This damning criticism of the investment chain's lack of client focus is a key finding of 'DB and DC plans: strengthening their delivery', a 2008 survey of more than 200 European pension funds by CREATE-Research and *Investment & Pensions Europe*. And this was not just a feature of the credit crisis: talking with asset owners reveals that the same perception remains to this day. Quite simply, asset owners in general believe that the investment chain does not currently act consistently in their interests and effectively on their behalf: it is a world turned upside-down whereby the agents set the terms of trade and the clients simply have to accept what the agents offer them.

This perception is an increasing focus for the industry and also for the regulators and legislators that look on. This is because the dominance of the industry by the agents rather than the principals may not just raise issues within the investment chain but because public policy-makers fear that the dominance of the service providers may encourage short-term trading behaviours which may damage long-term investment in productive companies. In the current economically troubled times, the desire for long-term investment in production and growth is more intense than ever.

In this light it's not surprising that the EU Green Paper on Corporate Governance opened its main section, which considered the investment chain, with the question of whether any existing EU legal rules contribute to inappropriate short-termism among investors and requested any suggestions as to how these rules could be changed to prevent such behaviour. This agenda reflects other work around the world. For example, the OECD has launched a project on long-term investment, and both IOSCO – the International Organisation of Securities Commissions – and ESMA, the European Securities and Markets Authority, have recently consulted on possible approaches to tightening the rules on high-frequency trading. ESMA has also just closed a consultation on the possible systemic risks inherent in ETFs and UCITs and how these are traded on the markets. The UK Department of Business has launched its Kay review of long-termism. And the focus on the regulation of credit rating agencies continues in both Europe and the US.

This global focus on market short-termism and how it might be addressed is also reflected in the development of stewardship codes and their equivalents around the world. The aim with such documents is again to ensure that the influence of the financial markets is a positive one for public companies, encouraging shareholders to act as positive long-term owners rather than just short-term traders of shares. And this is now a global development: the UK Stewardship Code has been followed closely in the code for external governance issued by EFAMA, the European fund managers' association (though the downgrading of the issue of conflicts of interest from a stand-alone principle to a bullet-point within one appears to many a negative shift). Other codes have tended to approach these issues from scratch rather than simply reflecting existing approaches: the Code for Responsible Investing in South Africa and the Guidelines for Members on Best Practices for Engaged Share-ownership issued by Dutch corporate governance association Eumedion both begin by considering investment approaches and integrating long-term factors into investment decision-making. There are also publicly announced intentions to develop such codes in Singapore and Malaysia as well as earlier stage steps in other markets.

Model mandates

Investors need not wait for the regulators to act – at least some of the tools are in available already, and in a sense the importance of stewardship codes is in offering asset owners a basis to call fund managers to account. If we wish to turn the world the right way up again then it makes sense for asset owners to seek to assert their bargaining power more clearly in the RFPs that they issue and the mandates that they agree with their fund managers.

This is the thinking which underpins the work at the International Corporate Governance Network (ICGN) on developing model terms for the contracts between asset owners and fund managers. The so-called Model Mandate Initiative, which has been led by a member of the EOS team, has scoured the market for existing best practice and developed much more afresh to provide a set of clauses many of which can be adopted into contracts to engender a greater alignment of interests and more long-term behaviour in the financial markets – as a way of improving long-term returns for investors. The draft was approved at the ICGN AGM during this quarter.

The Model Mandate includes clauses covering such areas as: a high level commitment to long-term principles, effective risk management, integration of long-term factors into investment decisions, stewardship, long-termism and alignment of interests, and commission and counterparties. The document also proposes specific reporting structures in each of these areas. While not all clauses will be appropriate for all contracts, asset owners will learn a great deal from asking for these to be included and from the negotiations that they hold with their potential fund managers on these topics.

We were proud to find the Model Mandate Initiative mentioned specifically in the EU Green Paper, and indeed in the OECD document. We hope that these international steps, together with developing behaviour by asset owners and fund managers, will over time shift the markets to a more long-term perspective.

Protection of personal data

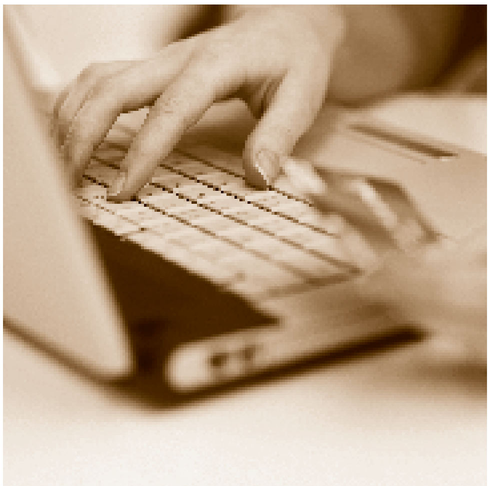
Appropriate risk management and protection of consumer data

EOS seeks to engage with companies across the world who do demonstrate best practice in managing risks associated with data protection. Failure to do so has the potential to cause significant financial and reputational risks which, if not properly managed may result in a loss to shareholder value.

