Hermes Equity Ownership Services

Public engagement report

Q2 2012

HERMES

Q2

www.hermes.co.uk

This report contains a summary of the responsible ownership activities undertaken by EOS on behalf of its clients. It covers significant themes that have informed some of our intensive engagements with companies in Q2 2012. The report also provides information on our voting decisions and the steps we have taken to promote global best practice, improvements in public policy and collaborative work with other shareholders.

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. Through pooling resource with other like-minded funds to create a stronger and more representative shareholder voice, our joint company engagements can be more effective. We currently act on behalf of 24 investors with roughly 143 bn. USD* in Assets under stewardship.

Hermes has the largest stewardship resource of any fund manager in the world. Our 28 person team includes former CEOs and other board members of public companies, as well as senior strategists, corporate governance experts, investment bankers, fund managers, lawyers and accountants.

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

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

*as at 31st of December 2011

How does EOS work?

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

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.

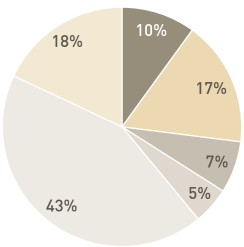
For further information please contact Colin Melvin on +44(0)207 680 2251.

Engagement by region

Over the last quarter we engaged with 249 companies on a range of 481 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.

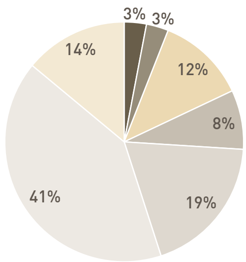
North America

We engaged with 28 companies on a range of 60 issues over the last quarter.



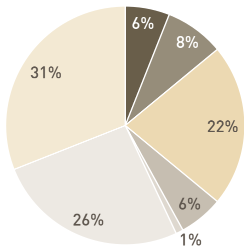
Asia

We engaged with 33 companies on a range of 73 issues over the last quarter.



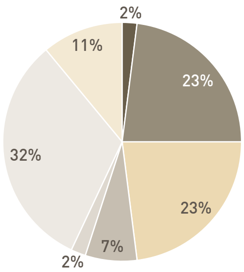
Australia & New Zealand

We engaged with 39 companies on a range of 77 issues over the last quarter.



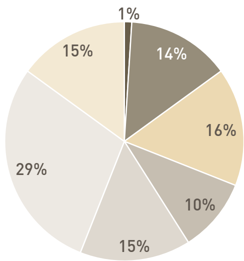
Emerging & Frontier Markets

We engaged with 30 companies on a range of 56 issues over the last quarter.



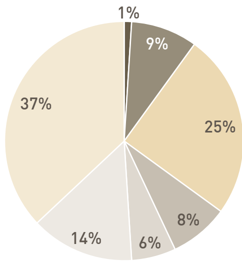
Europe

We engaged with 58 companies on a range of 105 issues over the last quarter.



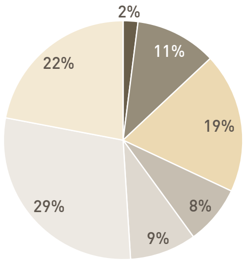
UK

We engaged with 61 companies on a range of 110 issues over the last quarter.



Global

We engaged with 249 companies on a range of 481 issues over the last quarter.



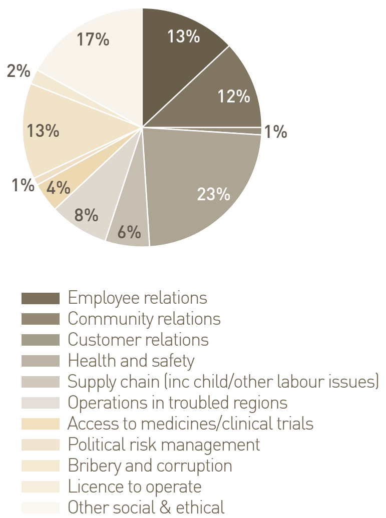
- Shareholder communications
- Environmental
- Social and ethical
- Risk management
- Business strategy
- Governance
- Remuneration

Engagement by issue

A summary of the 481 issues on which we engaged with companies over the last quarter is shown below.

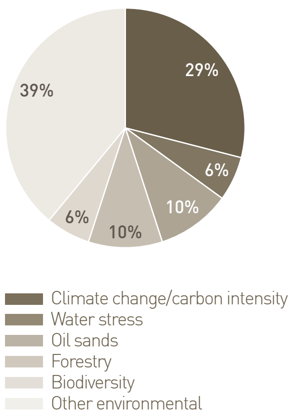
Social and ethical

Social and ethical issues featured in 19% of our global engagements over the last quarter.



Environmental

Environmental issues featured in 11% of our global engagements over the last quarter.



Other engagement

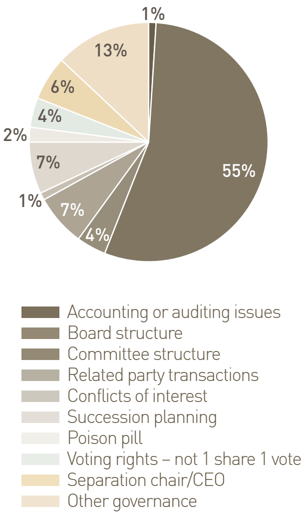
Shareholder communications featured in 2% of our engagements over the last quarter.

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

Remuneration featured in 22% of our engagements over the last quarter.

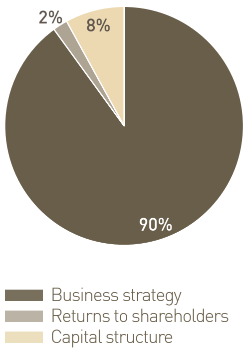
Governance

Governance issues featured in 29% of our global engagements over the last quarter.



