Hermes Equity Ownership Services

Public engagement report

Q4 2011

HERMES

Q4

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 Q4 2011. 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.

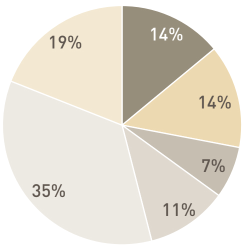
For further information please contact Colin Melvin on +44(0)207 680 2251.

Engagement by region

In Q4 2011 we engaged with 194 companies on a range of 394 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.

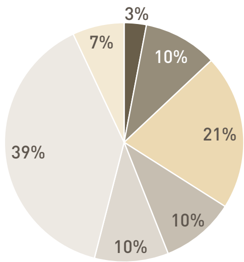
North America

We engaged with 32 companies on a range of 75 issues over the last quarter.



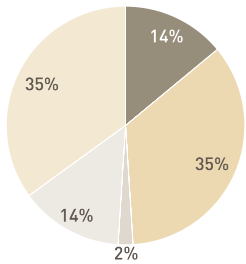
Asia

We engaged with 37 companies on a range of 71 issues over the last quarter.



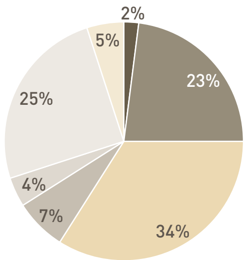
Australia & New Zealand

We engaged with 21 companies on a range of 49 issues over the last quarter.



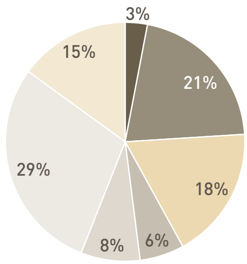
Emerging & Frontier Markets

We engaged with 28 companies on a range of 44 issues over the last quarter.



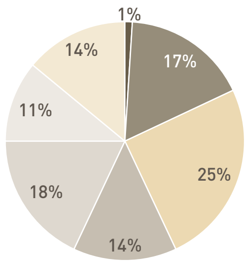
Europe

We engaged with 38 companies on a range of 71 issues over the last quarter.



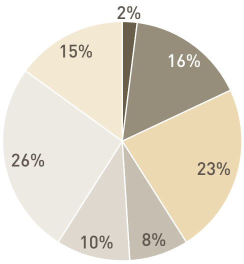
UK

We engaged with 38 companies on a range of 84 issues over the last quarter.



Global

We engaged with 194 companies on a range of 394 issues over the last quarter.



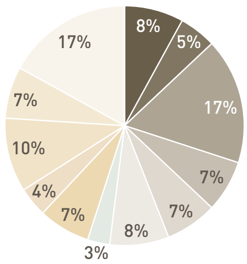
- Shareholder communications
- Environmental
- Social and ethical
- Risk management
- Business strategy
- Governance
- Remuneration

Engagement by issue

A summary of the 394 issues on which we engaged with companies over the last quarter is shown below.

Social and ethical

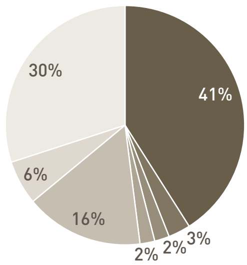
Social and ethical issues featured in 23% of our global engagements over the last quarter.



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

Environmental

Environmental issues featured in 16% of our global engagements over the last quarter.



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

Other engagement

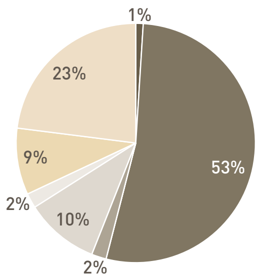
Remuneration featured in 15% of our engagements over the last quarter.

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

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

Governance

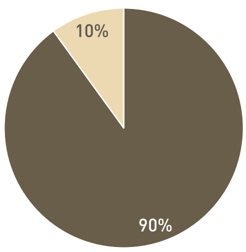
Governance issues featured in 26% of our global engagements over the last quarter.



- Accounting or auditing issues
- Board structure
- Related party transactions
- Succession planning
- Poison pill
- Separation chair/CEO
- Other governance

Business strategy

Business strategy issues featured in 10% of our global engagements over the last quarter.



- Business strategy
- Capital structure

Business strategy and board structure

Strategic engagements

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

Statistics

Number of companies engaged with on strategic matters this quarter:	147
North America	80
Asia	13
Australia and New Zealand	21
Emerging and Frontier Markets	7
Europe	8
UK	18

Number of significant steps forward in strategic/governance engagements this quarter:	25
North America	5
Asia	6
Australia and New Zealand	0
Emerging and Frontier Markets	5
Europe	4
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 held a conversation with the executive director of policy and governance at a **large oil and gas company in North America** to start our engagement on board declassification. We commended the progress the company has made in recent years in developing its governance structures as it turns into a larger, more sophisticated company – the ratification of the auditors by shareholder vote was introduced a couple of years ago and a presiding lead director role was created within the last year. We noted that within this timeline of events the declassification of the board is a natural next step and thus advocated for the voluntary implementation of such a change in anticipation of a likely shareholder proposal. While the company still considers a classified board as an additional defence mechanism against potential hostile takeovers, the company

representative agreed to share with the board our recommendation for a voluntary management proposal and we agreed to meet again shortly to discuss the board's plan of action ahead of the 2012 AGM.

