OUTCOMES BEYOND PERFORMANCE

PUBLIC ENGAGEMENT REPORT

Chopping through the undergrowth – Cultivating stewardship in Brazil

Hermes EOS
Q3 2017

www.hermes-investment.com

This report contains a summary of the stewardship activities undertaken by Hermes EOS on behalf of its clients. It covers significant themes that have informed some of our intensive engagements with companies in Q3 2017.

The report also provides information on voting recommendations and the steps we have taken to promote global best practices, improvements in public policy and collaborative work with other long-term shareholders.

2 Preface
What is Hermes EOS?
How does Hermes EOS work?

3 Hermes EOS team
Our team

4 Engagement by region
Engagement statistics by region

5 Engagement by theme
Engagement statistics by theme

6 Environmental
Revolutionary recommendations? – Reporting on the risks and opportunities from climate change

8 Social
Opening doors – Ethnicity, experience, gender and beyond

10 Governance
Untangling tight knots – Tackling Japan's corporate governance dilemma

12 Strategy
Chopping through the undergrowth – Cultivating stewardship in Brazil

14 Business strategy
Engagement on strategy and governance issues

16 Public policy
Public policy and best practice

19 Overview
Regional voting statistics

What is Hermes EOS?

Hermes EOS helps long-term institutional investors around the world to meet their fiduciary responsibilities and become active owners of public companies. Our team of engagement and voting specialists monitors the investments of our clients in companies and intervenes where necessary with the aim of improving their performance and sustainability. Our 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.

Pooling the resources of other like-minded funds creates a strong and representative shareholder voice and makes our company engagements more effective. We currently act on behalf of 42 clients and £317.1/€359.7/$424.9 billion* in assets under advice.

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

The depth and breadth of this resource reflects our philosophy that stewardship 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, experience and 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.

We have extensive experience of implementing the Principles for Responsible Investment (PRI) and various stewardship codes. Our former CEO led the committee that drew up the original principles, and we are engaged in a variety of workstreams through the PRI Collaboration Platform. This insight enables us to help signatories in meeting the challenges of effective PRI implementation.

How does Hermes EOS work?

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

The Hermes Responsible Ownership Principles[1] set out our fundamental 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 engagement programme we have agreed with our clients, as well as the Principles and their regional iterations, guide our intervention with companies throughout the world. Our approach is pragmatic, as well as company- and market-specific, taking into account the circumstances of each company.

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

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

While we can be robust in our dealings with companies, the aim is to deliver value for clients, not to seek headlines through campaigns which could undermine the trust that would otherwise exist between a company and its owners. We are honest and open with companies about the nature of our discussions and aim to keep these private. Not only has this proven to be the most effective way to bring about change, it also acts as a protection to our clients so that their positions will not be misrepresented in the media.

For these reasons, this public report contains few specific details of our interactions with companies. Instead, it explains some of the most important issues relevant to responsible owners and outlines our activities in these areas

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

For further information, please contact:

Head of EOS Dr Hans-Christoph Hirt on +44(0)207 680 2826

* as of 30 September 2017

[1] https://www.hermes-investment.com/wp-content/uploads/2015/09/the-hermes-ownership-principles.pdf

Hermes EOS team

Engagement

Dr Hans-Christoph Hirt
Head of EOS

Frédéric Bach
Sectors: Chemicals, Financial Services, Industrials, Technology

Dr Emma Berntman
Sectors: Chemicals, Financial Services, Mining, Oil and Gas, Pharmaceuticals, Utilities

Roland Bosch
Sector lead: Financial Services

Dr Christine Chow
Sectors: Financial Services, Mining, Oil and Gas, Technology

George Clark
Voting and Engagement Support

Natacha Dimitrijevic
Sector lead: Pharmaceuticals

Bruce Duguid
Sector lead: Mining, Utilities

Claire Gavini
Sectors: Consumer Goods and Retail, Industrials

Tim Goodman
Sector lead: Oil and Gas

Jaime Gornsztejn
Sectors: Industrials, Mining, Oil and Gas, Technology, Utilities

Bram Houtenbos
Voting and Engagement Support

Pauline Lecoursonnois
Sector lead: Consumer Goods and Retail

James O'Halloran
Head of Voting and Engagement Support

Nina Röhrbein
Reporting and Communications

Sachi Suzuki
Sector lead: Industrials

Dr Michael Viehs
Sector lead: Automotive

Maxine Wille
Sector lead: Chemicals

Business Development and Client Service

Amy D'Eugenio
Head of Business Development and Client Service

Alan Fitzpatrick
Client Relations

Rochelle Giugni
Client Relations

Felicity McDonald
EOS Events and Marketing

Alice Musto
Client Relations

Engagement by region

Over the last quarter we engaged with 175 companies on 428 environmental, social, governance and business strategy issues and objectives. Our holistic approach to engagement means that we typically engage with companies on more than one topic simultaneously.

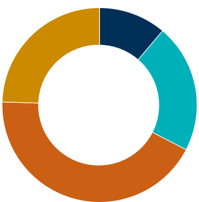
Global

We engaged with **175** companies over the last quarter.

- Environmental **17.5%**
- Social and ethical **28.0%**
- Governance **36.4%**
- Strategy, risk and communication **18.0%**

Developed Asia

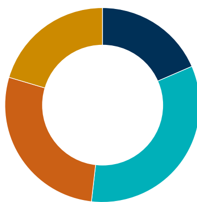
We engaged with **27** companies over the last quarter.



- Environmental **11.2%**
- Social and ethical **21.4%**
- Governance **42.9%**
- Strategy, risk and communication **24.5%**

Emerging and Frontier Markets

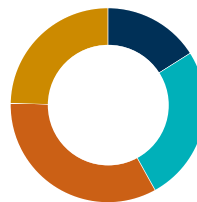
We engaged with **25** companies over the last quarter.



- Environmental **18.5%**
- Social and ethical **33.3%**
- Governance **27.8%**
- Strategy, risk and communication **20.4%**

Europe

We engaged with **30** companies over the last quarter.



- Environmental **16.0%**
- Social and ethical **25.9%**
- Governance **33.3%**
- Strategy, risk and communication **24.7%**

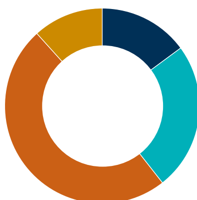
North America

We engaged with **48** companies over the last quarter.

- Environmental **26.7%**
- Social and ethical **36.6%**
- Governance **25.7%**
- Strategy, risk and communication **10.9%**

United Kingdom

We engaged with **45** companies over the last quarter.



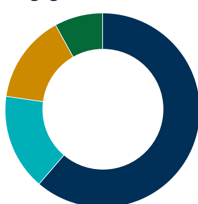
- Environmental **14.9%**
- Social and ethical **24.5%**
- Governance **48.9%**
- Strategy, risk and communication **11.7%**

Engagement by theme

A summary of the 428 issues and objectives on which we engaged with companies over the last quarter is shown below.

Environmental

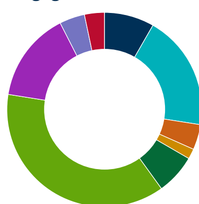
Environmental topics featured in **17.5%** of our engagements over the last quarter.



- Climate change **61.3%**
- Environmental policy and strategy **16.0%**
- Pollution and waste management **14.7%**
- Water **8.0%**

Social and ethical

Social topics featured in **28.0%** of our engagements over the last quarter.



- Bribery and corruption **8.3%**
- Conduct and culture **19.2%**
- Cyber security **4.2%**
- Diversity **1.7%**
- Human capital management **6.7%**
- Human rights **37.5%**
- Labour rights **15.0%**
- Supply chain management **4.2%**
- Tax **3.3%**

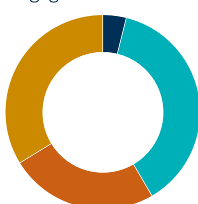
Governance

Governance topics featured in **36.4%** of our engagements over the last quarter.

- Board diversity, skills and experience **25.6%**
- Board independence **17.9%**
- Executive remuneration **30.8%**
- Shareholder protection and rights **12.2%**
- Succession planning **13.5%**

Strategy, risk and communication

Strategy and risk topics featured in **18.0%** of our engagements over the last quarter.



- Audit and accounting **3.9%**
- Business strategy **37.7%**
- Integrated reporting and other disclosure **24.7%**
- Risk management **33.8%**

Revolutionary recommendations? – Reporting on the risks and opportunities from climate change

We have long called for improvements in the reporting by companies on climate change and are supportive of the Task Force on Climate-related Financial Disclosures.