Business strategy

Business strategy issues featured in 9% 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:	125
North America	19
Asia	28
Australia and New Zealand	14
Emerging and Frontier Markets	13
Europe	35
UK	16

Number of significant steps forward in strategic/governance engagements this quarter:	20
North America	4
Asia	5
Australia and New Zealand	0
Emerging and Frontier Markets	3
Europe	3
UK	5

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.

Examples of successful engagements

We are pleased that a **North American financial ratings agency** announced at its AGM its intention to separate the roles of CEO and chair and to appoint an independent chair. This shift is a direct result of our lengthy engagement over the past three years, which has included discussions with the current CEO and chair as well as the filing of three separate shareholder proposals. In 2009 we identified the company as high-risk due to its role in the run-up to the crash in the credit markets. We began to press the company in a series of meetings to enhance the board's independent leadership by separating the roles of chair and CEO, and thereby improve management accountability. The appointment of an independent lead director with a reasonably robust set of duties did not seem sufficient in the context of the threats to the business. Our first shareholder proposal went to a vote at the 2010 AGM and garnered 33% support, a notable increase from previous years. We continued to meet extensively with the company on this issue but it proved impossible to achieve

further progress through behind-the-scenes discussions. We thus decided to re-file the shareholder proposal for the 2011 AGM. In April 2011 a landmark result saw our shareholder proposal win majority support, with 56% of investors voting in favour. Unfortunately, despite the clear message sent by shareholders, the company remained determined not to implement the proposal. Thus, in late 2011 we sent a strong signal by filing a binding shareholder resolution seeking to amend the by-laws to require an independent board chair. Binding resolutions are rare in the US as most proposals are filed on a 'precatory' basis, meaning that, while a company is expected to implement a majority-supported shareholder proposal, there is no legal requirement for it to do so. In early 2012, following productive discussions with the executive chair and board of directors, the company agreed to split the roles in exchange for the withdrawal of our binding proposal. This decision to adopt a governance structure which promotes the highest levels of independent oversight and management accountability through the appointment of an independent chair is a significant and timely change which we believe is in the long-term interests of shareholders.

We met with a **major Japanese electrical utility company** to continue discussions on strategy, risk management and governance issues. While acknowledging ongoing political tensions and complex processes, we reiterated our great dissatisfaction with the company's prolonged actions and passive attitude to defining future strategies. We also raised significant concerns about its poor communication with stakeholders and lack of leadership. On corporate governance, we welcomed the move to a board-with-committees system, with the aim of enhancing corporate governance practices and transparency in decision-making. We finally emphasised the importance and necessity of changing the corporate culture and mindset across the organisation. Following this meeting, we were pleased to learn that the company has announced further measures to improve its corporate governance, including a reduction in board size from 16 to 11 directors, among whom the vast majority will be outside directors.

We met with the remuneration committee chair of a **financial services company in Australia and New Zealand** to discuss potential industry remuneration reforms, and how the bank manages both retail interest rate risks and European exposures. The bank's current remuneration practices already incorporate EOS's banking remuneration principles. When we challenged the bank to include one or more strategic performance conditions in the long-term incentive, we received a frank explanation that strategic objectives changed too quickly for use in a long-term incentive scheme. On the threat from European instability, the bank explained that due to its strategic focus on Asia the European crisis actually presented more of an opportunity. The company expressed an interest to maintain closer contact in future as it seeks to better understand the long-term investor perspective.

We met with the senior independent director of **a mining company in the Emerging Markets**, which is controlled by the chair's family. We noted that there was not much operational mining experience among the non-executives and, whilst we heard about the board's use of expert advisers to supplement its knowledge, we will continue to suggest that the company consider this when it examines board succession. We asked specifically about succession plans for important individuals, including the chair and CEO, and were assured that the SID, though not on the nominations committee, satisfied himself that such plans are in place at least twice yearly in conversation with the chair. He also noted that the chair was able to import senior management from other mining companies under his control. We expressed our belief that the SID should be guiding the chair on delicate issues when necessary and were assured that such discussions did take place. We also got a commitment that the chair was very alive to UK corporate governance issues and best practice.

Following an intensive engagement with a **European financial institution**, we were pleased that the combined chair and CEO is stepping down from the nomination committee, a change we had specifically pressed for. Through successive meetings with the chair, vice-chair, secretary to the board and chair of the nomination committee, we gained reassurances on the quality and proper functioning of the board. We continue to push for a separation of the chair and CEO roles, and for more formal and effective board evaluation and director selection processes. We discussed the opportunity for a widespread change in governance structure in 2015 when a number of board mandates, including the chair's own, will be renewed and highlighted our expectations of any candidate for the chair.

We met the chair of a **UK manufacturer** to discuss the strategic difficulties in the business, governance and executive remuneration. We asked how the company manages both the increased pressure on costs from its main customers and the shift towards electronic and cyber-defence away from equipment and services, talking through both cost-saving and growth opportunities. We questioned how the board retained oversight of its US business, obtaining some comfort that the company has the ability to manage all of its staff. We asked about board dynamics and the constraints on board structure. We agreed that a little more flexibility would be helpful and agreed on the characteristics that should be sought in non-executives, as well as backgrounds that are unhelpful.

Collective bargaining: Sustainable labour practices

Employee relations in an age of austerity

EOS engages with companies across the world to ensure sustainable management of employee relations and to encourage companies to exploit opportunities to protect and enhance shareholder value.

Statistics	
Number of companies engaged with:	8
Number of companies where substantive change sought:	8
Number of these showing progress so far:	4

'Any fixed capital asset that is treated badly breaks down, and in the case of the workforce this is even more obviously true.'

Overview

The continued global economic downturn is contributing to increasing conflict between managers, employees and their unions. The crisis has continued to impact workers, as many governments favour austerity measures over stimulating growth and employment. Consequently, unemployment has risen to record levels, with over 205 million people out of work across the world.