We continued an engagement with a **large manufacturing company in Asia**, discussing strategy and governance matters. This was in the light of its new mid-term strategy following the reorganisation into a holding company structure. While we appreciate that the company has a clear vision and objectives for the next five years, we expressed our concern that it seemed to lay much more focus on scaling up the business than on increasing profitability or returns to shareholders. In particular, we questioned the criteria and plans for overseas acquisitions. We emphasised the importance of due diligence and accountability in assessing and agreeing any mergers and acquisitions. We challenged the company's adoption of a takeover defence scheme, as we are not convinced by the rationale provided. We also reiterated the importance of having a board with appropriate oversight, by appointing genuinely independent directors.

We met with a non-executive director of a **large retailing company in the Australia and New Zealand** region to discuss remuneration as well as strategy. On remuneration, we talked at some length about the board's decision to issue new share awards to the CEO and CFO during the life of existing incentives since it became apparent that the existing incentives would not pay out. We talked about the board's perception of the need to keep these key individuals incentivised and aligned, and shareholder concerns that executives are being made whole while shareholders still suffer from the consequences of the missed performance targets. We discussed how these individuals might respond to any rejection, and how this downside risk might be mitigated. On the strategic side, we again raised the issue of the fit of the company's insurance business with the rest of the group, and noted the increasing squeeze on insurance businesses as climate change seems to be increasing the likelihood of extreme events.

We met the **chair of an industrial company in the Emerging Markets** region in London to discuss business strategy and corporate governance. We understand that the level of independence required of the company is relatively low compared to other markets, but we encouraged the company to consider appointing more independent directors to its board. We also encouraged the chair to appoint independent directors to its compensation committee. We then questioned the management of health & safety and environmental matters and the measures to ensure standards are applied in practice. We tested the efficiency of the recycling programme of the PET resin, and welcomed the creation of an in-house package and transfer system to reduce transport costs and carbon emissions. We encouraged the company to expand this system to its overseas plants to reduce carbon emissions further. We raised concerns about the current floods in Thailand and its impact on the company's plants there, and finally talked about its long-term overseas expansion plan. We made clear our view that the company needs to have robust risk management strategies to mitigate the political and operational risks when it enters new markets.

We had a discussion with a **major insurance company in Europe** in order to press for governance change. We pushed for a board refreshment that would include a higher level of independence and more relevant skills and experience. As it stands, the board is heavily dominated by representatives of its controlling shareholder. While we acknowledge the concept of proportionality in Spain, we expressed our desire to see a more balanced representation of shareholder interests. Further, we strongly encouraged the company to reduce the size of its board, which currently significantly exceeds that of best practice in Spain. We then pressed for a separation of the roles of chair and CEO, and asked that at a minimum a lead independent director should be appointed as a safeguard for the current structure. Finally on board structure, we asked that the company seriously consider replacing the chair of the remuneration and nominations committee with an independent director. The committee is currently chaired by an executive director. On remuneration, we highlighted the need for clear and measurable performance metrics for the executive stock option scheme.

We held an **introductory meeting with the new chair of a leading UK** retail company. He was clearly in listening mode and wanted to hear our feedback on the main concerns we have about the company. We welcomed his encouraging comments about the new CEO's focus on capital allocation and returns, evidenced by the recent decision to exit Japan and delay another strategic initiative. He has also been visiting the US operations, about which we have a number of concerns; we challenged the chair on the long-term viability of the business, which has destroyed a significant amount of value since its inception. He was clearly not going to be drawn on the prospects for the country, but suggested that there might be some non-financial consequences of exiting the business – a view we challenged. We moved on to discuss the chair's view of the company's culture: he has been impressed by the meritocracy of the business the board appears to have a 'healthy curiosity' about having an outside chair. We put forward our concerns about the company's union policies in the US, which give us broader governance worries about the company's implementation of group-wide policies throughout its business units. We lastly touched on sustainability strategy and pressed that it is important for the company to start to express its initiatives in financial terms and explain the costs and the benefits more fully. This was an encouraging meeting with the chair, of whose appointment we were highly supportive: we will meet again in 2012 once he has settled in to his role.

Board effectiveness in Japan

Appropriate accountability to shareholders by the board

Recent scandals surrounding Japanese companies have revealed weaknesses in Japanese corporate governance. These weaknesses result from a lack of independence and adequate oversight by the board. EOS continues to engage on these on these and other issues with companies and regulators in Japan.

Statistics	
Number of companies engaged with:	13
Number of companies where substantive change sought:	9
Number of these showing progress so far:	3

Overview

Olympus' corporate governance was called into question after its CEO Michael Woodford, who was fired in October 2011, alleged publicly that his dismissal came after he pressed management to probe suspicious past payments. Weeks later, it emerged that a sizeable sum of money accounted for as acquisition fees had in fact been used to cover up losses from investments made during the 1990s.

Meanwhile, the former chair of another Japanese company, Daio Paper, has been arrested for several billions yen of company money for personal use, mostly to fund gambling activities. The former chair is the grandson of the founder whose family appears to have been controlling the company.

It seems clear that the boards of these companies failed to fulfil their duties of overseeing significant events at the companies or challenging suspicious behaviours of senior management. This reinforces our view that it is imperative for boards to include a sufficient number of truly independent directors who are in a position to exercise objective and fiduciary judgement and hold management properly to account.