'As a consequence, there are almost daily news stories of companies gathering personal information in ways that many would find unacceptable.'

Overview

The recent Annual General Meeting of News Corporation witnessed considerable shareholder protest about the dominance of the Murdoch family and those close to it over the company's board. The catalyst for the increased concern of shareholders about the dysfunctional governance of this global media giant were the problems within its News International subsidiary concerning illegal practices to obtain stories at one of the newspapers, peremptorily closed in a vain attempt to limit the damage to its business the scandal was causing. The crisis has demonstrated the company's seemingly corrupt links with individuals within the police but also its insidious power over both senior police officers and politicians. However, central to the scandal was the company's illegal obtaining and use of personal information. This article focuses on the dangers to companies' reputations arising from the use of personal information and the importance of companies managing risks associated with data protection.



Issues and companies

Whilst most companies would not sanction the 'industrial' level of illegal activity alleged at News International, it is instructive to note that other British companies have been heavily fined for data protection abuses. Last year the UK's Financial Services Authority fined Nationwide Building Society, £980,000 and in the previous year it levied almost £3,000,000 in fines on HSBC companies for failures to protect personal information appropriately. Companies need to ensure that systems and controls are appropriate to protect it; these fines were levied in part for crass procedural problems such as sending unencrypted bank account information via insecure methods such as couriers. These are two leading financial institutions with which customers share some of their most private information. If these companies can fall so far short of reasonable standards, what might other companies be doing? Sony suffered a huge blow to its reputation as a result of serious security flaws with how its Playstation connected online. It seems that global companies are exposed to similar problems.

At this problem's heart is the importance of personal information to all companies worldwide. As a consequence, there are almost daily news stories of companies gathering personal information in ways that many would find unacceptable. Facebook and Google, for example, have business models which rely on collecting, analysing and sharing your personal data with advertisers or using them themselves to market their or other companies' products. As the war for online dominance continues other companies are likely to face similar accusations with increasing frequency. These companies attract the most attention because of their size but every company is collecting data as part of its online strategy and otherwise. As the cost of data storage plummets and processing power increases companies increasingly want to understand their customers and potential customers better, plus they wish to communicate more effectively, more quickly and more cheaply with their suppliers and other stakeholders via intranets, extranets and other online methods.

Such activities carry other potential risks. As companies become more and more reliant on electronic systems and communications for so much of how they work, if these fail, the consequences can be grave. Whilst writing this article, Research in Motion, owners of Blackberry, have suffered huge problems when one of their data centres failed and their disaster recovery systems did not work as expected. The long term effect of the incident appear likely to result in further deterioration of the company's competitive position compared to other smartphone providers.

Where do these trends leave boards and what should concerned shareholders be doing? Information technology is increasingly vital to all companies but its complexities mean that boards often do not have sufficient skills and knowledge to challenge companies' IT strategies; appropriate board composition is therefore vital. As part of a company's risk management assessment and internal controls it is essential that these types of risk, which can undermine companies reputations overnight and have significant financial implications, are appropriately managed. Therefore the formulation of strategy, the governance of IT, the different legal regimes in relation to personal data and the acceptability of how data is collected, stored and used all need to be assessed, refined and developed rigorously by the board and throughout the company. Above all, the culture of the company must be such that individuals must question what they are doing with data and subject what they would like to appropriate testing. Would those at the company be happy if their personal data was used in the way that they wish to use it? Shortcuts in data collection and use tend to lead to long-term repercussions that damage brands and so there should be a long-term approach to developing and maintaining customer relations. An overly legalistic view on such relations may lead to problems as data protection legislation varies so widely from jurisdiction to jurisdiction that companies with international interests or who even process data in different countries will quickly sink into a quagmire of conflicting law.

Appropriate management of customer data is very much aligned with shareholder's long-term interest and EOS will engage with companies where lack of adequate risk management systems appears to be a threat to shareholder value. This is an issue which has the potential to impact all companies, particularly those which are primarily consumer facing.

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.