According to the International Labour Organisation [ILO], over 400 million new jobs will be needed over the next decade to avoid a further increase to record unemployment levels. Hence, in order to generate sustainable growth while maintaining social cohesion, the world must create 600 million productive jobs over the next decade. This would still leave 900 million workers and their families below the US$2 a day poverty line, largely in developing countries.[1]

The rise in precarious work, a term describing work that is temporary, indirect, informal or otherwise insecure, is partly the result of employment practices intended to maximise short-term profitability and flexibility at the expense of the workforce. Unions in many countries have cited the high level of contract and casual labour as one of the biggest challenges to protecting workers' rights and the cause of significant industrial conflict.

It is a cliché for business leaders to say "Our people are our greatest asset" and yet companies do not always regard or treat them as such. It is self-evident that no organisation can operate without people, and thus that an organisation's performance is directly dependent on the performance of its people. By any definition, this makes them assets. Yet people are often the first of these to be jettisoned when the economic climate deteriorates - something that manifestly demonstrates how little management recognises their asset value.

Unless the economic change is a permanent one, however, they are likely to be needed again in the future. Redundancy programmes may therefore be nothing more than a cost reduction exercise for limited short term benefit, taking no account of either the past investment in people or the future costs of replacing them. Most managers recognise this but argue that they are constrained by market pressures – an outlook which runs counter to any sense of people as assets. Any fixed capital asset that is treated badly breaks down, and in the case of the workforce this is even more obviously the case.

1 'Global Employment Trends 2011: The challenge of a job recovery', International Labour Organization, 2011

Companies and issues

EOS has long emphasised in its engagement with companies that stable employee relations is one of the most important factors in the sustainability of businesses. This applies across industry sectors and to both emerging and developed markets. We believe that constructive and equitable employee relationships are essential to ensuring that companies' business practices are sustainable and that shareholder value is both protected and enhanced in the long term.

During the last six months in particular, the importance of employee relations has garnered an increasing amount of attention across the world. We continue to engage and build on long standing relationships with companies who face growing pressures in their employee relations, ensuring that there is a systematic approach across the business. In some cases, the issues tackled relate to a clash of cultural approaches or where industrial relationships are in their infancy.

We have engaged with a number of companies on the subject of insecure employment and the right to collective bargaining; in some cases, companies are subject to disputes which have been running for considerable time. During our engagements we press for conciliation between companies and unions, particularly if the disputes are long running. Through this process a closer working relationship can be developed and such conflicts avoided in the future, ushering in a new period of constructive industrial relations.

A recurrent theme this year has been the right to trade union recognition and collective bargaining in the USA, affecting companies who do involve and bargain with trade unions in their host European nation. In general, US labour laws are considered comparatively lenient on the protection of workers' rights. The workforce is entitled to unionise provided enough workers vote in support of the creation of a union presence; however, many observers complain of barriers and infringements to this process.

There are both reputational and industrial relations issues to contend with when a company with established trade union relationships in their host country denies or obstructs similar requests from unions or employees in a US subsidiary. These companies face the potential for global trade union campaigns, including shareowner activity, due to the established relationships with unions within their European operations that often include collective bargaining, co-determination and works councils.

This is particularly, but not exclusively, true for companies that operate in markets which have not ratified ILO conventions. By seeking short- term gain in countries without a history of formalised industrial relations they run the risk of creating a militant labour force, with little to lose.

For companies to ensure that workers are really treated as their greatest asset and that long-term success is achieved, furthering dialogue with employees around the labour process, their contribution to overall success, and their rights to trade union organisation and collective bargaining is a necessary perquisite.

Companies with issues in this area include: BP, Cosan SA Industria e Comercio, Deutsche Telekom, ExxonMobil, Foxconn, Hon Hai Precision Industry, Hyundai, Loomis AB, Maruti Suzuki, Nestlé, Statoil, Tesco.

German corporate governance

Improving the role of the supervisory board

Hermes EOS continued its work on the development of corporate governance in Germany by filing a counterproposal at Deutsche Bank's AGM this year. This received considerable support from shareholders, thereby sending a strong message about the standards expected by shareowners.

'The annual vote on the discharge of the supervisory board allows shareholders to express their opinion about the performance of its members.'

Overview

Since the German Corporate Governance Code was introduced ten years ago, the composition and work of supervisory boards of major listed companies has improved significantly. However, there remain cases where shareowners find it difficult to understand why particular candidates are presented for election to the supervisory board, and where boards do not perform to the standards that shareowners expect.

Hermes EOS has played a significant role in the development of German corporate governance and particularly the role of the supervisory board, leading, for example, the first proxy contest at a major German company, Infineon AG, in 2010 and making regular submissions to the German Corporate Governance Code Commission, which develops self-regulation.

This year, we continued to promote dialogue between shareowners and their supervisory board representatives on issues such as board nomination, both at the company and regulatory level. We also filed a counterproposal at Deutsche Bank's AGM opposing the discharge of the supervisory board. Supported by 22.26% of shareholders, this not only sent a strong signal to the supervisory board about its unsatisfactory performance but also to all current and future supervisory board members in Germany that shareowners expect them to meet certain performance standards.

Improving dialogue between shareowners and supervisory boards

In the two-tier German board structure, the main functions of the supervisory board are to appoint and remove management board members, to control and advise the management board, and to be responsible for the remuneration of its members. Traditionally there has been no contact between the supervisory board and shareowners since the management board represents the company to stakeholders. As such, minority shareholders have little involvement in the nomination of candidates for election to the supervisory board. Candidates are selected behind the scenes and historically included former management board members, as well as directors of other German large caps.