Issues and companies

Board independence

A lack of independent oversight on the board is a significant concern for EOS in relation to Japanese companies. Very few companies have a board with a sufficient level of genuine independence and boards consisting solely of insiders are not uncommon. This inevitably brings the board's thinking close to that of the management and creates a culture that does not welcome different opinions to challenge those of senior executives. A vast majority of Japanese companies have adopted the two-tier board system where independent statutory auditors are supposed to counter the lack of independent directors. However, we do not believe that statutory auditors can implement their duties so as to fulfil the roles of independent directors effectively. These concerns have been exemplified by recent scandals about corporate governance at Olympus and Daio Paper.

EOS welcomed the news that Olympus appointed Mr Woodford as its first non-Japanese CEO in the hope that he would bring in a different perspective to the company and would challenge the company's traditional style of corporate governance in a way Japanese executives might not. Ironically, however, Mr Woodford was dismissed after he challenged the rest of the management. From 15 directors, only two could be considered to be truly independent and indeed Mr Woodford has claimed that his predecessor retained ultimate control and went unchallenged by the board. This lack of appropriate oversight contributed to a situation where a 1.2bn USD fraud went unreported for years and, once disclosed, led to an initial shares price drop of almost 80%.

We wrote to the company shortly after the dismissal of Mr Woodford, requesting a fundamental change of its board composition by appointing additional independent directors and including concrete measures to enhance board functions and oversight such as: a) establishing key committees including nomination and remuneration committees; b) increasing transparency in the selection process of outside directors; and c) reviewing the current internal control system with an aim to prevent and detect any potential wrongdoings in the future.

Another example of a dysfunctional board is that of Daio Paper, which allowed its chair to borrow over JPY 10 billion from subsidiary companies for his personal use, without security or prior approvals by the boards. We believe that a significant enabling factor in the fraud was the influence over the company of the founding family. Three of the 14 board members, including the ousted chair, are members of the founding family and there were no independent (or 'outside') non-executives on the board. This lack of independent oversight is believed to have facilitated the gross misconduct.

Cross-shareholdings

EOS has voiced concerns about the practice of cross-shareholdings, which entails the risk of tying up decision-making rights and thereby acting against the interests of minority shareholders. We are also concerned that the practice of cross-shareholding discourages company managers to act in a way that optimises shareholder value and can be used as an anti-takeover measure to entrench management. Since Olympus announced its plan to hold an EGM in early 2012, Mr Woodford was reportedly planning to launch a proxy fight at the upcoming EGM and propose himself for re-election to the role of CEO. However, he announced that he dropped his plans stating that he was unable to win support from institutional investors in Japan. This reinforces our view that practices such as cross-shareholdings encourage companies to maintain comfortable relationships and avoid confrontation even when necessary. We have hence been seeking increased disclosure around cross-shareholdings.

We are also concerned that Olympus is reportedly preparing to issue JPY 100 bn in shares – potentially diluting existing shareholdings should this take the form of a third-party placement. It is reported that the shares to be issued will be preference shares which will not carry voting rights, but they may be convertible into ordinary shares in future, which will have a further significant dilutive effect. EOS strongly supports the principle of pre-emption and believe that it is a proprietary right through which the current shareholders of a company can retain their ownership without finding their interest diluted by the introduction of other investors and finance. We have raised these concerns with Japanese regulators on a number of occasions and pressed for enhanced disclosure by companies about sufficient strategic explanations for any capital raising beyond minimal level such that we can be assured that any funds raised will be used in shareholders' best interests.

After the Tokyo Stock Exchange announced the potential de-listing of Olympus, we co-signed a letter by Asian Corporate Governance Association together with a number of other investors, requesting that TSE not de-list the company. We raised concerns that delisting would unfairly punish shareholders and other stakeholders who had already suffered enough due to the actions of Olympus executives.

EOS has long engaged with local regulators on these issues of Japanese corporate governance, including recent meetings with the Tokyo Stock Exchange and Financial Services Agency in Japan. We reiterated strongly that Japanese regulators should make the appointment of independent outside directors mandatory. In addition, given that Japan is one of the very few major financial markets that do not have a best practice code on corporate governance, we suggested the introduction of such a code on a basis of 'comply or explain'. Previously we also discussed the FSA's proposal to simplify current legal and regulatory procedures to encourage and facilitate rights issues. We reiterated our strong support for the principle of pre-emption and requested that legislators and regulators in Japan consider introducing this concept into practice.

We plan to respond to the Ministry of Justice's public consultation on amendments to Company Act to request to re-consider its proposal to set up a supervisory committee system, which is supposed to be a compromise between the existing two-tier board system and committee system. We believe that the proposed structure will only complicate the existing system without providing a meaningful solution to the issue of a lack of independence on the board.

Companies affected by these issues include: Chubu Electric Power, DoCoMo, Hitachi, Inpex Corp, Lawson, Mitsubishi Corp, Nissan Motor, NTT, Olympus, Panasonic Corp, Rohm, Sojitz, Takeda Pharmaceuticals, Tokyo Electric Power, Toyota Motor.

Governance and Environmental risks in Russia

Promoting better corporate governance and management of environmental risks at Russian companies.

Hermes EOS works closely with Russian regulators and companies to promote corporate governance best practice and has launched a new engagement strategy focusing on environmental risks at natural resources companies in Russia.