Setting the scene

The Task Force on Climate-related Financial Disclosures (TCFD) was the brainchild of the governor of the Bank of England and chair of the Financial Stability Board Mark Carney who in his speech on Breaking the Tragedy of the Horizon in September 2015, outlined the risks climate change poses to financial stability and the lack of consistent, comparable, reliable and clear disclosure of these. Shortly afterwards, at the 2015 UN climate change summit in Paris, the industry-led TCFD was launched. A public consultation on its draft report ensued and, in the summer of 2017, the final TCFD recommendations were published. Their aim is to spur companies into producing comprehensive climate change-related financial disclosures and thus provide useful information to lenders, insurers and investors. In turn, the disclosures seek to help companies effectively measure and evaluate their own risks and those of their suppliers and competitors. In addition, the TCFD has developed supplemental guidance for banks, insurance companies, asset managers and owners, as well as companies in the energy, transportation, materials and buildings, agriculture, food and forest product sectors to assist them in implementing the recommended disclosures.

Disclosure recommendations

Governance	Strategy	Risk Management	Metrics and Targets
Disclose the organisation's governance around climate-related risks and opportunities	Disclose the actual and potential impacts of climate-related risks and opportunities on the organisation's businesses, strategy and financial planning where such information is material	Disclose how the organisation identifies, assesses and manages climate-related risks	Disclose the metrics used to assess and manage relevant climate-related risks and opportunities where such information is material

Source: TCFD

Climate change poses several types of risk. Physical risks are reflected in higher temperatures and more frequent severe weather events, such as flooding, while transition risks are the financial risks facing companies, sectors and economies as a result from the shift towards a lower-carbon economy. This includes the effects of changes in policy and technology and market shifts, such as a decline in the demand for fossil fuels that can significantly affect the revenues and valuation of companies. Disclosures that help measure transition risk include 2°C stress-testing information, strategies for transitioning to a lower-carbon economy, the setting of absolute emissions reduction targets, capital expenditure and research and development plans, revenues allocated to cope with the physical impacts of climate change, as well as Scope I and II, and where relevant, Scope III emissions. In addition, there is a risk of litigation for companies that have not put in place adequate measures to deal with climate change.

Climate change-related financial disclosures by companies should focus on all of the above, as well as any progress made and plans to align value-creation towards building a lower-carbon economy.

Pros and cons

The Task Force on Climate-related Financial Disclosures (TCFD) aims to provide a voluntary, consistent framework to improve the production and application of disclosures. It focuses on the financial impact of climate change-related risks and opportunities on an organisation. Its recommendations are based on the four thematic areas of governance, strategy, risk management and metrics and targets, which represent the core elements of how organisations operate.

In our view, the TCFD has correctly identified the problem of insufficient comparable disclosure of the risks and opportunities climate change presents to companies. We have long been pushing companies to undertake scenario analyses and report in their annual reports and financial filings on the resilience of their portfolios of assets to the effects of climate change, such as the stranding of assets, and their preparation for this. Our involvement in the Aiming for A initiative, for example, which called on companies to improve the disclosure on their exposure to climate change risks and involved the filing of shareholder proposals at their AGMs, has led to substantial improvements and some good reporting by the likes of BHP Billiton and Statoil.

The reporting envisaged by the TCFD would alleviate some of the uncertainty hanging over the companies for investors and, we believe, not be a burden to companies. As it is unprecedented, the TCFD could lead to vast improvements in the disclosure of climate change risks of companies. We strongly support its focus on forward-looking risk analysis instead of increased reporting of historical data, which is often less relevant to the most exposed businesses, such as oil and gas and automotive companies, whose long-term product is at risk. We believe that the use of scenarios is an appropriate tool by which to achieve this.

The critical element of the recommendations is the requirement for companies to explain the financial materiality of climate change under a range of low-carbon scenarios. This will encourage companies and investors to deploy new mitigation strategies, preserving value for long-term investors and improving the lives of beneficiaries. However, the TCFD does not explain in its recommendations which mechanism to

use to determine the materiality of the risk of climate change to the company. In addition, the time horizon is uncertain. This ambiguity is likely to lead to a lack of comparability across disclosures.

Nevertheless, we welcomed the key differences from the initial draft, which were in line with our suggestions, such as guidance that governance and risk disclosures should be included in financial disclosures regardless of materiality. Meanwhile, strategy and metrics and targets, which contain the critical scenario analysis, should be included in the disclosures only to the extent that they are material. This is an improvement to existing reporting practices.

Another concern is that companies and investors will use different climate change scenarios and analytical approaches which would make a comparison of the disclosures, even within the same sector, more difficult, as the guidelines do not prescribe a set of standardised scenarios. Over time, the development of standardised scenarios containing the necessary data and assumptions for sector-based analysis should be developed to resolve this.

We understand that implementation will take place at the national level and may be voluntary for a number of years. It will therefore fall onto investors to press companies to deliver this enhanced form of disclosure. In our consultation response, we proposed that the TCFD tighten its recommendations to comply-or-explain guidelines.

Overall, we believe the TCFD recommendations are a good foundation for improved reporting. However, a period of innovation in climate change-related reporting is anticipated and frequent updates are likely to be required to keep the recommendations up to date on best practice.

Investor involvement

The recommendations also require more disclosure from investors. Asset owners and managers ought to conduct scenario analyses on their investment portfolios and report the results. They should describe any engagement activities with investee companies to encourage better disclosure and practices. We signed the TCFD statement of support, which means that Hermes Investment Management is committed to disclosing against the recommendations from 2018 although the TCFD does not specify a timeframe.

As the guidelines were only finalised in June 2017, there has been little experience of formal reporting to date, other than the efforts of some earlier adopters prior to finalisation. Nevertheless, we were pleased to see a good number of high-profile companies give their support at the launch of the recommendations, as this indicates their willingness to help establish best practice reporting, which others can then use as a precedent to follow. Investors, meanwhile, will, via the newly launched Climate Action 100+ engagement initiative, focus on the adoption of the TCFD guidelines by the world's top 100 strategically important greenhouse gas emitters.

Engagement

We expect the key issue regarding the implementation of the TCFD recommendations to be whether the guidelines require disclosure of the quantitative value-at-risk under certain low-carbon scenarios. Companies are likely to argue that this is voluntary, commercially sensitive and potentially immaterial information that is difficult to provide as it is based on a large number of uncertain assumptions. Furthermore, they could state that it is difficult to compare the results of companies without a standard methodology. We would respond that approximate numbers have to be calculated in order to develop a perspective on materiality, as well as to provide additional financial reporting, which is the focus of the recommendations. Without this, investors may wonder whether the company has something to hide or lacks the skills to conduct such analysis. In addition, some companies already provide details that others claim is commercially sensitive. However, it is a barrier that needs to be overcome through industry guidance, best practice by companies, the encouragement of the TCFD and the users of company reporting.

In our engagement, we will focus on the sectors to which climate change is a particularly material risk. While most companies need to determine their own materiality threshold, the recommendations are compulsory for those in the four highlighted non-financial groups with more than $1 billion of annual revenue. As part of a coalition of institutional investors with close to $2 trillion in assets under management, we signed a letter to 62 of the world's largest banks encouraging them to back the TCFD recommendations and provide more robust disclosure on climate change-related risks.

We believe that it is possible for companies to report against the TCFD recommendations in an efficient and coherent manner and are looking forward to seeing the first reports, on which we will provide feedback.

However, for the recommendations to be a success, investors need to embed the principles in their voting practices at AGMs and stock exchanges should include them in national listing guidelines. Ideally, we would also like to see the recommendations implemented in the advice given by proxy advisory services.

Our regional corporate governance principles – which form the basis of our dialogue with companies – already include our high-level expectations with regard to the TCFD. As best practice develops, we will consider how to define the minimum requirements for reporting against the TCFD and include this in our voting guidelines.

Outlook

We believe that through market practice, the framework it will eventually become effectively standardised reporting. In order for this to happen, institutional investors need to hold everyone affected to account on their implementation of the recommendations. With countries such as France pushing for mandatory climate change reporting, the intention of the Principles for Responsible Investment to align their reporting framework with the TCFD, the UK government endorsing the recommendations and legal complaints emerging about the disclosure of some oil exploration firms, the outlook is positive.

The big uncertainty is whether reporting against the TCFD recommendations will take off in the US, due to the lack of interest in climate change by the country's administration and the refusal by many US companies to take part in their development. Nevertheless, there is a chance to aid their implementation in the US through listing rules and investor pressure.

Their success will be defined by increased convergence and standardisation in climate change-related financial disclosures and the adoption at country, industry and company levels.