The dissolution of the 'Deutschland AG', when German companies held large stakes in each other, numerous legal developments, and the advance of corporate governance guidelines have gradually changed the environment in which German companies operate. This has enhanced transparency

and made management and supervisory boards more accountable to shareowners. However, a vital, outstanding development is to close the gap between shareowners and their representatives on supervisory boards.

Through forums such as the German Corporate Governance Commission, which this year invited a Hermes EOS representative to deliver a speech at its conference, we have been calling for corporate governance in Germany to be moved to the next level. Rather than ever more detailed regulation on issues such as supervisory board composition, we have encouraged closer links between shareowners and supervisory board members. Whilst some companies have started to facilitate this dialogue – often as a result of our request and encouragement – there needs to be another push to make this accepted best practice. The dialogue should involve discussions about the criteria that ought to be considered when searching and selecting nominees for election to the supervisory board. To this end, we have encouraged the Commission to provide both companies and shareowners with guidance on the format and substance of dialogue between chairs and investor representatives in the German corporate governance system.

Supervisory board accountability: Deutsche Bank case study

Following an engagement since 2008, and because there have rarely been such strong concerns about the work of non-executive directors in a major German company, at Deutsche Bank's 2012 AGM we asked shareholders to vote against the discharge of the members of the supervisory board for their performance in 2011. 22.26% supported our counterproposal. The annual vote on the discharge of the supervisory board gives shareholders an opportunity to express their opinion about the performance of its members in the last fiscal year and express continued confidence, or otherwise, in them.

Results of our engagement have included the recent improvements to the company's remuneration report following EOS' public intervention ahead of last year's AGM. In 2010, only 58% of shareholders supported the management board remuneration system – the second worst such voting result in the DAX. Massive public pressure from institutional investors therefore followed the decision not to give shareholders the opportunity for a vote in 2011, and this failure to take account of investor concerns formed part of the basis for our counterproposal at this year's AGM.

A second pillar of the counterproposal concerned our engagement on risk management – namely, the insufficient alignment of the company's culture and strategy with the principle of sustainability. Since the late 1990s, Deutsche Bank has evolved from a lender operating predominantly at a national level into a global investment bank. During this period, it appears that the company has not always focused on sustainable creation of value and protection of its reputation. It is not only ongoing investigations and pending litigation, but also ethically questionable business practices that raise the question of whether Deutsche Bank is meeting the standards set out in its Code for Business Conduct and Ethics.

One of the most important tasks of the supervisory board, though, is management board appointments. Here there was an insufficient process regarding the succession of the CEO, Josef Ackermann, one affected by internal, and sometimes public, conflicts. This caused damage not only for potential candidates, but, first and foremost, for Deutsche Bank. In addition, the fact that, only a few months after his nomination for election to the supervisory board, Dr Ackermann withdrew his candidature for entirely predictable reasons, suggests that the nomination was badly prepared by the supervisory board.

At the 2012 AGM, we therefore outlined these arguments in support of our counterproposal that "The members of the supervisory board in office during the financial year 2011 are not discharged". The support of this by 22.26% of votes is very significant for the development of corporate governance in Germany, making it clear to all current and future supervisory board members in Germany that shareowners expect them to meet certain performance standards. It has also sent a strong signal to Deutsche Bank and given the incoming chair a mandate for change. We believe this should involve an external evaluation of the composition and work of the supervisory board, further personnel refreshment and, most importantly, better integration of sustainability into the bank's culture and strategy. We believe our engagement with Deutsche Bank will lead to more accountability of supervisory boards going forward.

Companies with issues in this area include: Bayer, Hochtief, Infineon, RWE, SAP, TUI and Volkswagen.

Brazil in focus

Promoting better corporate governance and management of environmental risks.

Hermes EOS stepped up its work with Brazilian regulators to promote corporate governance best practice and has launched a new engagement strategy focusing on environmental risks at natural resources companies.

'Brazil achieved one of the highest growth rates in the 20th century, transforming its economy and society.'

Overview

South America's largest country, which recently overtook the UK to become the world's sixth largest economy, is here to stay. Brazil achieved one of the highest growth rates in the 20th century, transforming its economy and society.

EOS is engaging with regulators and institutions to promote best practice and better corporate governance. There have been significant improvements in the last few years, such as the creation of the Novo Mercado listing segment requiring higher corporate governance standards, but much remains to be achieved.

Family ownership is common and, whilst this is not in itself an issue, dual class share structures and lack of independent directors on boards raise concerns about minority shareholder protection. Furthermore, the strong government presence in the economy, principally via BNDES, the Brazilian Development bank and the presence of large, relatively silent pension funds are other forces for shareholders to reckon with.

We have met with senior executives of the BM&FBOVESPA, the Chairman of the Comissão de Valores Mobiliários (CVM), the Brazilian Securities & Exchange Commission, senior executives at Brazilian Financial and Capital Markets Association (ANBIMA), the deputy governor of the Brazilian Central Bank, as well as the CEO of AMEC, the Brazilian Association of Shareholders, to discuss the progresses made and encourage improvements of the rules for better protection of minority shareholders.

Playing host to the Amazon, Brazil also has to deal with how it manages its natural resources. The recent discovery of large oil reserves of the coast of Rio de Janeiro and the various hydro-electric projects in the Amazon, such as the Jirau and Belo Monte dams, have brought their share of controversy. We met with the head of technical assessment of the Brazilian Institute of Environment and Natural Resources (IBAMA) to discuss the process for environmental licensing.