Overview

Since the Duma elections on December 4 2011, Russians have taken to the streets in hundreds of thousands to protest against the alleged widespread fraud and vote rigging in favour of the ruling United Russia party and to urge the Prime Minister to step down. Anti-government demonstrations are rare in Russia and the country has not seen such large scale public protests since the end of the Soviet Union. The elections results acted as a catalyst for the anger felt by many Russians at the system's pervasive corruption, and fraud that many consider is ingrained in the culture of the current government. Whilst it remains likely that Mr Putin will be re-elected at the next presidential elections in March 2012, the protests mean that politics and political risk has returned to Russia. This echoes the ongoing concerns of many foreign investors with regards to the Russian market who apply a significant political discount to the country.

However, President Medvedev's plans to make Moscow an international financial centre, the privatisation of state-owned companies and the upcoming WTO membership are potentially strong catalysts for significant economic reform and improvements to corporate governance practices in the market.

More robust governance systems are crucial to ensure an adequate management of risk, particularly with regard to environmental matters. During the second half of 2010, EOS launched a new engagement initiative focusing on environmental risks at natural resources companies in the country. Central to this strategy is ensuring that strong risk management systems are in place to effectively respond to high impact low probability incidents. In addition, environmental risks should be integrated in the core of companies' strategy and should have adequate board and senior management level oversight.

Issues and companies

Promoting better corporate governance

There have been some positive indications in Russia in recent years with regards to developments in corporate governance; however, improvements in overall transparency and strengthening of risk management structures to deal with bribery and corruption have been slow. Transparency International[1] assessed Russia as one of the worst performers, ranking 143 out of the 183 countries analysed. EOS is working with the **Centre for Business Ethics in Russia** on initiatives to address this issue. We have engaged with a number of companies in the financial sector and extractives industry to probe how their risk management systems helped prevent corrupt practices.

EOS engages with regulators and institutions to promote best practice and encourage better corporate governance in Russia. To this end, we have met with the head of listing and CEO of **MICEX-RTS** to discuss the current listing rules and encourage better protection of minority shareholders rights. EOS is part of an international expert group working with the **Corporate Governance Committee** established by the Russian Government aimed at improving the financial market structure and legal framework for financial activities in the country. Over the year, we also worked closely with the **Russian Institute of Directors** on several governance projects.

Lack of transparency and lingering perceptions of corruption often stem from the rather blurred lines existing between business and the state in Russia. President Dmitry Medvedev called for the privatisation of most state-owned enterprises and for government officials to step down from the boards of state-run companies. EOS met with the Rector of the **Russian New Economic School** who also sits on the board of Russia's largest bank as an independent director to discuss the potential impacts the Kremlin's privatisation programme could have in terms of governance. We questioned how this would work in practice and raised concerns about the influence the State may still have on these companies. The independent director indeed stressed that the main challenge will be to ensure that government representatives on boards of state-owned companies are not merely replaced with government proxies.

In addition, we met with the **CFO of Russia's largest bank** to investigate the current situation with regards to the Kremlin's holdings in the bank. Whilst the government maintained its intention to sell, doubts remain as to how much it would ultimately privatise and by when, and whether it would still keep a controlling stake with decisional power. We tested how minority shareholder rights were respected given that most Russian companies are controlled by either oligarchs or by the Russian state. We raised concerns with regulators and companies about the general lack of independence on Russian boards and discussed the challenges in finding the right candidates with the relevant skills, background, experience and independence.

Management of environmental risks

EOS has also intensified its engagement programme focusing on environmental risks at natural resources companies. We met with the **head of the Environmentally Responsible Finance Programme for WWF Russia** to discuss how we could work together to raise awareness of sustainability issues amongst local companies, investors and regulators.

We challenged oil companies on pipeline integrity which is becoming a major challenge for the energy industry, with ageing infrastructure and increasing volumes putting pressure on the current network. Maintaining pipeline assets in a safe and reliable condition is one of the major tasks for their owners to ensure effective operations, financial success and also the management of reputational risks.

As part of our intensive engagement with a **leading oil company in Russia** , we met the **head of environmental protection** and undertook a site visit to the company's operations in northern Russia where its subsidiary is facing several civil and criminal charges for water and soil pollution resulting from leaking pipelines to speak with local management and test its handling of environmental and other risks. We were able to challenge the objectives put in place by the company and pressed for specific targets to be set and comprehensive disclosure on a group and regional basis, detailing how these policies are being implemented in practice.

Amongst those companies with issues in this area are: **Gazprom, LUKOIL, Norilsk Nickel, Novatek, Rosneft, Sberbank, Severstal, Sistema, Vimpelcom**.

1 Corruption Perceptions Index (CPI), Transparency International, 2011

Stewardship and corporate bonds

Investing for the long-term: engaging with the issuers of corporate bonds

Bonds increasingly matter, and bonds increasingly matter for the long term. Some client bond portfolios on which EOS provides stewardship services include corporate issues with a repayment date well beyond 2050, and even where individual holdings are of shorter duration it is likely that clients will have bond exposures to individual companies over long time horizons. It is thus imperative for long-term investors to consider the impact of environmental, social and governance risks on their bond portfolios and to engage in these respects.

Overview

Bond investors often feel like the poor relations of the investment world. Given that their rights are fully outlined in the contractual relationship set out in the bond prospectus, this tends to be seen to crowd out other interactions that bondholders might have with the companies in which they invest. In contrast, the relationship that shareholders have with the company that they part own is much less fully defined in the contract between the parties, such as it is, in the company's bylaws or articles of association. It is for this reason, and because of the formal levers of influence that shareholders wield, through voting and otherwise, that there can be a greater expectation of detailed shareholder dialogue with companies than is the case for bond investors.