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

Overview

EOS actively participates in debates on public policy matters to protect and enhance value for clients by increasing shareholder rights and boosting protection for minority shareholders. This work extends across: company law, which in many markets sets a basic foundation for shareholder rights; securities laws, which frame the operation of the markets and ensure that value creation is reflected in value for shareholders; and in developing codes of best practice for governance, management of key risks and disclosure. In addition to this work on a country-specific basis, we address regulations with a global remit, which are currently in the areas of accounting and auditing standards.

Investment institutions are typically absent from public policy debates even though they can have a profound impact on shareholder value. EOS seeks to fill this gap.

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

Highlighted sample activities

Forest Footprint Disclosure Project (FFD)

We co-ordinated a letter with other investors with assets under management totalling $3.6 trillion in support of the Forest Footprint Disclosure project. The letter was sent to those companies which have previously not responded and whose responses would be most valuable from investors' and FFD's perspective, requesting their participation in the 2011 disclosure request. We look forward to seeing an increased response rate this year, assisted by our outreach.

Singapore Exchange

We welcome the Singapore Exchange's recently announced amendments to its Listing Manual, effective from the end of September. We particularly welcome the additional requirement for listed companies to disclose the level of fees paid to auditors for both audit and non-audit services, which we have been seeking for several years. We are pleased that our strong support for this requirement in our response to the public consultation on the Listing Manual in 2010 has been reflected.

Overfishing

Following our successful webinar which we co-organised with Threadneedle and the UNPRI, we launched our collaborative engagement on overfishing by sending out letters to 40 public companies from different industries that are directly or indirectly affected by the issue of overfishing. The problem of rapidly declining fish populations is one of the most urgent environmental problems today given the importance of the marine eco-system in terms of biodiversity and as a source of nutrition. The last decade has seen the rise of several initiatives that aim to address this issue. We are supportive of these initiatives and encourage companies to source as much certified fish as possible and abstain from selling endangered species. To this end we launched a seminar earlier this year to raise awareness about the issue and gather support in the investment community. We simultaneously conducted research on current best practice and the most affected industries and companies. At the same time we witnessed a sharp increase in public awareness of overfishing and the associated danger which has also led several companies to update their policies. Consequently our engagement gained strong support among other investors and we were able to gain support from 19 asset owners and managers with a total of $1.6 trillion in assets. The letter sets out our concerns about the risks associated with overfishing and our support for certification and similar initiatives. It further aims to gain a better understanding of companies' current policies. We aim to continue our dialogue in a collaborative way with the companies we have contacted, following up on the responses we receive.

Sharman Inquiry into Going Concern

We responded to this consultation about reporting of liquidity and the going concern statement. While this is a UK consultation we believe that other markets are interested in the outcome of the Inquiry and may follow its lead. By implication the consultation asks whether the format of the going concern statement is the best way to address the issue. Our response suggests that some light should be shed on the rigour, methodology and process used to arrive at the statement. We further suggest that IFRS, and the audit process itself, serve to make it harder to provide the reassurance that outside investors would like to see. We also met with the inquiry team considering how to make more effective the process boards and auditors go through with regard to deciding whether a company is a going concern, and whether to enhance reporting requirements to support this. We talked through perspectives on the weaknesses of the current process and ways in which it could be made more effective. In particular, we talked about enhancing auditor reports so that they reflect the debate and discussion on going concern between the auditor and the board – ensuring that such a debate does indeed happen.

Canadian dual voting shares

We continue to work as a member of the Canadian Coalition for Good Governance's Public Policy Committee to develop a model policy for new issues of these securities of dual voting shares. We urged the committee to consider further protections for ordinary shareholders in such companies. In particular, we strongly recommended that multiple voting class shares should revert to holding a single vote in an 'Exempt Bid', a low-premium takeover bid to five or fewer shareholders. We also argued that when unwinding a dual class structure, the premium paid to the control group, if any, should be carefully capped. And we noted the need for the draft policy to encompass derivative contracts and note that the shareholders strongly oppose any transaction that would allow a controlling shareholder to monetize all or part of their position through a forward sale while retaining the multiple voting rights attached to these shares. These comments were all taken on board.

Australian Corporate Governance Principles

We wrote to the chairs of every S&P/ASX200 company ahead of the peak Australian proxy voting season, to introduce Hermes EOS's new Australian Corporate Governance Principles and its accompanying appendix which discusses externally-managed trusts (a highly-conflicted investment vehicle typical in the Australian market). We hope thereby to encourage an enhancement of Australian governance practices and disclosure, and to make clear our likely voting stance ahead of times.