For further information, please contact:

Bruce Duguid
bruce.duguid@hermes-investment.com

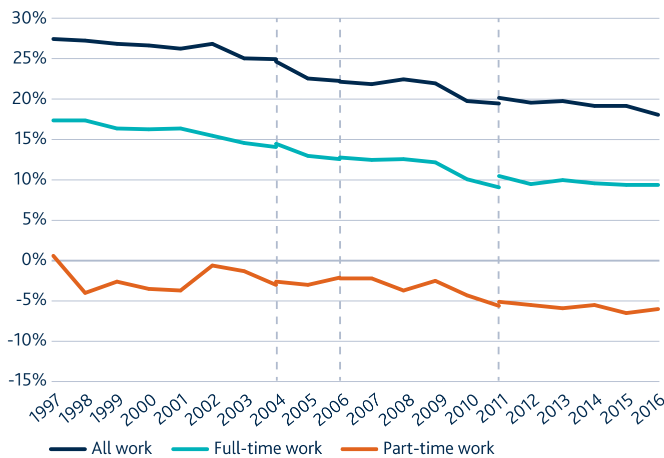
Opening doors – Ethnicity, experience, gender and beyond

While some progress has been made, the diversity journey is still in its early stages. We therefore continue to engage on greater diversity in the boardroom and beyond.

Setting the scene

According to The Power of Parity report by the McKinsey Global Institute, advancing women's equality can add $12 trillion to global growth. The organisation also says that gender-diverse companies in the top quartile for diversity are 15% and ethnically diverse companies 35% more likely to financially outperform those in the bottom quartile.[2] Yet women occupy only 20% of board seats and 6% of CEO roles in S&P 500 companies.[3] For ethnicities, the figures are just as bad. Only 1.5% of directors in FTSE 100 boardrooms are UK citizens from a minority background[4] and non-white directors on FTSE 100 boards make up only about 8% compared with 14% of the overall UK population. However, some progress has been made. The boards of FTSE 100 companies have exceeded the 25% target set for 2015 by the Lord Davies' review, standing now at 27% according to the Counting Every Woman[5] 2017 report, while the 20% of women on Equilar 500 board seats is an improvement[6] to the 16.5% reported five years earlier. The recommendations from the UK's Parker Review[7] meanwhile seek for each FTSE 100 board to have at least one director of colour by 2021 and for each FTSE 250 board to have at least one non-white director by 2024.

Gender pay gap in the UK 1997 to 2016



Source: Annual Survey of Hours and Earnings, ONS

Companies need diverse leadership to fully assess the risks and size up the opportunities in the societies in which they operate. We also view diversity as the bedrock of board effectiveness, as greater diversity means that a sufficient number of board members can provide the different perspectives necessary to challenge senior executives, as well as to counter the groupthink that might dominate the decision-making process.

We have firmly backed gender diversity as the most straightforward and visible entry point to encourage a strengthening of the board and source talent from beyond the traditional pool of candidates, thus facilitating greater diversity overall. At food and drink company Nestlé, for example, the women on its board are significantly more diverse in terms of ethnicity and nationality than their male counterparts.

Culture

A strong tone from the top is required to drive progress on diversity. But achieving diversity across an organisation also implies cultural change. It requires the alignment of a company's purpose and strategy with its policies, processes, monitoring tools and disclosure, as well as consistent communication and human capital management.

As we engage with companies across industries, from banking to the pharmaceutical sector, we look for best practice and appropriate indicators that help bring about change and maintain progress.

Progress

The launch of the UN Sustainable Development Goals brings a lot of leverage to the pursuit of a balanced board as gender equality and reduced inequalities are two of the goals. However, the pressure put on companies by institutional investors is also having an impact. We have seen progress on the topic in our conversation with companies. Just three years ago, a number of companies were dismissive of the issue or said they struggled to find the right talent in a narrow pool, which is not so much the case anymore.

While across Asia, companies used to provide boilerplate explanations for the lack of women on their boards, we now see movement across the continent. In Japan, this is driven by government policy targeting for women to make up 30% of management by 2020, with companies with more than 300 employees required to set and disclose benchmarks, such as the percentage of female hires and managers. We have encouraged many Japanese companies to appoint female directors to their boards. India's 2013 Companies Act meanwhile requires companies to have at least one woman on their board. However, as this is often a family member, we have been pushing companies to put independent female candidates up for nomination.

Nevertheless, in a few markets, culture and attitude can still stand in the way of increasing the diversity at all levels.

Diversity is often too narrowly defined and some companies may pay lip service to it as a compliance issue without understanding how diversity initiatives could bring benefits to them. We therefore seek to engage with companies and discuss their strategy on how different dimensions of diversity are taken into account, so that it becomes a strategic response rather than a box-ticking exercise. At present, we engage with 144 companies on objectives and issues in relation to the sub-themes of diversity or board diversity, skills and experience.

One positive example of our engagement programme is UK mining company BHP Billiton, which aims for a 50/50 split between men and women in its workforce by 2025 in a notoriously male dominated

industry. The target is based on the outcome of a business case referring to evidence that a more diverse and inclusive workforce is more productive. The company was keen to point out to us that the target is achievable, requiring a 3% per annum increase in women. We welcome its strong tone from the top and attempt at changing its culture. The initiative has been led by its CEO, which has proved important in gaining traction. The company has already seen improvements in its hiring. In our engagement, we discussed the advantages of monitoring changes across other dimensions of diversity, such as ethnicity, in addition to age and gender. We have also challenged it on how it measures the initiative's success, in particular as it does not want to set hard targets.

Voting

In some cases, we have stepped up our efforts by recommending voting against relevant board members because of a lack of progress.

We oppose the election of nomination committee chairs of FTSE 100 companies that fall significantly short of the 2015 target set by the Lord Davies review of a quarter of their directors being women and cannot demonstrate credible plans to achieve the goal of 33% women directors by 2020. Similarly, we recommend voting against FTSE 250 company chairs with no female board directors and no credible plans to rectify this in the near future. Following changes to the board earlier this year, including the appointment of three male non-executive directors, only two out of the 12 board directors at mining company Rio Tinto are women, which falls significantly short of the 25% target. Although the company has stated its commitment to diversity and seeking to ensure better gender balance in future appointments, due to the lack of diversity and in the absence of a credible plan to address this, we recommended voting against the re-election of the chair of the nominations committee. We also opposed the election of the nomination chairs and/or chairs of Antofagasta, Glencore and RSA Insurance because of a lack of board diversity.

Our guidelines for the US recommend voting against the chairs of governance committees at companies in our engagement programme with no women on board, and we have supported shareholder proposals seeking greater diversity.

In Asia and emerging markets we want to see at least one woman director on the board and decide where to oppose the chair on a case-by-case basis, apart from Hong Kong and Japan where we recommend voting against in these circumstances at all times. In India, where boards lack independent female directors, we expect at least one of those to be put forward for election by listed companies. If not, we recommend voting against all members of the nomination committee.

Parker review

We encourage companies to approach diversity beyond gender to also include nationality, ethnicity, experience, skill sets and socio-economic background. However, diversity in terms of, for example, ethnicity is even more difficult to achieve as, because of a lack of available data, it is challenging to measure progress.

We therefore welcome the recommendations on the ethnic diversity of UK boards made by the Parker review, which sets out practical issues and outlines objectives and timescales for companies. In our response to the consultation, we pressed for the disclosure of a more all-encompassing strategy by companies on diversity to give ethnicity equal consideration alongside gender and other relevant aspects to foster deeper organisational buy-in. We are increasingly taking into account the ethnicity of board members in our engagements.

Pay gap

The UK government has requested all employers with more than 249 employees to publish a gender pay gap, with the final deadline for publication set for 4 April 2018. The gender pay gap is the difference between the average earnings of men and women, expressed relative to men's earnings. Companies will need to disclose the mean and median gender pay gap in hourly pay, the mean and median bonus gender pay gap, the proportion of men and women receiving a bonus payment and the proportion of men and women in each pay quartile.

We welcome the publication of a gender pay gap, as we believe that increased transparency on the matter is likely to propel companies into action. From 2018, we will engage with companies that are poor performers on the gender pay gap to assess their plans to reduce it.

Policy work

As diversity comes in a variety of shades, depending on the history, culture and legal framework of a market, one of the biggest impacts we can have is through engagements at the public policy level. Across the main markets, we have supported and encouraged tougher requirements, from a 40% women on board quota in Switzerland to beyond one ethnic director in the more advanced UK market.

At the human capital management level, we have joined the steering committee of the Workforce Disclosure Taskforce, which explores pay gaps and voluntary disclosures of information, as well as other efforts to enhance the diversity at the senior management and board level, such as processes, training, incentives, mentoring and networking. We are also the chair of the attraction work stream of the Diversity Project, which encourages diversity in the UK's financial services industry.