For institutional investors that have signed the UNPRI or are otherwise committed to responsible investment across all their asset classes, this is not wholly satisfactory. They interact with the organisations in which they invest to fulfil two aims, reflecting the first two principles of UNPRI: to ensure that they will only invest in organisations with an appropriate stance on all the key factors which will impact value over the long-term; and to work with those organisations to help them better address those factors which they are not yet managing as well as they might.

It is possible to engage as a bondholder, but the door is often more open – simply because it is more expected – for a shareholder. This is why, for us, it makes sense where possible to engage companies from the perspective both of bond- and share-holder, uniting the perspective and enabling a rounded dialogue. While there can be conflicts between these two perspectives, these arise only in rare instances and so for us the focus of engagement and its objectives are generally the same.

Companies are increasingly issuing longer-term debt in response to market demand for long-term fixed income assets. In the current environment many sovereign issuers are becoming less attractive investments and corporations are keen to obtain long-term financing for their businesses. Debt issuance is no longer the preserve of large companies: increasingly, the markets are open to smaller companies, and with the significant deleveraging which is going on and the removal of bank finance that accompanies it such smaller companies are keen to diversify their sources of finance. Bonds are also becoming increasingly higher proportions of some asset owners' portfolios as they face a maturing of their liability profiles.

Long-term factors relevant to the current and likely future health of the company matter to both its bond- and share-holders. Although the cash flows from bonds held to maturity will not alter unless an unmanaged risk causes such harm that the company's ongoing existence is under real threat, the value in an investor's portfolio will nevertheless be impacted. As the equity buffer is eroded, value is also lost on the bond side: even if the cash flows remain intact, the yield on the bonds will widen whether or not the credit rating is downgraded and the mark-to-market valuation reduced. Investor valuations are never done on a held to maturity basis, so the value of the investor's portfolio will fall – the unmanaged risk will have its impact. Typically these days such long-term risks are described as ESG factors, and certainly poorly managed and mitigated environmental, social and governance risks can destroy value for both equity and bond investors.

It is for this reason that it makes sense for investors to engage on these matters: to work to preserve and to enhance value over the long-run. Except in the rare circumstances where the interests do indeed diverge, it makes sense to engage on these issues as both, share- and a bond-holder. Both have value at risk if these long-term factors, on which engagement focuses, are not managed effectively.

Conflicts?

Some suggest that there are innate conflicts between the interests of shareholders and bondholders. This is undeniably the case where a company is in a state of crisis where its very survival is in doubt: at this point, bond- and share-holders compete with each other over what is available from the carcass. Institutional investors will in these circumstances need to consider actively how they handle such situations, given that often they will themselves have conflicting interests driving in opposite directions at the same time. While generally their interests will be represented by fund managers on both the bond and equity side of the argument, it may make more sense for the client, the principal, to assert its interests in the face of this conflicting clamour from its agents.

However, outside of such extreme circumstances, the alignment of bond- and share-holder interests is much stronger than many currently suppose. There are two situations which are often quoted as being indicative of a clear difference of interests between the two modes of investment in a company's cash flows: poison pills and cash outflows from the company.

Poison pills are anti-takeover protections and traditionally shareholders oppose them because they remove the possibility of takeover and the discipline on corporate performance which the market for corporate control provides. Often, bondholders support poison pills because they believe that protecting the company from hostile takeover will better protect value in the bonds. We are not convinced that this is an appropriate stance, however. Shareholders do not support the dropping of poison pills simply in the hope that this will open the door to a takeover: the far greater attraction is that removing poison pills ensures that boards are more accountable to their investors, and less likely to be wasteful of value within the business. In short, the discipline of the market for corporate control means that the business should be run more efficiently and effectively. This greater accountability, efficiency and effectiveness is in the interests of bondholders as well as shareholders; bondholders do not benefit from having companies run by management and boards which do not feel obliged to run the business in the interests of their investors.

In a similar way, shareholders welcome dividends partly to generate returns from their investment but also because of their disciplining force on management. This is particularly true where management feel constrained to at least maintain the level of dividend payout. Shareholders will usually therefore press for dividends to be paid where the company has sufficiently stable returns and enough money to reinvest in its business. It is a fallacy for bondholders to believe that such pressure will always be against their interests. Clearly, in extreme circumstances a high dividend will be unsustainable, and any increase would be damaging – but the damage in such circumstances will be felt as much by the long-term shareholder as by the bondholder.

The discipline of regular dividend payouts is an important discipline on management, to the benefit of both bondholders and long-term shareholders. Bondholders might imagine that they benefit from companies building untouched cash piles, but the reality is that the mindset of a management which is willing to be so inefficient and so unresponsive to the interests of its investors is likely to manifest itself in other ways which harm the interests of bondholders as much as shareholders.

This article has referred on a few occasions to long-term shareholders, and it is developing that long-term mindset which helps marry the interests of bond- and share-holders. While in the short term and in extreme circumstances their interests certainly will diverge, when considering the long-term and especially long-term risk management, the interests of share- and bond-holders are in practice identical.

Climate change: What's the Deal?

Durban Climate Summit

The United Nations Climate Change Conference in Durban, South Africa, was held from 28 November – 11 December 2011. The conference involved a series of events, including the seventeenth session of the Conference of the Parties (COP 17) to the UN Framework Convention on Climate Change (UNFCCC) and the seventh meeting of the Conference of the Parties serving as the Meeting of Parties to the Kyoto Protocol (CMP 7).