Public policy and best practice continued

Other public policy work this quarter included:

Securities Laws and Regulations

- Co-signed a submission to the Governments of Canada and Alberta urging action on implementing recent recommendations for creating a world-class environmental monitoring system for the oil sands region.
- We participated in a conference call as part of our involvement in a coalition seeking to push for the SEC to formulate a rule-making consultation on political donations.
- Met with the newly appointed vice chair of the Egyptian Stock Exchange to discuss the aftermath of the recent revolution.
- Participated in a roundtable about the evolution of shareholder rights protections in the US and Europe.
- Working with other investors to develop a petition to the US Securities and Exchange Commission asking the SEC to develop rules to require public companies to disclose to shareholders the use of corporate resources for political activities.
- Responded to the SEC's consultation on additional listing requirements for companies applying to list after carrying out a 'reverse merger' with a shell company.
- Hosted a meeting of the Quoted Companies' Alliance's corporate governance committee at which we met with the Financial Reporting Council (FRC) team on its going concern inquiry.
- Responded to a questionnaire by ESMA regarding the voting advisory business.

Codes of best practice

- We were actively involved in the development and welcomed the publication of a substantial guide to good corporate governance for Islamic banks and other financial institutions.
- We met representatives from the Forest Footprint Disclosure to discuss the recently released report by Global Witness.
- As part of our investor working group we spoke to the recently appointed Secretary General of the Roundtable on Sustainable Palm Oil to discuss governance.
- Met with the head of Investment Regulation at the Mandatory Provident Fund Schemes Authority (MPFS) in Hong Kong to discuss recent developments in Europe with regards to responsible investment and active ownership.
- Corporate Governance Council (Singapore) – Responded to a public consultation on amendments to the Code of Corporate Governance.
- Met with China-based senior representatives of BSR to discuss and promote ESG best practices among Chinese companies.
- We were the only foreign investor representative to participate in the workshop on the German Sustainability Code in Frankfurt.
- Spoke at a seminar hosted by the UNPRI, UN Global Compact and Spainsif on responsible investment in the Spanish market.
- Sent a letter to the chairs of several German top-30 companies which will hold supervisory board elections in 2012, we encouraged them to engage in a dialogue with shareholders ahead of their AGMs.
- Participated in a survey focussed on the role of institutional investors in the governance of Italian companies.
- Participated in a meeting of the Investment Committee of Eumedion, the Dutch collaborative platform on governance matters, to discuss the key topics for the forthcoming voting season in Netherlands.
- Played a role in hosting a seminar on reporting linked to the ICSA/Hermes Awards for best practice.
- Parliamentary Corporate Responsible Group – took part in a session of this group on reputation and risk management.
- Provided a panellist on conflicts of interest at a meeting hosted by the FRC to mark the first anniversary of the launch of the UK's Stewardship Code.
- Responded to the UK Remuneration Consultants' Group's consultation on its progress to date and suggestions for reform.

Global standards

- IAASB – met with chair of the IAASB to discuss a range of issues but principally the current work on auditors reports.
- IASB – met with Hans Hoogervoorst and Ian Macintosh, respectively the new chair and vice chair of IASB; for an introductory discussion.
- IFRS – responded to the latest round of the IFRS Trustees' paper on the future strategic direction of International Accounting Standards and the IASB.

Hermes votes at general meetings wherever practicable. We take a graduated approach and base our decisions on annual report disclosures, discussions with the company and independent analysis. We inform companies before we vote against or abstain on any resolution, usually following up such votes with a letter. 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.

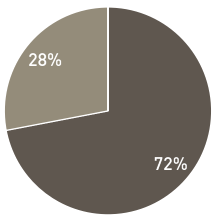
Hermes votes at company meetings all over the world, wherever its clients own shares.

Voting overview

Over the last quarter, we voted at a total of 2,202 meetings around the world, analysing 21,675 resolutions. At 1,129 of those meetings we opposed one or more resolutions and we abstained at 24 meetings. We voted with management by exception at 27 meetings, while we supported management on all resolutions at 1,022 meetings.

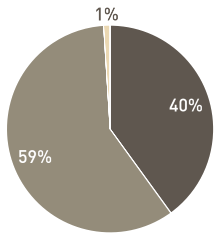
Africa and Middle East

We voted at 39 meetings (383 resolutions) over the quarter.



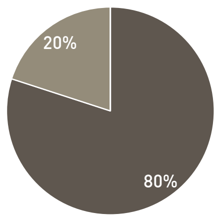
North America

We voted at 390 meetings (3,117 resolutions) over the quarter.



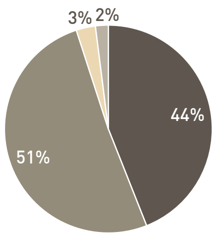
South America

We voted at 49 meetings (260 resolutions) over the quarter.