Remaining challenges

While gender diversity on the board of companies is being addressed, more work needs to be done across the organisation. At the recruitment stage, this is relatively easy because a wide variety of tools exist to make the hiring process fairer. The challenges tend to appear afterwards as evidence suggests that the glass ceiling continues to be relatively intact, leading to a lack of progression and promotion and a loss of talent in the executive pipeline. We have yet to find out how best to tackle this as there does not seem to be a silver bullet.

It is only an inclusive, supportive and ultimately fair culture that will truly open the door to a greater variety of experience, background, nationality, education, skill sets and ethnicity in companies.

For further information, please contact:

Natacha Dimitrijevic
natacha.dimitrijevic@hermes-investment.com

[2] Diversity Matters, McKinsey 2015
[3] https://www.americanprogress.org/issues/women/reports/2017/05/21/432758/womens-leadership-gap/
[4] http://www.ey.com/Publication/vwLUAssets/A_Report_into_the_Ethnic_Diversity_of_UK_Boards/%24FILE/Beyond%20One%20by%2021%20PDF%20Report.pdf
[5] http://newfinancial.eu/wp-content/uploads/2017/06/Counting-Every-Woman-2017-FINAL.pdf
[6] http://www.equilar.com/press-releases/83-boards-seek-diversity-in-response-to-investors.html
[7] http://www.ey.com/Publication/vwLUAssets/A_Report_into_the_Ethnic_Diversity_of_UK_Boards/$FILE/Beyond%20One%20by%2021%20PDF%20Report.pdf

Untangling tight knots – Tackling Japan's corporate governance dilemma

Cross-shareholdings are one of the biggest issues standing in the way of corporate governance improvements in the land of the rising sun. We are engaging with Japanese companies on the issue.

Setting the scene

After the Second World War, Japan's large financial and industrial conglomerates, whose influence and size allowed control over significant parts of the country's economy, were broken up by order of the General Headquarters, the Supreme Commander for the Allied Powers, into separate entities, such as banks, trading houses and manufacturers. However, the resulting companies continued to maintain close ties with each other through interlocking their boards, trading among themselves and through the practice of cross-shareholdings – also known as strategic or allegiant shareholdings – by which they hold shares in each other. Banks in particular have played a significant part by acquiring shares of a large number of companies to which they lent money, while life insurance companies have also been a major contributor to this system. Although they may be small on an individual company basis, together cross-shareholdings account for a substantial part of the equity of many Japanese companies.

Japan's strategic or cross-shareholdings were designed for companies to maintain or strengthen relationships with each other, to provide a stable shareholder base and to protect each other from hostile takeovers. In addition, suppliers may hold shares of their customers to secure future contracts and companies may receive favourable treatment from service providers, for example in sourcing and distribution, in which they are long-term shareholders.

However, while the practice may have helped to grow and protect Japanese businesses in the past, it is now increasingly seen as dubious by investors in terms of long-term value creation, corporate governance and shareholder rights. It is perceived as an inefficient use of shareholder funds that could to lead to functional failures of the Japanese financial market.

Cross-shareholdings go against market principles of fairness as companies are expected to do business with those they have shareholding relationships with instead of those that offer the best quality products or service or the lowest price. We are also concerned that many companies are obliged to hold shares of other companies in order to maintain a business relationship with them.

Furthermore, seeking economic benefits from cross-shareholdings can be problematic in light of the country's Anti-Monopoly Act. The guidelines of the act indicate that if a company uses shareholdings as a means to prevent the investee companies from trading with its competitors or refuses to trade with those without shareholding relationships, it could be viewed as an unreasonable restraint of trade.

Cross-shareholdings can also contribute to poor governance at investee companies. The practice promotes the unequal treatment of shareholders because those who hold shares for strategic purposes, for example to secure a contract, may receive benefits, while other shareholders, including institutional and retail investors, do not. This could contribute to sustaining poor governance practices and blocking attempts by other investors to improve governance at the investee companies.

In addition, when companies hold shares of others to maintain good relationships, they tend to support the management of the investee companies instead of exercising their voting rights appropriately to hold management and the board to account. This is exacerbated by a common practice at AGMs in Japan where blank votes, typically by retail investors, are counted as support for management. In short, companies effectively buy and control the yes votes at AGMs.

The practice also casts doubt about the independence of members of the board, as a large number of companies have appointed non-executive directors who represent some of their cross-shareholding partners and have designated them as independent despite the relationship between these entities.

Last, cross-shareholdings can function as anti-takeover measures. The holding of shares for non-investment purposes raises concerns about inappropriate and inefficient financial capital management because institutional investors only profit from stock return, which is poor, as many companies trade below their book value because they do not face the threat of takeovers.

Reduction

While many Japanese companies still believe them to be acceptable, pressure has been mounting on them to dissolve cross-shareholdings. The Japanese government, for example, has encouraged the country's three major banks to reduce them. They are also under pressure from the capital adequacy requirements of the Basel III regulatory framework for banks.

Although they have begun to decline, with holdings by banks and life insurance companies falling from over 40% of listed stocks in the late 1980s to below 20%, cross-shareholdings still make up a substantial part of the Japanese equity market[8]. According to a study by Japan Investor Relations and Investor Support, in 2016 cross-shareholdings represented 34.1% of the total shareholdings of Japanese companies, exceeding the holdings of the country's institutional investors, which amounted to 31.9%.

While major Japanese banks have announced plans to sell many of their cross-shareholdings, questions remain about the extent of this, as well as about these holdings by other financial institutions and companies with business relationships. It is important to ensure that the shares sold by the major banks do not end up being held by other companies or banks for similar strategic purposes.

Corporate Governance Code

Japan's Corporate Governance Code, which was introduced in 2015, requires companies to disclose their policy on cross-shareholdings. It also asks company boards to examine the mid- to long-term economic rationale and outlook for major cross-shareholdings on an annual basis, taking into consideration associated risks and returns. The annual review should result in a detailed explanation by the board of its reasons for the cross-shareholdings. Many companies state that they will analyse the economic benefit of each of their holdings and make decisions, implying that they will continue to hold these shares as long as they make sense as an investment or lead to benefits for the company. They do not appear to understand that fundamentally investors are not supportive of this practice and ultimately would like to see it disappear.

Engagements

The biggest challenge for us in our engagement is therefore to overcome the widespread belief among companies that cross-shareholdings are an essential part of relationship building and that selling shares in their business partners would negatively affect their relationship, thus leading to the destruction of shareholder value. In our dialogue with them, we have found there to be a significant lack of understanding of shareholder perspectives. Worryingly, few companies recognise the problems of the practice and seem to understand the rationale for unwinding.

We have been engaging with various stakeholders on this matter, including regulators and companies, raising awareness and pressing for change. We have set 30 objectives and issues on this topic as part of our engagement programme with companies.

Public policy work

As we believe detailed disclosures will help to untangle cross-shareholding relationships and allow investors to identify more easily the extent of those, we have encouraged the regulator to introduce a rule for companies to disclose theirs.

In a meeting with the Financial Services Agency (FSA) of Japan, we raised concerns about the lack of transparency of cross-shareholdings by Japanese companies and pointed out that many of them still do not understand why investors ask them to reduce theirs, particularly in view of the new cross-shareholding arrangements agreed by some of them. We suggested the FSA ask Japanese companies to improve their disclosures in annual securities and corporate governance reports. We welcomed that the Council of Experts Concerning the Follow-up of Japan's Stewardship Code and Japan's Corporate Governance Code continues to discuss cross-shareholdings and retain dialogue with investee companies on the issue. Equally positive, is that the FSA welcomes feedback from investors on the issue and encourages them to raise this with companies.

We subsequently sent a letter to the FSA, which was backed by several large global investors, encouraging it to strengthen the disclosure requirements for cross-shareholdings. We highlighted that cross-shareholdings are believed to be a contributor to deterring investments in Japanese companies and thus could be a major obstacle to the growth of the market.

And while we largely welcomed the proposed amendments to Japan's stewardship code, in our response to its consultation, we highlighted that the revision of the code and investor efforts to implement its principles need to be matched by reforms in other parts of the capital markets in order for stewardship activities to be effective. We particularly pointed out the sizeable cross-shareholdings by companies which are not accountable in the same way as institutional investors who sign up to the code. We cautioned that the influence of institutional investors and ultimately the impact of the stewardship code may be limited without a swift and substantial reduction in cross-shareholdings.

We also contributed to the development of the Fiduciary Duty in the 21st Century – Japan Roadmap[9] report by the Principles for Responsible Investment. The roadmap identifies key themes on which investors engage with Japanese companies, many of which have a strong ESG focus, and provides recommendations on stewardship and engagement, corporate governance and disclosure. We were particularly pleased to see cross-shareholdings highlighted as a key challenge to corporate governance in the country, which was in line with our input.