Highlighted sample activities

While in Brazil this quarter, we met with the sustainability team of the world's second-largest mining company. We raised concerns about the **management of sustainability issues and the standards across the company's operations**. In recent years, the company has produced extensive disclosure regarding its Brazilian operations and its impacts on the local environment. However, it is not clear whether the positive picture painted in these disclosures is replicated at the company's facilities, nor is it clear that anything beyond minimal legal standards are applied outside Brazil. We tested how the policies adopted at group level are being applied and implemented throughout all its international subsidiaries and joint-ventures and pressed for further clarity on this. Given the company's stated aim to become the largest miner in the world, which will require further M&A activity, we raised concerns about whether the company's structures are sufficiently robust to deal with the **large environmental and social risks** involved. We also challenged the company's management of such issues in areas like Indonesia and sub-Saharan Africa. With regards to its Brazilian operations, the group was recently awarded the Public Eye award for the worst company in terms of sustainability because of its 6% participation in the Belo Monte dam project. We questioned the company on this recent accolade and discussed how it manages its reputational risks. The company emphasised its need for energy (one of Brazil's largest, consuming over 3% of the nation's total energy output) and that its board member on the consortium building the project is actively pushing a sustainability agenda. We tested the board's involvement in the **management of environmental, health and safety risks, as well as indigenous rights issues**, and discussed the objectives and targets currently in place. The company committed to arrange a further discussion with the head of sustainability and invited us to visit their operations when we next visit Brazil.

We met with a senior executive who is also a member of the founding family of one of Brazil's largest financial institutions, which still lacks governance structures commensurate with its scale and valuation. The company is controlled by a family which holds 51% of the bank's voting shares and a further 39% via a holding company. We raised concerns about the shareholding structure which sees the families controlling close to 90% of the voting rights whilst owning under 45% of the share capital, and discussed the role and influence of the family on the board as well as among the executives (his brother is the current CEO of the bank and chair of the holding). When pressed on **succession and legacy issues** however, he recognised that there will be a need to look outside the families when no one among them has the will or skills to take over. We questioned why the bank, despite its significance, continues to be listed on the exchange's corporate governance level 1, meaning it need comply with only the most basic governance standards. The bank does not adhere to best practice standards, such as those exhibited by more progressive companies listed in the Novo Mercado segment, and falls even further short of internationally recognised governance standards promoted by the Brazilian Institute of Corporate Governance. Whilst the bank stressed that it endeavours to apply best corporate governance, the Novo Mercado segment remains unattractive because of a provision requiring there to be a single class of shares, which would require changes putting the founding families' control at risk. At present, **directors are elected every three years and only four out of 13 are independent**; we pressed for the inclusion of further independent board members to ensure that minority shareholders' rights are respected. We tested how the remuneration committee incentivises senior management and executives to inspire performance and so that their interests are aligned. We pressed for more specifics on the targets to be achieved for variable remuneration and offered our help to improve on both disclosure and substance.

After a series of letters and other efforts we were finally offered a meeting in Rio to discuss our concerns with a large oil company. We had written to express our discontent with the temporary appointment of an individual with clear ties to the government to occupy one of the **board seats legally designated for representatives of minority shareholders**. We welcomed hearing that our letters had struck a chord with both management and board members and have led to internal discussions regarding the director election process and communications with shareholders. However, when we pressed the company on the issues raised in the letter, the answers were unsatisfactory and rather elusive, suggesting that various government-linked organisations are treated as minority shareholders for the purpose of nominating and electing directors representing their interests, giving them key roles in the election of the controversial candidate. The company acknowledged this to be an issue but said it could not interfere in the decision of shareholders to categorise themselves as minorities or part of the controlling group, in this case the Brazilian government. The company confirmed it is in the process of evaluating the practical procedural issues related to voting at director elections, in particular those related to allowing minority shareholders to nominate and vote for the candidate of their choice. In parallel, we had a meeting with the board member whose election created controversy. Our discussion, which focused on our concerns about the director appointment process and his in particular, was tense and not wholly welcoming. To this end, we offered our help in explaining to the company how international proxy voting works in practice to ensure this will not be available as an excuse in the future. We reiterated our disappointment at the way international investors had been treated and the clear lack of respect for minority shareholders. We urged that there should be better **communications between the company and its international shareholders** and received his commitment that the company is open to dialogue.

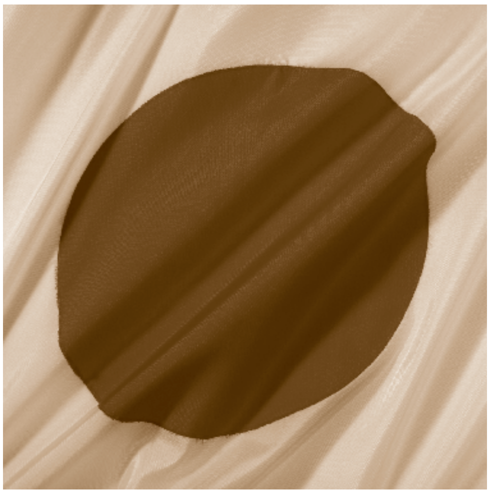
Risk management in the nuclear industry

Enhancing safety measures and transparency

Following the Fukushima accident, EOS has been intensively engaging with major operators of nuclear power plants in Japan, Europe and the US, seeking a higher level of accountability and disclosure on safety measures and risk management. We also request that companies demonstrate effective oversight of the board and its preparedness for crisis management.