"As we look to 2012, investors face immense challenges in ensuring that their portfolios are not exposed to carbon risk. If we are to avoid a much larger problem from our high carbon economy then long-term investors must act now to protect their assets from the serious impacts of climate change."

Overview

After the frustrations at the Copenhagen conference and the struggle to rescue the multilateral climate regime in Cancun, negotiators in Durban were able to not only breathe new life into the Kyoto Protocol but, in doing so, to adopt a decision that will lead to negotiations on a more inclusive 21st century climate regime. There was a strong feeling that certain elements of the Durban package, guided by the need to fulfil overdue commitments that go back to the Bali Roadmap, provided an adequate platform for a new negotiation process. The challenge still remains that climate initiatives will continue to see differentiated interests between developed and developing countries, but many insist on the urgent need to significantly scale up the level of ambition to address the gap between existing mitigation pledges and the needed emission reductions recommended by science.

Two days after the scheduled end of negotiations, conference delegates finally agreed a deal, outlining a roadmap for the next 10 years. A newly created body, the Durban Platform for Enhanced Action, will be in charge of developing "a new protocol, another legal instrument or agreed outcome with legal force" that would be applicable under UNFCCC by 2015 with implementation by 2020. The conference was also successful in putting in place an agreement to establish a second commitment period under the Kyoto Protocol, which is to start in January 2013 and to end in either 2017 or 2020 (to be determined by COP18). Many also welcomed the agreement to establish the operations of the new Green Climate Fund although questions still remain as to its funding scale and source.

Issues and companies

As the dust settles on the agreement in Durban, EOS believes that while some significant steps have been taken, government action to address climate change has not had the pace and scale required to avoid ongoing damage to the environment. This lack of progress has significantly increased the risks of climate change to society, businesses and the economy at large.
EOS believes that companies, policy makers and investors need proactively to manage climate change issues now as any future agreement may be too late to keep the earth below the two degree Celsius warming previously agreed to be a 'safe' target. EOS will act on behalf of its clients to provide input into the discussions leading up to the decisions on the extent of the emission reduction targets by the Durban Platform. We will also continue to engage with companies on their carbon emissions and their alignment with obligations under the Kyoto Protocol. Last but not least, we will join in the discussions on the design of the Green Climate Fund and how to make it fit for purpose.

Mandate for a global deal in 2015

This global agreement to reduce greenhouse gas emissions is different from past climate agreements, as none of its predecessors have been legally binding. The precise phrase, agreed to at a last-recourse huddle in the early hours of December 11th that included the South African COP presidency, Brazil, China, India, the EU, and the United States, is "a protocol, a legal instrument or an agreed outcome with legal force". While the phrase managed to balance the parties' concerns and requests, many believe that it leaves too much open for interpretation, though it is agreed generally that this is still a step forward from prior voluntary arrangements. The agreement, referred to as the 'Durban Platform', is expected to go into effect in 2020, with discussions slated to finish in 2015. as such, governments will now spend four years negotiating how far and how fast each country should cut carbon emissions.

Extension to the Kyoto Protocol

Under EU leadership, signatories of the Kyoto Protocol agreed to enter a second commitment period for reducing their greenhouse gas emissions, extending the treaty terms through 2017 or 2020. This symbolically salvaged the agreement—the only existing climate treaty with internationally binding reduction targets. However, the 27 EU countries, together with Australia, New Zealand, Norway, and Switzerland, are the only ones to take on these targets, and they agreed to do so only on the condition that all major countries agree to a new, truly global and comprehensive climate treaty, if necessary outside the Kyoto structure.

Meanwhile, other major developed-country emitters—including Japan, Canada, and Russia—have announced their abandonment of the Kyoto Protocol in recent months. The US never ratified the agreement. Thus, the symbolic act of keeping the Kyoto Protocol alive accommodates the demands of developing countries, which will be hit hardest by climate change, but the renewed commitment covers only 15% of global greenhouse gas emissions. Still, salvaging Kyoto was necessary to leverage developing countries' willingness to enter a new global deal, scheduled to be finalised in 2015 and operational in 2020.

The Green Climate Fund

The Green Climate Fund (GCF), which was established during the Cancun Agreements, will act as the operational entity for the convention's financial mechanism. It aims to provide $100bn of government funds by 2020 in order to achieve its goals.

After a year of technical work by the Transitional Committee, the Durban decision provides a basic framework for how to operationalise the GCF over the next year. It established a process for appointing the Fund's Board by April 2012 (with the first board meetings to take place in Switzerland and Korea), sets up an interim trustee (the World Bank) and an interim Secretariat, and lays out a process to appoint the permanent Trustee and Secretariat personnel. But what many believe Durban failed to clarify is the scale and sources of financing, as well as funding priorities. Parties have recognised the need to scale up financing from public and private sources, but concrete plans are yet to emerge on how to do this.

REDD+ for forests

The negotiations at Durban led to mixed results for REDD + (Reduced Emissions from Deforestation) has been made on how to set levels of baseline emissions and how to measure the emission reductions resulting from forestry initiatives, but the decision on social and environmental safeguards of the program is still lacking. Little progress was made concerning the sources of long-term funding.

What do the Durban outcomes mean for investors?