It is likely to take years to abolish or even substantially reduce cross-shareholdings across Japan because they span the interests of many parties and dissolving them typically requires their consensus. But the public announcements of some large companies, such as Olympus and Terumo, to sell their cross-shareholdings, while at the same indicating their intention to maintain their operational partnerships or for others to have formed new operational tie-ups without cross-shareholdings, are encouraging signs.

It is crucial that investors continue to raise their concerns about cross-shareholdings and ask companies to explain their plans in order to raise awareness of the degree of the problem and accelerate the speed of change.

For further information, please contact:

Hans-Christoph Hirt
hans-christoph.hirt@hermes-investment.com

[8] http://www.jpx.co.jp/markets/statistics-equities/examination/nlsgeu000001q8j8-att/j-bunpu2015.pdf

[9] https://www.unpri.org/page/pri-publishes-japan-roadmap-new-report-makes-recommendations-on-esg-considerations-for-the-japanese-market

Chopping through the undergrowth – Cultivating stewardship in Brazil

Our engagement with Brazilian companies has focused on a variety of issues, from bribery and corruption to good governance and climate change.

Setting the scene

Brazil – home to roughly half the population of South America and the continent's largest economy – is in the middle of a political crisis. Found guilty on corruption and money-laundering charges, former president Lula da Silva was sentenced to over nine years in prison in July 2017. His successor Dilma Rousseff was impeached in 2016 for budget breaches and misconduct in the corruption scandal that has engulfed state-controlled oil company Petroleo Brasileiro and led to Operation Car Wash. The widespread investigations of this operation, as well as those concerning construction company Odebrecht and meatpacker JBS, both of which entered guilty plea agreements with Brazilian and US authorities, revealed the involvement of a large number of politicians in kickback schemes with the private sector. Brazilian media, the public and shareholders have applied pressure on the country's companies and politicians to clean up their act.

The root cause of Brazil's bribery and corruption scandals lies in the country's colonial past, which created a dependent relationship between the state and its companies. Several Brazilian companies such as CSN, Embraer and Vale were founded by the state. From the1970s onwards, some of these listed publicly, with the government retaining a stake. This resulted in conflicts of interest between the government as a controlling shareholder and a regulator and policy-maker, some of which were managed badly.

In the case of energy company Petróleo Brasileiro (Petrobras), for example, the domestic oil price was influenced by the government and the drilling equipment the company used had to comply with minimum local content requirements, all of which was to the detriment of minority shareholders. The domestic oil price was kept below the international price for extended periods in order to control inflation. The local content requirements, designed to help develop the Brazilian capital goods industry, led to many of Petrobras' projects exceeding their budget and falling behind schedule.

The culture and corporate governance practices of companies have also played a role in the scandal. Before the corruption crises engulfed the country, best practice in corporate governance was not regarded as a priority.

Lessons from Petrobras

Since then, Petrobras has worked hard to improve its governance and compliance. It appointed independent directors to its board to replace the previous government ministers, as well as two minority shareholder representatives proposed by its shareholders, including us on behalf of our clients. The company also added independent members to its fiscal council, which is responsible for the oversight of audit issues. Furthermore, to create a strong compliance function in the company, a chief compliance officer was appointed, who put in place what we believe to be an appropriate compliance programme. Petrobras has also appointed a person to improve the governance of its subsidiaries and joint ventures.

We were therefore able to complete our engagement objectives with the company on board structure and bribery and corruption. Our engagements on governance helped open the door to further discussions with the company on, for example, health and safety, water and climate change. A shift is already underway as its board has begun to focus on the risks and opportunities presented by climate change, and responsibility for environmental issues has been given to its strategy team. Nevertheless, we continue to encourage the company to publish the impact of climate change on its business and apply the recommendations of the Financial Stability Board's Task Force on Climate-related Financial Disclosures.

JBS

The investigation into Petrobras also brought to light more revelations of corrupt activities at other companies, for example at Brazilian meat-processing company JBS, which was founded by Jose Batista Sobrinho. Through its holding company J&F and other investment vehicles, the Batista family is the major shareholder of JBS with 42% of the shares. The company confirmed in its plea bargain the involvement of more than 1,000 politicians in corrupt activities, including that of existing president Michel Temer. The sons of JBS' founder, who had been the chair and the CEO respectively, are both in custody accused of bribery, money laundering and insider trading. In the absence of succession planning and despite efforts from minority shareholders to stop this, in particular from the Brazilian Development Bank (BNDES), which owns 21% of the shares, Jose Batista Sobrinho was appointed CEO. At the lower end of the scale, the company also allegedly bribed government food inspectors to approve the sale and export of contaminated meat. J&F has agreed to pay a BRL10.3 billion/$3.2 billion fine[10] over the next 25 years for its involvement in the large-scale corruption of politicians.

In a reflection of the pressure put on corrupt companies by society and in an attempt to remove the Batista family from JBS' management and board, BNDES proposed an EGM. The bank also filed a shareholder resolution to approve measures to protect the company's rights in relation to seeking compensation for the losses incurred. Although, in principle, we supported the proposal and welcomed the action taken, we raised concerns that its generic wording could prevent it from gaining support from minority shareholders. We provided an example of a shareholder proposal we filed at German car manufacturer Volkswagen with a similar purpose, which the bank used to improve its draft resolution and allowed us to support it. As at Volkswagen, we suggested that the proposal call for a special audit and specific legal procedures to be initiated by JBS in order to protect its rights and possibly seek financial compensation from its controlling shareholders. There was no recommendation on the shareholder proposal from management and the EGM was subsequently suspended pending a court decision on conflicts of interest in relation to the voting rights of the founding family.

We want to see an appropriate compliance structure put in place at JBS, with a chief compliance officer who reports to the board, as well as public policies on bribery and corruption, the disclosure of the metrics used in its whistleblowing process and training to effect a change in the company's culture. As part of our client engagement trip to Brazil, we had scheduled a meeting with the chair. It was cancelled at short notice due to the arrest of the company's former CEO, however we will continue to seek to engage with the company.

JBS seems to be in a similar position to where Petrobras was two years ago, which is why we are hopeful that the former's crisis is an opportunity for change.

One-share one-vote momentum

We also met mining company Vale and paper and pulp company Suzano Papel e Celulose at their headquarters, both of which are in the process of moving their listings to the Novo Mercado, the B3 Stock Exchange segment with higher corporate governance standards. As part of this process, we supported the proposals submitted to their AGMs to convert their non-voting into voting shares and to amend their articles of association to incorporate the requirements of the Novo Mercado.

In the case of Vale, the adoption of the one-share one-vote principle and the dissolution of the controlling shareholders agreement, which has been in place since its privatisation in 1997, will result in a dispersed ownership structure.

The companies also promised to improve their disclosure on climate change-related risks and opportunities. We continue to encourage them to adopt best practice in board diversity and independence, exceeding the minimum regulatory requirements of the Novo Mercado.

Listing rules

The push towards better governance at Brazil's listed companies has been helped by various initiatives. While initial pick-up was slow, most of the companies listing since its inception in 2000 have done so on the Novo Mercado.

Regular reviews of the listing segment are designed to maintain its value. In the fourth quarter of 2016, we responded to the consultation of the revision of the Novo Mercado. In our view, the revision is an improvement, for example with regard to the requirement of the independence of board committees. Unfortunately however, as the draft needs to be voted on by all companies listed on the segment, some measures – for example such as the use of international standards for reporting on sustainability – were rejected. But, according to the new rules, companies listed on the Novo Mercado will need to have a board audit committee with at least one independent director and one financial expert, an internal audit function reporting to the board and provide better disclosure of executive remuneration. Companies will also have to disclose material facts and press releases in English and have policies and guidelines in place on remuneration, nomination, risk management, related party transactions and sustainability reports. The new final Novo Mercado regulations are expected to be approved by Brazil's market regulator CVM later in 2017.

In addition, in September 2015, the voluntary State-Owned Enterprises Governance Program was launched with the objective of encouraging the companies falling into this category to improve their corporate governance structures and practices. We had encouraged Petrobras to work towards the certification from the programme, which it received in August 2017.

Stewardship

Brazil has also tried to officially ensure the involvement of shareholders. The Brazilian Stewardship Code launched in October 2016. It had been drafted by a working group of members of the Association of Capital Market Investors (AMEC), of which we were the only non-resident member. The process comprised a benchmarking of stewardship codes, interviews with the International Corporate Governance Network, the UK's Financial Reporting Council, local and international asset managers and owners, as well as a public consultation. We believe that the code will be instrumental in developing a stewardship culture in the Brazilian market and were pleased by the attendance of some major local asset managers at the launch, as well as that of the regulator CVM. The code has to date attracted 16 signatories, mainly asset managers, including that of our parent, Hermes Investment Management.