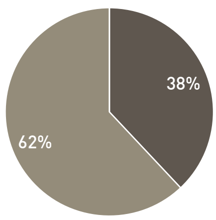
Asia (except Japan)

We voted at 338 meetings (2,403 resolutions) over the quarter.



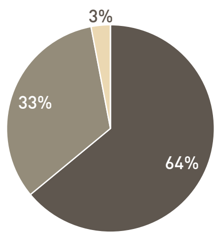
Japan

We voted at 813 meetings (9,292 resolutions) over the quarter.



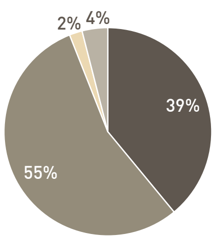
Australia and New Zealand

We voted at 45 meetings (161 resolutions) over the quarter.



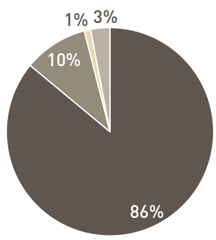
Europe

We voted at 295 meetings (3,208 resolutions) over the quarter.



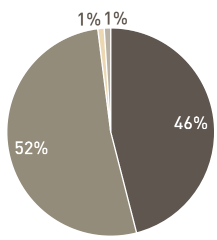
UK

We voted at 233 meetings (2,851 resolutions) over the quarter.



Global

We voted at 2,202 meetings (21,675resolutions) over the quarter.



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

Important information

This communication is directed only at recipients who are eligible counterparties or professional clients. Any investment or service to which this communication relates is only available to and will only be engaged in with such persons and any other persons who receive this communication should not rely on or act upon this communication.

This communication is issued and approved only for the purposes of section 21 of the Financial Services and Markets Act 2000 by Hermes Investment Management Limited ("HIML").

Hermes is a multi-boutique asset manager, independent of any broader financial services organisation. Each Hermes operating entity is either a subsidiary of, or is otherwise affiliated to, Hermes Fund Managers Limited. They carry on business under the name "Hermes". The main operating companies within the Hermes Group are Hermes Investment Management Limited ("HIML"), Hermes Administration Services Limited ("HASL"), Hermes Equity Ownership Services Limited ("HEOS"), Hermes Focus Asset Management Limited ("HFAM"), Hermes Focus Asset Management Europe Limited ("HFAME"), Hermes Real Estate Investment Management Limited ("HREIML"), Hermes BPK Partners LLP ("HBPK"), Hermes Sourcecap Ltd ("HSL"), Hermes Fund Managers (North America) ("HFMNA") and Hermes Fund Managers (Australia) Pty Ltd ("HFMA"). All of the above named operating companies are separately authorised and regulated by the Financial Services Authority except for HREIML, HEOS, HFMNA and HFMA. HIML currently carries on all regulated activities associated with HREIML (which is not regulated) and is responsible for marketing HREIM products to prospective investors and for arranging their investment. HIML, HBPK, HFMNA and HSL are all registered investment advisers with the United States Securities and Exchange Commission (SEC). HFMA is registered with the Australian Securities and Investments Commission (ASIC) and holds Australian financial services license number 351784. HFMA is authorised to provide certain financial services to wholesale clients only.

Hermes Equity Ownership Services Limited ("HEOS") has its registered office at Lloyds Chambers, 1 Portsoken Street, London, E1 8HZ.

Please note that the Financial Services Authority does not generally regulate any activities referred to in this document which are not regulated activities under the Financial Services and Markets Act 2000 (Regulated Activities) Order 2001.

This document has no regard to the specific investment objectives, financial situation or particular needs of any specific recipient. This document is published solely for informational purposes and is not to be construed as a solicitation or an offer to buy or sell any securities or related financial instruments. Prospective investors must rely on their own examination of the legal, taxation, financial and other consequences of an investment in the funds, including the merits of investing and the risks involved. Prospective investors should not treat the contents of this document as advice relating to legal, taxation or investment matters. Before entering into an agreement in respect of an investment referred to in this document, you should consult your own professional and/or investment advisers as to its suitability for you and should understand that statements regarding future prospects may not be realised. No action should be taken or omitted to be taken in reliance upon information in this document.

Figures, unless otherwise indicated, are sourced from Hermes.

This document may include a list of Hermes Equity Ownership Services Limited ("HEOS") clients. Please note that inclusion on this list should not be construed as an endorsement of Hermes Equity Ownership Services Limited ("HEOS") services. Should you wish to contact a client for reference purposes, please let Hermes know in advance.

CM102232 UK 10/11

Hermes Equity Ownership Services

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