Statistics

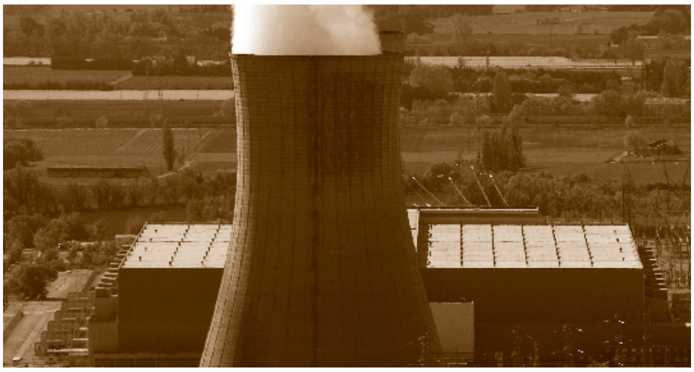
Number of companies engaged with:	14
Number of companies where substantive change sought:	10
Number of these showing progress so far:	6



Overview

Japan's devastating earthquake and tsunami occurred in March 2011, resulting in one of the worst nuclear related disasters in history. The size and duration of the accident was unprecedented for the country's nuclear industry, not least in causing the fatal damage to a major nuclear facility in Fukushima. It triggered a provisional International Nuclear Event Scale (INES) level 5, which was later raised to the highest level with a provisional INES level 7. While the radiation leakage has since stopped, there are still large areas around the plant site which show radiation levels above the safety limit and need decontamination. Following the accident, the share price of TEPCO, the operator of Fukushima Daiichi nuclear plants, has plummeted over 90%. Uncertainty remains about the potential costs for compensation as well as decommissioning and dismantling damaged plants. Having been restructured into a temporarily nationalised entity, the company is still largely struggling to get its businesses back on track.

In the meantime, the severity of the accident also provided valuable lessons and indicated the need for changes. The relevant areas include insufficient protection against extreme events, inadequate preparedness for tail risks and poor communications. Regarding TEPCO, the severe consequences and much delayed crisis management have clearly indicated a lack of leadership and solid governance system. As such, EOS' intensive engagements with major nuclear operators in Japan, Europe and the US seek a detailed assessment on key risks associated with each nuclear power plant that the companies operate. We also request that current risk and crisis management procedures be sufficiently prepared for protection against extreme or tail risk events. We believe that the board should appropriately oversee sustainability risks, and demonstrate that a culture promoting nuclear safety and responsible operating practices is truly embedded at the organisation. Furthermore, given the resulting reviews of safety standards and reactions to the Fukushima accident by regulators and politicians around the world, companies in nuclear-related industries, especially in Japan and continental Europe, have had to confront alternative business strategies and further investment requirements for upgrading safety systems. We therefore expect the board to demonstrate an adequate understanding of potential changes in the regulatory and social environment and of the impact on strategy and business plans over time, as well as ensuring that safety and environmental performance versus overall financial performance is managed appropriately.



Issues and companies

Compared to most power generation sources, nuclear power presents strong advantages in addressing global warming concerns. Before the Fukushima disaster, Japan had put in place some of the most aggressive nuclear development plans, with an aim to increase nuclear power's share of electricity output to 50% by 2030 from the current level of around 25%. Nevertheless, the Fukushima Daiichi accident has clearly cast doubt on the credibility of nuclear power. The material impact and damage caused for the operator of the Fukushima Daiichi plants has threatened the future viability of the company.

The focus of our engagement with the company concerned has been on risk management, corporate governance and business strategy. In 2007, we visited the company's headquarters in Tokyo to discuss governance and environmental policies. We were told we were the first institutional investor to seek a dialogue on these issues. We challenged the company in detail about past wrongdoings relating to concealing accidents at its nuclear power plants and the falsification of inspection data, which reflected a negligent culture on safety issues. After the Fukushima accident, we further accelerated dialogues on related concerns. We held two lengthy meetings with the company, along with a number of phone dialogues. Earlier this year, the company provided us with a detailed update on the current status of the Fukushima nuclear power station and compensation-related issues. While we acknowledged ongoing political tensions and complex processes, concerns remained about the company's delayed actions and passive attitude to defining future strategies. We suggested that management could have taken further steps proactively to review and define its business strategy according to different possible scenarios, and, going forward, provide shareholders with forward-looking plans on operations and risk management, as well as measures for improving governance. We raised significant concerns about its poor communication with stakeholders and lack of leadership. In May, the Japanese government approved the company's 'Comprehensive Special Business Plan', which includes a JPY1 trillion injection of public funds through the government-sponsored Nuclear Damage Compensation Facilitation Corporation. Under current circumstances, strengthening the capital base is apparently imperative to ensure the company remains solvent. Most recently, we welcomed the company's significant step forward in corporate governance by establishing a more accountable board structure with key committees and appointing a majority of outside directors to the board. We will continue monitoring the progress in strategy and risk management.

In Japan, the close relationships between the nuclear industry regulator The Nuclear and Industrial Safety Agency ("NISA") and electric power companies was highlighted as one of the causes that had led to serious regulatory failures on safety culture and governance. Recently, the regulatory system has been restructured with the aim of ensuring independence and an effective decision-making process. The Fukushima disaster has also prompted a rethink on emergency plans and crisis management in the nuclear industry around the world. Regulators in most countries have commissioned a thorough review and reassessment of safety standards and issues associated with nuclear power generation and operations. Clearly, the Fukushima accident has had a major impact on nuclear policies in Japan, as well as in central Europe; for instance, Germany announced that it would close all nuclear plants by the end of 2022. In other regions, such as China, Russia and India, the impact appears to have been minimal and these countries' nuclear policies have remained largely the same, with ongoing plans in favour of nuclear energy expansion to meet the countries' growing electricity demand. The US possesses the largest nuclear fleet in the world, with 104 reactors. Reactions from the Federal government and regulators have also been relatively positive toward nuclear power, although President Obama did urge the industry to conduct a comprehensive safety review on US nuclear plants. We continue to watch closely for regulatory developments in different markets and, where necessary, to proactively engage with relevant regulators on safety enhancement and risk management measures for nuclear plant operations.

Companies affected by these issues include: Chubu Electric Power, EDF, Edison International, Entergy, E.ON, Exelon, Iberdrola, Kansai Electric Power, Korea Electric Power, Kyushu Electric Power, RWE, Shikoku Electric Power, Tokyo Electric Power, Fortum and Vattenfal.