Following the launch, we were invited by AMEC to join a steering group of the code's signatories in order to develop guidelines for its implementation and to share best practice, with a view of broadening the signatory base, in particular the buy-in from pension funds. We subsequently spoke at the implementation guidelines launch event held at the B3 Stock Exchange in São Paulo where we also joined a panel of pension funds and asset managers discussing stewardship in Brazil and its main challenges, a dialogue we will continue.

For further information, please contact:

Jaime Gornsztejn
jaime.gornsztejn@hermes-investment.com

[10] http://www.bbc.co.uk/news/world-latin-america-40109232

Engagement on strategy

Many of our most successful engagements include discussions on business strategy and structural governance issues.

Overview

We adopt a holistic approach to engagement, combining discussions on business strategy and risk management, including social, environmental and ethical risks, with structural governance issues. We challenge and support corporate management in their approach to the long-term future of the businesses they run, often when there is minimal outside pressure for change. We are generally most successful when we engage from a business perspective and present environmental, social and governance issues as risks to the company's strategic positioning. Companies may benefit from new perspectives on the board and from promoting fresh thinking at the head of the company. An independent chair or change of CEO is frequently the key to improving performance and creating long-term value for shareholders.

Examples of recent engagements

Board changes

Lead engager: Masaru Arai

We welcomed the progress an Asian company has made to improve its board structure following concerns we raised about the independence of one of its directors. He stepped down from his post at the company's AGM in June 2017. Of the board's 13 directors, six are now truly independent and have no affiliation with the company. We were also pleased that one female director has joined the board. Equally positive is that the company has over the last year started to report in line with the guidelines of the Global Reporting Initiative and the CDP climate change and water frameworks. In addition, its first integrated report was due to be published shortly. Although the company discloses the ESG issues it faces on its website, this will be the first report on ESG-related topics since it stopped producing CSR reports. We recommended the company disclose more detailed information with statistics. It recognised the issue and has set up a new office in order to improve its ESG disclosures and publish the integrated report.

Climate change disclosure

Lead engager: Jaime Gornsztejn

We were pleased about the commitment of an emerging markets company to disclose climate change data to the CDP initiative and to publish medium-term targets for its sustainability-related key performance indicators. We had been pressing the company to submit its response to the CDP questionnaires on climate change, water and forests, as many of its peers already do. Therefore we welcomed its plan to submit a public response to the climate change questionnaire in 2018 and to the other surveys subsequently.

In a meeting with us, the company's head of sustainability business intelligence also agreed with our request to disclose medium-term targets for carbon emissions, water and energy in relation to its key performance indicators. We discussed the climate change adaptation initiatives underway. The company described the increase in recycling rates of water and the reduction in water use per tonne produced. It is also adapting its business management techniques to regional weather characteristics. We were encouraged by the steps the company has taken to address the climate change risks it faces and agreed to provide feedback once its sustainability targets and CDP responses are published.

Climate change reporting

Lead engager: Bruce Duguid

We welcomed the first reporting in line with the recommendations of the Task Force on Climate-related Financial Disclosures by a European company. The company has used an appropriate range of scenarios that test its business under low and potentially higher-carbon scenarios. As the analysis only covers 60-70% of its business, the company would like to make this more comprehensive by including its other business. However, it found conducting a quantified financial analysis challenging, which is why it has omitted this from its disclosure for now. Nevertheless, it is aware of the challenge of reporting on materiality and will consider additional disclosure in future. It would also like to include more analysis of different risks and sees its first analysis as only the beginning of potentially more in-depth work. We encouraged the company to consider conducting a teach-in session to enable us to understand in more detail the nature of its analysis.

Cyber security

Lead engager: Christine Chow

In view of high-profile global cyberattacks, we were reassured by the measures an Asian company has taken to strengthen its cyber security. As a member of the Financial Security Institute, an agency set up to safeguard the financial sector of its home market, the company receives technical cyber security training, as well as information about cyberattack patterns and risk trends. Its cyber risk committee, which is made up of representatives from cyber security institutes, universities and white hat hacker groups, provides risk updates and advice. In addition, a white hat hacker group is contracted to identify weak points in the company's cyber security systems. The company uses this information to continually revise and upgrade its security systems. Positively, the company's management of cyber risks led to the threat from a cyberattack being handled in an appropriate and timely manner.

Low-carbon strategy

Lead engager: Bruce Duguid

Positively, the new strategy of a European company, which focuses on monetising the energy transition of its consumers to a low-carbon economy, seems to be working well. Its chair explained that the decision to invest less in energy exploration and production and more in consumer services to deliver energy efficiency is a major shift for the company and consistent with lower-carbon scenarios. Its board regularly debates whether it should act in the interests of its

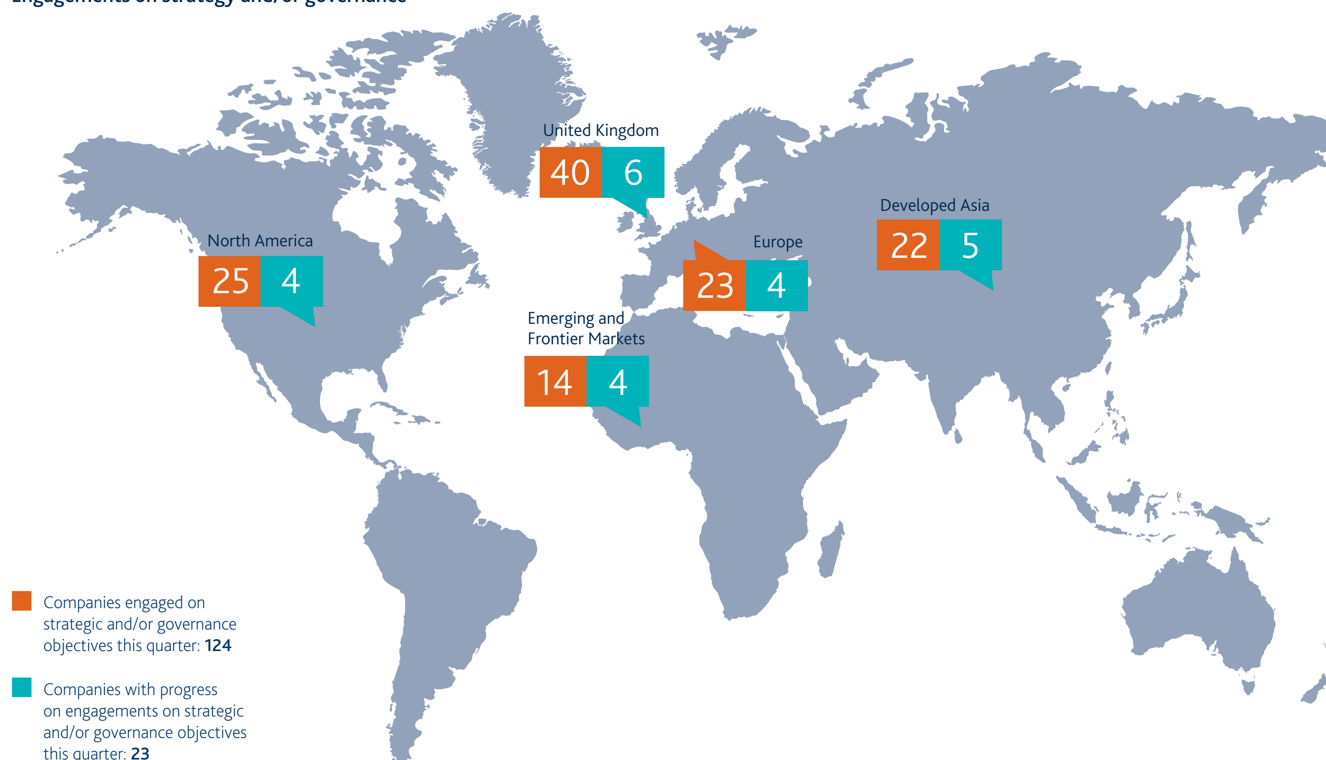
shareholders or for the benefit of wider stakeholders and seeks a far-sighted approach by which to ensure these are aligned. A good example is energy pricing, where the company passed up the opportunity of a consumer price rise in order to retain the confidence of its consumers and wider stakeholders. In response to our question raised at its AGM, the company indicated that it would seek to report on climate change-related risks in line with the recommendations of the Task Force on Climate-related Financial Disclosures (TCFD). We subsequently encouraged the ongoing development of metrics and targets to aid the success of its energy efficiency advice service, including a target for the reduction in energy and greenhouse gas emissions attributable to the advice service. We also set out our expectations that the increased information on stakeholder opinion, which is important to maintain its licence to operate and is available to the board through a stakeholder mapping project, will enable a more objective approach to optimising shareholder outcomes. In light of the company's commitment to report in line with the TCFD guidelines, we requested that any reporting should give an indication of the materiality of risks and opportunities, using quantified analysis.