The fact that a concrete agreement won't be reached by governments until 2020 means that investors and pension funds are faced with the challenges of increased long-term portfolio risk due to the potential increased severity and frequency of extreme weather events. As a result, it appears that investors may need to intensify their efforts to act on the risks imposed by climate change at a faster pace than governments in order to protect their assets.

A further concern for portfolio risk is that when governments do finally come to a new binding climate change agreement, the speed at which companies will need to address emissions may lead to unintended risks as a result of knee-jerk reactions in order to correct their emission levels and decouple them from their growth strategies.

So what action can investors take?

EOS has long been undertaking initiatives to encourage companies to consider the impacts of their emissions on their sustainable development, in advance of regulation. EOS not only undertakes one-on-one engagements with companies on climate change, particularly those in high impact industries such as utilities, extractives and industrials, but also actively leads and participates in collaborative engagements through various platforms such as the UNPRI, the Carbon Disclosure Project, Forest Footprint Disclosure project and the Roundtable for Sustainable Palm Oil. We believe that engagement with policy makers is also necessary, and therefore over the past years have signed up to initiatives such a Global Investor Statement on Climate Change and have proactively encouraged a carbon price in Australia.

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 received a list of responders to the 2011 Forest Footprint Disclosure questionnaire and are pleased to note that several companies with which we have been discussing the issue of the impact of their supply chains on deforestation have responded to the project. We aim to target those companies who received the letter of endorsement we arranged through the UNPRI clearinghouse earlier in the year but which did not communicate with FFD for early discussions.

Response to consultation on IASB agenda

We responded to a highly significant consultation from the International Accounting Standards Board on its forward agenda for the next few years. We regard this as an opportunity to ensure that the financial reporting standards developed for the bulk of the world more effectively meet the interests of shareholders and welcome the new openness displayed by the new chair of the board. We thus emphasised the need for the IASB to shift its focus away from the balance sheet towards the reporting of the performance of companies, both in terms of the income statement and the cashflow. This would change the insights provided by reporting and should reduce the impact of fair value movements in balance sheet numbers. We were able to influence the responses of the CRUF, the CFA committee of which we are a member, and several other investor representative groups to make similar points.

Monetary Authority of Singapore

We met with the head of market conduct policy to talk through a range of issues in relation to the current review of the Singapore corporate governance code. We welcomed many of the proposals, which mark notable steps forward for standards in the country and are explicitly stated to reflect thinking elsewhere in the world. We talked through the challenges of making comply or explain work effectively in practice and shared our experience in developing guidance for smaller companies to make them feel better able to explain areas of non-compliance. Since MAS is clearly concerned about the impact of the higher new standards on small companies in particular, we hope that this approach may mean that a shorter transition period is applied at least for larger companies. We talked about our experience with stewardship codes, something which is clearly being contemplated in Singapore, and undertook to share some EOS and ICGN documents in this regard. We also talked through ways to encourage better explanations by companies, in particular highlighting our experience with the ICSA/Hermes awards for disclosure which have seen significant improvements over recent years across much of the market. We agreed to share some information on this and also to maintain our dialogue going forward.

Financial Stability Board – risk reporting roundtable

We were one of only a handful of investors invited to speak at a new initiative from the FSB, a roundtable on bank risk reporting drawing together senior regulators from around the world, bank representatives, auditors and investors. We were the sole investor speaker on the initial roundtable, enabling us to set the agenda for the whole day, and we emphasised the need for honesty in reporting by financial institutions, noting the damage that is done to wider confidence in individual banks and indeed markets as a whole when banks hide the truth. We referred to our vigorous dialogues with some of these banks, and noted that there have been some positive improvements in reporting, not just by those banks we had had such dialogue with. We highlighted areas where we believe that further improvements can be made and noted other areas of regulation and broader banking culture which also need to be addressed over time. We were also the sole investor to speak in relation to auditing issues, emphasising the need for care over which elements of reporting are audited and which are subject only to a so-called 'read requirement', an assessment of any discrepancies with the audited numbers. We regard this as important so as not to generate safety-first boilerplate reporting but to enable management to respond quickly to market needs for information. We believe that there is scope to take forward this dialogue to a collaboration which will enhance global best practice, and look forward to participating in this process.

Kay Review

We responded to the call for evidence which launched the Kay Review into short-termism in the financial markets and its impact on the ability of companies to invest for the long term. This is a crucial consultation in the UK, raising questions which range across multiple issues around the functioning of the markets and the relationships between listed companies and their shareholders. We laid out our concerns across the full range of these issues, from the Stewardship Code to market volatility, and suggested ways in which the market can be moved towards being more long-term in its outlook. In particular, we highlighted our work developing and strong support for the ICGN's Model Mandate Initiative. We have also followed up more informally sending additional evidence to various members of the Kay Review team whom we have met over recent weeks.

Public policy and best practice continued

Other public policy work this quarter included:

Companies Acts and equivalents

- We discussed amendments to the Company Act with a senior executive of the Japanese Financial Services Agency.
- Responded to the UK Department of Business's two concurrent consultations, one on narrative reporting and the other covering remuneration.