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

Financial Stability Board Enhanced Disclosure Task Force

We are one of a handful of institutional investors invited to participate in a private sector initiative brought together by the Financial Stability Board to develop best practice in risk reporting by banks and financial institutions. Called the Enhanced Disclosure Task Force, the group is charged with identifying existing best practice but also highlighting new disclosure which would enhance market confidence in reporting. The aim is that this work is finalised and presented to the FSB in October and that, with that regulatory endorsement, it begins to be put into effect already in 2012 annual reporting.

Stock Exchange discussions on Japanese corporate governance

We held a meeting with senior representatives of the Tokyo Stock Exchange's (TSE) Listing Department to advance discussions on corporate governance in Japan. We welcomed the TSE's recent amendments to the Listing Rules to enhance disclosure on independent directors and statutory auditors. We highlighted the importance of developing appropriate clarity as to the role and responsibilities of independent non-executive directors.


We further exchanged views on encouraging Japanese companies to develop a strategic and proactive approach to appointing independent directors and improving board accountability. We again pushed for the TSE to initiate a working group to develop a Code of Corporate Governance, to ensure that various high-level principles become widely recognised as best practice. Finally, prior to the forthcoming AGM season, we discussed our concern about the obstacles which face international institutional investors who wish to attend the general meetings of investee companies in Japan.

OECD Taskforce of Middle East and North African Stock Exchanges for Corporate Governance

We continued our participation in this taskforce constituted to advance corporate governance in the region at its second meeting. This was attended by heads of stock exchanges and securities regulators from the region that are able to influence corporate governance laws and regulations as well as company practices in implementing them - EOS is the sole international institutional investor to be a member of this taskforce. We engaged in the lively debate and identified priorities for the development of the regional stock exchanges to improve their global standing. While the MENA exchanges are at different stages of development we consider there to be an appropriate level of investor protection and transparency across the major exchanges. We therefore addressed the taskforce on the importance of the exchanges making a transition to the next stage of promoting good governance, through encouraging implementation by listed companies. Our comments were positively received.

Meeting with Bank of England

We met officials from the Bank of England to discuss bank remuneration. They approached us having read our discussion paper on executive remuneration. This was a wide-ranging discussion on bank pay, and wider issues in the sector. In particular, we emphasised our desire, as representatives of long-term universal owners, for a healthy banking system where risk and adverse consequences through faulty incentives were avoided. The Bank was particularly interested in the work we had led on the International Corporate Governance Network's model mandate and the intermediation problems in the investment chain that had encouraged short-term thinking in the banking industry.

Kay Review interim report response

Facing the requirement that comments made needed to be new and additional to responses to the initial call for evidence, our response to the Kay Review interim report was necessarily limited. We believe in any case that the bulk of our initial comments have been taken on board - not least because they were quoted directly on two occasions - so the points that we made this time around were incremental to those or addressing matters which seemed to have been neglected in the current thinking of the Kay Review team. The principal one of these is the need for consolidation among pension funds, both in the defined benefit and defined contribution arenas, so that schemes are better able to call their agents to account and ensure that the financial sector genuinely operates in the interests of its beneficiaries. Second, we noted that the current review of the listing rules, and particularly the limits around that review, highlight the point which Professor Kay has rightly made (reflecting our own comments) that market regulation favours trading activity over ownership. We also flagged recent work by Mercer Consulting on the frictional costs facing the investment industry and how these can rapidly erode the returns of long-term investors.

Response regarding changes to listing rules

We responded to the significant consultation on potential amendments to the UK listing rules. Using the thinking underlying our recent thought piece 'Governance in a time of oligarchs' we proposed a number of key reforms first identified in that document as a way to bolster the protections provided to investors in the UK market, and particularly to index investors whose holdings are largely determined by the listing requirements set by the UK Listing Authority. In particular we sought: higher protections for minority shareholders in relation to major transactions; a system whereby there is a rebuttable presumption that major shareholders who take an active role in running companies are shadow directors and so subject to the same disclosure requirements and standards as the formal directors; we asked that the proposed board of a listed company must be in place for a significant period ahead of its IPO, and so able to function effectively as a board rather than brought in at the last minute; and that prospectuses are required to be complete before marketing occurs.

Centre for Audit Committee and Investor Dialogue initial logistical meeting

We met with other large institutional investors and Mazars, the mid-tier audit firm, to discuss the creation of a Centre for Audit Committee and Investor Dialogue, which we envisage as a group uniquely bringing together institutions and audit committees to discuss matters of mutual interest and concern. We talked through the logistics and administrative issues for the group, which we aim to launch later in the year.

Public policy and best practice continued

Other public policy work this quarter included:

Promoting best practice

- We participated in the latest steering committee meeting of the Forest Footprint Disclosure Project and discussed the amalgamation of the project with the Carbon Disclosure Project.
- We participated in a meeting of Carbon Disclosure Project's Carbon Action catalyst group, offering input on developing the programme to encourage stronger carbon reduction initiatives from companies reporting under the CDP banner.
- An EOS representative moderated a UN Principles for Responsible Investment webinar on anti-bribery and corruption at which speakers, including one from Transparency International, provided insight into the latest trends in international legislation, enforcement and corporate anti-corruption practices.
- We hosted a conference call with PRI members on the collaborative engagement effort we are leading on the sourcing of minerals from the Democratic Republic of Congo by electronics companies, and to coordinate future activities.
- We participated in the first meeting of a Canadian Coalition for Good Governance sub-committee charged with updating the organisation's executive compensation best practice guidelines.
- We presented the perspective of a long-term shareholder at the Japan Corporate Governance Network, especially as to the significant value which could be unlocked by governance reforms.
- EOS held a roundtable meeting with a group of Japanese corporate executives. The discussion focused on the expected roles and quality of non-executive directors in Japan.
- We spoke at an event on the oil and gas industry organised by the Horn of Africa Business Association. We stressed the importance of good corporate governance and developing standards, particularly in the context of weak or fragile states and legal systems.
- We spoke at two high level conferences in Germany, looking back at developments over the 10 years since the German corporate governance code was first introduced.
- Under the aegis of the PRI anti-bribery and corruption engagement, we met the head of the Serious Fraud Office, the UK's enforcer of anti-bribery legislation, most notably the recently enacted Bribery Act. We discussed its attitude both to enforcement and wider compliance.
- We met with a formal body of FTSE100 remuneration professionals, typically those executives in charge of remuneration frameworks, to encourage adoption of the concepts put forward in EOS's remuneration discussion paper.