Splitting of chair/CEO role

Lead engager: Michael Viehs

Following a public announcement, a US company informed us that its board has decided to split the CEO/chair position upon the retirement of the incumbent CEO. We had engaged with the company on this and made clear our intention to support a shareholder proposal calling for a separation of the two roles. Its remuneration system, which we also opposed, received 73% votes against. As a result, the company's remuneration committee is going to carefully review its pay practices. Positively, from 2018 onwards, the company's long-term incentive plan will be at least 50% based on performance targets. Prior to this, the company had tried to reassure us that its lead independent director (LID) effectively acts like an independent chair by presenting us with a letter the LID had sent out a few days earlier. In this, the LID explained the company's remuneration policy and how the board has been working over the past 12 months. While we were pleased with the publication of the letter, we recommended the company include it in its proxy statement.

Engagements on strategy and/or governance



Public policy and best practice

Hermes EOS contributes to the development of policy and best practice on corporate governance, sustainability and shareholder rights to protect and enhance the value of its clients' shareholdings over the longer term.

Overview

We participate in debates on public policy matters to protect and enhance value for our clients by improving shareholder rights and boosting protection for minority shareholders. This work extends across company law, which in many markets sets a basic foundation for shareholder rights, securities laws, which frame the operation of the markets and ensure that value creation is reflected in value for shareholders, and developing codes of best practice for governance, management of key risks, as well as disclosure. In addition to this work on a country-specific basis, we address regulations with a global remit. Investment institutions are typically absent from public policy debates even though they can have a profound impact on shareholder value. Hermes EOS seeks to fill this gap. By playing a full role in shaping these standards, we can ensure that they work in the interests of shareholders instead of being moulded to the narrow interests of other market participants whose interests may be markedly different – particularly companies, lawyers and accounting firms, which tend to be more active than investors in these debates.

Highlights

Dual-class share structures

Lead engager: Hans-Christoph Hirt

As part of a panel at the conference of the Council of Institutional Investors, we addressed the competition of stock exchanges and regulators for listings and the impact on requirements. Following the listing of e-commerce company Alibaba in the US instead of Hong Kong in 2014, which was at least partly driven by the possibility to list shares with differential voting rights, stock exchanges in Asia are once again considering whether to allow companies with dual-class share structures to list, at the expense of the one-share one-vote principle. At the same time, the prospective listing of oil company Saudi Aramco seems to have triggered a review of the UK listing rules, which would accommodate sovereign-owned companies by diluting the investor protection provided by the rules.

We suggested looking at the issue from a global investor perspective and with the interests of the ultimate beneficiaries in mind. In light of the trend towards stewardship codes and guidelines, we also questioned the regulatory inconsistency in pushing investors for better stewardship while at the same time allowing deviation from the one-share one-vote principle and dilution of investor rights. With ongoing consultations in a number of key markets, this issue will remain topical. We plan to respond to the consultations and to continue to intervene in the debate.

Human capital management

Lead engager: Tim Goodman

We co-signed a petition to the US Securities and Exchange Commission to change its disclosure rules for companies so that they are required to provide more information and metrics on human capital management. The initiative was led by the US Human Capital Management Coalition, of which we are a member. We will continue to work with the coalition to encourage companies to improve their practices and advocate policy changes to assist improvements.

Investor protection rules

Lead engager: Will Pomroy

We conveyed concerns to the Financial Conduct Authority (FCA) about its proposed exemption to existing investor protection rules for companies with a sovereign controlling shareholder wanting to obtain a premium listing in the UK. The FCA acknowledged that the existing rules are a problem for only a small number of companies and provided reassurance that it does not want to dilute the UK's standards of governance. We accept that a national government is inherently a more complex organisation, which can lead to problems of compliance with existing rules. Nevertheless, we pointed out that not all sovereign-controlled companies have a good track record of utilising shareholder capital solely for the purposes of independent business. Therefore, a dilution of, for example, minority shareholder oversight of related party transactions is concerning.

Sustainable Development Goals

Lead engager: Tim Goodman

We were a panellist in a discussion at a UN Global Compact event in New York at which companies and investors discussed how best to report against the Sustainable Development Goals (SDGs). We explained how we have begun to map our own engagement programme against the SDGs, focusing on the ones that we can help to influence and encouraged companies to do the same. We also said that the best way for companies to serve their long-term shareholders is to be clear on their social purpose and to deliver on that. This will deliver returns to their long-term shareholders and to wider society.

US Investor Stewardship Group

Lead engager: Tim Goodman

We agreed to become an endorser of the US Investor Stewardship Group, which has developed lowest common denominator corporate governance and stewardship codes for the market. The initiative is an important step in the evolution of governance in the US, where regulators and stock exchanges lack the will to enact their own codes. While the codes are insufficiently stringent and lack a formal monitoring and review mechanism, we decided on balance that it is better to participate in the initiative and argue for change than to stand aside from it. We aim to participate in the promised review of the codes' provisions to seek further progress.

Other work in this quarter included

Promoting best practice

- We attended a European investor meeting led by the executive director of the **Access to Nutrition Foundation** (ATNF) and the co-chair of the collaborative engagement we are part of. The ATNF gave an update regarding the launch of the 2018 global and US indices. We also discussed how the ATNF can better support the engagement efforts of investors.
- Together with the CIO of Japan's Government Pension Fund, we spoke at a panel about global trends in responsible investment and ownership at the **Asian Leadership Conference** in Seoul. The event was headlined by former US President Obama whose speech covered a wide range of Asian-specific and global leadership challenges, such as climate change. We explained one of the key drivers behind responsible investment, namely a greater focus on the interests of the ultimate beneficiaries, and highlighted challenges in the investment chain. As South Korea has introduced a stewardship code, we also discussed global developments in active ownership and set out critical success factors for investor guidance.
- We attended the launch of the **Assurance Guidance of the UN Guiding Principles Reporting Framework**, which was supported by the Institute of Internal Auditors. The panel discussion at the launch comprised company representatives, a director from the UK's Financial Reporting Council and the president of the Chartered Institute of Internal Auditors.
- We participated in a collaborative investor initiative with the banking sector on **climate change**. In a letter to 62 of the world's largest banks, the group of 100 institutional investors – with assets close to $2 trillion – called for enhanced disclosure of the climate change-related risks and opportunities facing the financial institutions and the management of these by boards and senior executives.
- We attended a meeting of the UK All-Party Parliamentary Corporate Responsibility Group to discuss the efforts of UK authorities to tackle **bribery and corruption** globally and the role responsible businesses can play to support this.
- We had a positive exchange with the executive director of the **50/50 Climate Project** on how investors can encourage a more climate change-aware board, especially with regard to the voluntary disclosure of climate change risks. Instead of pushing for one specific director with climate change knowledge to be sitting on a company board, he recommended climate literacy across the board and organisation to improve the links between board discussions, strategy, remuneration, risk management and reporting on climate change related issues.
- We met the Living Wage Foundation to understand the challenges facing companies when seeking accreditation as a **living wage** employer. Outside of the UK, the foundation is working with the Global Living Wage Coalition to develop standards on the poverty of workers. NGO ShareAction meanwhile updated us on the progress of its campaign for major public companies to pay the living wage, as calculated by the Living Wage Foundation. Nearly one third of FTSE 100 companies are now official living wage employers.
- We encouraged IPIECA, the oil and gas industry's global trade association for environmental and social matters, to call on its members to report in line with the recommendations of the **Task Force on Climate-related Financial Disclosures**. While it reiterated member concerns about the detailed disclosure of scenario plans, the association acknowledged that expectations from investors on climate change-related disclosure are increasing and that the industry needs to respond. We noted that boards think deeply about climate change and are aware of the risk of having a blind spot in relation to the accelerating pace of the transition to a low-carbon world.
- We joined the advisory board of the **Strategic Investor Initiative** (SII) of CEO coalition CECP and participated in the second CEO Investor Forum in New York. The SII supports companies that seek to embrace long-termism by creating a forum and tools to facilitate regular communication of long-term strategies with incorporated financial and material ESG factors to investors and key stakeholders. We believe that by joining its advisory board we can contribute to better and more long-term focused dialogue between companies and investors.
- We participated in a private roundtable hosted by the UK Financial Reporting Council (FRC) in which we discussed our thoughts on the likely changes to the **UK Corporate Governance and Stewardship Codes**. The FRC will publish a formal consultation in November with a view to finalising the revised Corporate Governance Code at the end of June 2018.
- We participated in a conference on the extractives industry convened by the International Petroleum Industry Environmental Conservation Association and the International Council on Mining and Metals on the **UN Sustainable Development Goals**. While some important developments were discussed by company representatives in relation to the goals, there is still much to do in both industries on many of the complex issues they face.
- We participated in the first meeting of the **working group on Japan of the International Corporate Governance Network** (ICGN), highlighting non-executive director dialogue, cross-shareholdings and collective engagement as key issues that could be tackled by guidance produced by the ICGN in collaboration with investors, companies and key regulators.