Securities Laws and Regulations

- We responded to a Ontario Securities Commission request for comments on Staff Notice 15–704, dealing with proposed enforcement initiatives.
- Actively participated in the Canadian Society of Corporate Secretaries Shareholder Democracy Summit as a member of the conference organising committee focusing on voting system reform.
- Flagged to the Korean Exchange a series of key issues which we believe it should address in its regulatory approach in order to reduce the so-called Korean discount.
- Met with senior executives of the Tokyo Stock Exchange to discuss ongoing concerns about the governance practices of Japanese companies.
- Responded to a consultation on empty voting which was issued by the European Securities and Markets Authority (ESMA).
- Spoke with the acting head of audit at the European Commission to highlight our views regarding the leaked proposals which have emerged form the process.
- Responded to two ESMA consultations seeking input on measuring compliance of credit rating methodologies with EU regulations as well as input on the newly introduced requirements for periodic reporting by credit rating agencies.
- Responded to a public consultation from the Malaysian Securities Commission regarding the issues of chair independence and voting by poll.
- Assisted clients to respond to the EU consultation on implementing Solvency II-style approach for pension funds.

Codes of best practice

- We spoke at a conference on share issuance in Russia and the CIS, providing a view on the key ESG factors for international investors.
- With met with the head of market conduct policy at the Monetary Authority of Singapore to talk through a range of issues in relation to the current review of the Singapore corporate governance code.
- We contributed to the final workshop on the German Sustainability Code for companies.
- Participated in a roundtable organised by PGGM on the experience in Europe of corporate governance codes and the lessons for their development in the US.
- At the meeting of Associate Parliamentary Corporate Responsibility group we presented on the role of shareholders in holding companies to account and in helping them to manage more effectively for the long-term.
- Spoke at a training session at Jon-Edis Bates Associates for company secretaries on good reporting.
- Took part in a roundtable gathering including pension funds, fund managers, asset consultants and the FRC, as well as members of the Kay Review team, to discuss fiduciary duty and stewardship.
- At our instigation, recruitment firm Harvey Nash held a roundtable discussion regarding the Kay Review into long-termism.
- Provided input into the FRC's new Reporting Lab – intended as a safe area for companies and investors to experiment with reporting which may serve both their interests better.
- We supported the ICSA/Hermes Awards for high quality and transparent corporate reporting.
- We played an active role in a roundtable meeting organised by FRC to discuss how to make comply or explain work more effectively.
- We provided the investor view on narrative reporting at the flagship financial reporting conference of the Institute of Chartered Accountants of England and Wales.
- Provided further input into the PRI's draft paper intended to support asset owners in drafting RFPs and contracts for fund management services.

Global standards

- IAASB – met with two members of the IAASB to discuss the draft auditing standard on the use of internal audit.
- IAASB – provided input to IAASB regarding their project on rewriting the international audit standard covering the auditor's responsibility for documents which accompany the financial reports.
- IAASB – presented to the IAASB working group considering steps the board should take arising from its broad consultation on auditor reporting.
- Provided input to Financial Stability Board on the list of Global Systemically Important Financial Institutions.

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.

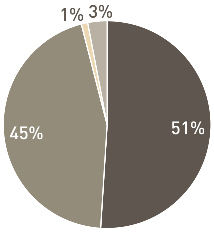
Hermes votes at company meetings all over the world, wherever its clients own shares.

Voting overview

Over the last quarter, we voted at a total of 1,430 meetings around the world, analysing 9,745 resolutions. At 622 of those meetings we opposed one or more resolutions and we abstained at 12 meetings. We voted with management by exception at 15 meetings, while we supported management on all resolutions at 781 meetings.

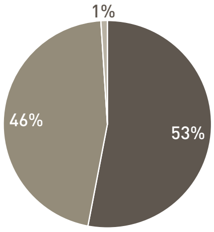
Africa and Middle East

We voted at 77 meetings (864 resolutions) over the quarter.



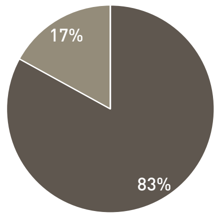
North America

We voted at 330 meetings (2,427 resolutions) over the quarter.



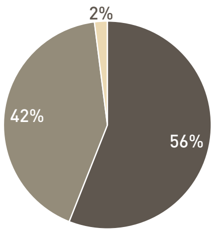
South America

We voted at 52 meetings (268 resolutions) over the quarter.



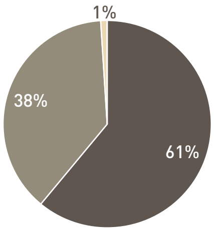
Asia (except Japan)

We voted at 264 meetings (1,565 resolutions) over the quarter.



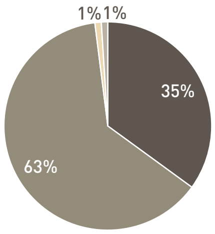
Japan

We voted at 56 meetings (457 resolutions) over the quarter.



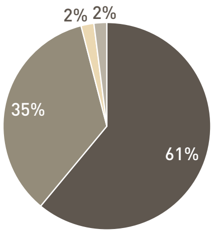
Australia and New Zealand

We voted at 319 meetings (1,645 resolutions) over the quarter.



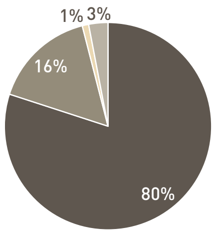
Europe

We voted at 191 meetings (1,153 resolutions) over the quarter.



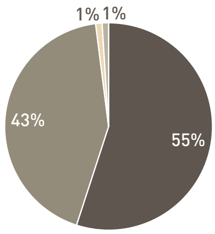
UK

We voted at 141 meetings (1,366 resolutions) over the quarter.



Global

We voted at 1,430 meetings (9,745 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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