Public Policy

- We responded to an International Organization of Securities Comissions consultation regarding exchange-traded funds, because of the potential systemic risks which ETFs may pose.
- We met with the deputy chair of the International Audit and Assurance Standards Board, the international auditing standards-setter, who is also leading its work on auditor reporting, to which the board has agreed to devote its entire agenda for this year. We were able to input our views on these issues, not least providing a rational way forwards for addressing the challenge of developing international standards for auditors.
- We met with the deputy director and other members of the Securities and Exchange Commission's corporate finance division to discuss a number of public policy topics such as progress on implementation of Dodd Frank, proxy access, political and lobbying expenditures and shareholder activism.
- We welcomed the launch of Singapore's Code of Corporate Governance 2012, which incorporates recommendations from the public consultation in 2011, in which EOS actively participated.
- We responded to a Hong Kong Stock Exchange consultation paper on a proposed Environmental, Social and Governance Reporting Guide. We made clear that we believe this proposed guide is a positive step.
- We met with the Corporations and Markets Advisory Committee, a formal Australian government think tank charged with considering reforms to company legislation and market regulation, regarding their assignment on the issue of AGMs. We welcomed their consideration of broader issues around shareholder engagement.
- We responded to an EU Commission consultation on policy options for female representation on company boards, stressing that the focus should be on achieving overall diversity without compromising on qualifications and ability.
- We provided the only institutional investor representative to speak at the German Corporate Governance Commission's annual conference, and used the opportunity to outline our thoughts on how corporate governance in Germany can be moved to the next level.
- We were put our name to a statement from the Institutional Investors Group on Climate Change to support a one-off setting-aside of EU Emissions Allowances to remove over-supply from the EU Emissions Trading Scheme, thereby maintaining a meaningful price in line with the 2020 reduction target.
- We gave evidence before the House of Commons Scrutiny Committee for the Enterprise and Regulatory Reform Bill, as to investors' response to its move to facilitate binding votes on remuneration, and we gave evidence as to investors' response to this and our commitment to take forward these new powers effectively.
- We responded to a call from the House of Commons Treasury Select Committee for evidence regarding the governance of, and remuneration at, systemically important financial institutions.

Working with other shareholders

- We chaired the latest meeting of the Shareholder Responsibilities Committee of the International Corporate Governance Network. Key areas of discussion were the next steps to promote the committee's Model Mandate Initiative, and starting a working group on diversity in the boardroom.
- We took part in the latest general board meeting of Eumedion, the stewardship group for Dutch investors, discussing key upcoming public policy matters.
- We took part in the latest meeting of the committee which shapes the activities of the UK's pension fund association (NAPF) in the area of stewardship and associated public policy.

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.

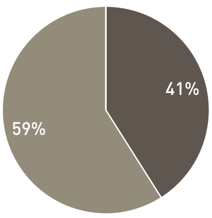
Hermes votes at company meetings all over the world, wherever its clients own shares.

Voting Overview

Over the last quarter, we voted at a total of 7,235 meetings around the world, analysing 73,668 resolutions. At 4,176 of those meetings we opposed one or more resolutions and we abstained at 51 meetings. We voted with management by exception at 95 meetings, while we supported management on all resolutions at 2,913 meetings.

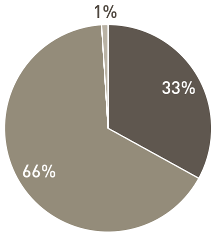
North America

We voted at 2,779 meetings (25,168 resolutions) over the quarter.



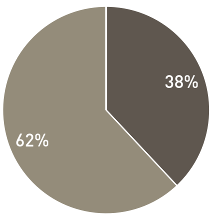
Asia Pacific

We voted at 1,602 meetings (16,749 resolutions) over the quarter.



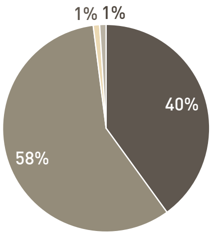
Australia & New Zealand

We voted at 74 meetings (384 resolutions) over the quarter.



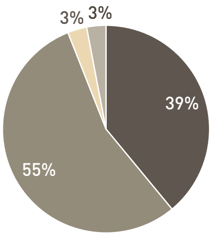
Emerging & Frontier Markets

We voted at 1,127 meetings (11,465 resolutions) over the quarter.



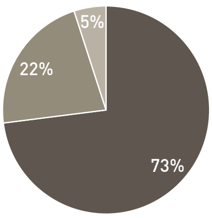
Europe

We voted at 1,240 meetings (14,180 resolutions) over the quarter.



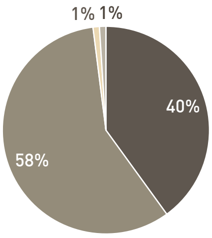
UK

We voted at 413 meetings (5,722 resolutions) over the quarter.



Global

We voted at 7,235 meetings (73,668 resolutions) over the quarter.



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

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