Public policy

- We wrote to the US Securities and Exchange Commission to support its proposed rule-making in order to improve the **audit reports** for companies listed in the country. In particular, we welcomed the disclosure of critical audit matters in the audit report, which should enhance the dialogue between audit committees and auditors.
- We gave feedback on the format of the new auditor report proposed by the **Public Company Accounting Oversight Board**. The new format allows investors to better harness the opinion of experts and include their insights in their dialogue with companies, which helps to focus engagement discussions and escalate any issues that have been challenging to raise in the past. We suggested auditors track how companies have improved their ability to address key audit issues year-on-year and their explanation of why some issues are no longer a priority. We recommended highlighting the most critical and challenging steps that the auditors have taken to attain assurance that the spirit of the audit is communicated, as well as that factual information is presented and procedures have been followed.
- The Hong Kong Stock Exchange put forward a new board consultation that aims to provide listing opportunities for companies with **weighted voting rights** structures. In our response, we strongly advised against the suggested non-standard governance structure in a one-track or dual-track listed regime as proposed in the paper and provided comments on a number of arguments that sought to justify the weighted voting rights structure.

Report written and produced by Nina Röhrbein

Hermes EOS makes voting recommendations at general meetings wherever practicable. We take a graduated approach and base our recommendations on annual report disclosures, discussions with the company and independent analyses. At larger companies and those where clients have significant interest, we seek to have dialogue before recommending a vote against or abstention on any resolution.

In most cases of a vote against at a company in which our clients have a significant holding or interest, we follow up with a letter explaining the concerns of our clients. We maintain records of voting and contact with companies, and we include the company in our main engagement programme if we believe further intervention is merited.

Hermes EOS makes voting recommendations at companies all over the world, wherever its clients own shares.

Overview

Over the last quarter we made voting recommendations at 1,097 meetings (9,506 resolutions). At 536 of those meetings we recommended opposing one or more resolutions. We recommended voting with management by exception at three meetings and abstaining at five meetings. We supported management on all resolutions at the remaining 553 meetings.

Global

We made voting recommendations at **1,097** meetings (**9,506** resolutions) over the last quarter.

- Total meetings in favour **50.4%**
- Meetings against (or against AND abstain) **48.9%**
- Meetings abstained **0.5%**
- Meetings with management by exception **0.3%**

Australia and New Zealand

We made voting recommendations at **28** meetings (**134** resolutions) over the last quarter.

- Total meetings in favour **71.4%**
- Meetings against (or against AND abstain) **28.6%**

Developed Asia

We made voting recommendations at **87** meetings (**587** resolutions) over the last quarter.

- Total meetings in favour **48.3%**
- Meetings against (or against AND abstain) **51.7%**

Emerging and Frontier Markets

We made voting recommendations at **477** meetings (**3,418** resolutions) over the last quarter.

- Total meetings in favour **50.9%**
- Meetings against (or against AND abstain) **48.4%**
- Meetings abstained **0.4%**
- Meetings with management by exception **0.2%**

Europe

We made voting recommendations at **105** meetings (**908** resolutions) over the last quarter.

- Total meetings in favour **61.0%**
- Meetings against (or against AND abstain) **39.0%**

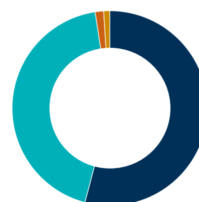
North America

We made voting recommendations at **193** meetings (**1,586** resolutions) over the last quarter.

- Total meetings in favour **37.3%**
- Meetings against (or against AND abstain) **62.7%**

United Kingdom

We made voting recommendations at **207** meetings (**2,873** resolutions) over the last quarter.

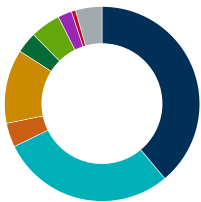


- Total meetings in favour **54.1%**
- Meetings against (or against AND abstain) **43.5%**
- Meetings abstained **1.4%**
- Meetings with management by exception **1.0%**

The issues on which we recommended voting against management or abstaining are shown below.

Global

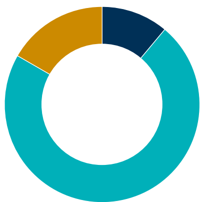
We recommended voting against or abstaining on **1,179** resolutions over the last quarter.



- Board structure **38.9%**
- Remuneration **28.9%**
- Shareholder resolution **4.0%**
- Capital structure and dividends **12.3%**
- Amendment of articles **3.5%**
- Audit and accounts **5.0%**
- Governance **2.3%**
- Poison pill/Anti-takeover device **0.7%**
- Other **4.4%**

Australia and New Zealand

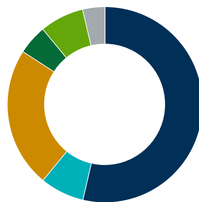
We recommended voting against or abstaining on **18** resolutions over the last quarter.



- Board structure **11.1%**
- Remuneration **72.2%**
- Capital structure and dividends **16.7%**

Developed Asia

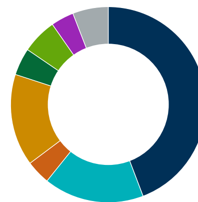
We recommended voting against or abstaining on **82** resolutions over the last quarter.



- Board structure **53.7%**
- Remuneration **7.3%**
- Capital structure and dividends **23.2%**
- Amendment of articles **4.9%**
- Audit and accounts **7.3%**
- Other **3.7%**

Emerging and Frontier Markets

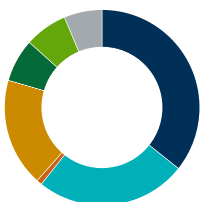
We recommended voting against or abstaining on **573** resolutions over the last quarter.



- Board structure **44.2%**
- Remuneration **16.6%**
- Shareholder resolution **4.0%**
- Capital structure and dividends **15.2%**
- Amendment of articles **4.5%**
- Audit and accounts **5.8%**
- Governance **3.8%**
- Other **5.9%**

Europe

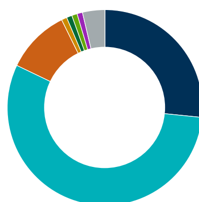
We recommended voting against or abstaining on **112** resolutions over the last quarter.



- Board structure **35.7%**
- Remuneration **25.0%**
- Shareholder resolution **0.9%**
- Capital structure and dividends **17.9%**
- Amendment of articles **7.1%**
- Audit and accounts **7.1%**
- Other **6.3%**

North America

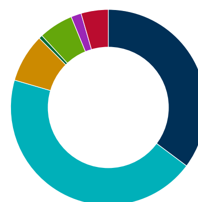
We recommended voting against or abstaining on **218** resolutions over the last quarter.



- Board structure **26.6%**
- Remuneration **55.5%**
- Shareholder resolution **10.6%**
- Capital structure and dividends **0.9%**
- Amendment of articles **0.9%**
- Audit and accounts **0.9%**
- Governance **0.9%**
- Other **3.7%**

United Kingdom

We recommended voting against or abstaining on **176** resolutions over the last quarter.



- Board structure **35.2%**
- Remuneration **44.3%**
- Capital structure and dividends **8.0%**
- Amendment of articles **0.6%**
- Audit and accounts **5.7%**
- Governance **1.7%**
- Poison pill/Anti-takeover device **4.5%**

This communication is directed at professional recipients only.
The activities referred to in this document are not regulated activities under the Financial Services and Markets Act. This document is for information purposes only. It pays no regard to any specific investment objectives, financial situation or particular needs of any specific recipient. Hermes Equity Ownership Services Limited (HEOS) does not provide investment advice and no action should be taken or omitted to be taken in reliance upon information in this document. Any opinions expressed may change.

This document may include a list of HEOS clients. Please note that inclusion on this list should not be construed as an endorsement of HEOS' services. HEOS has its registered office at Lloyds Chambers, 1 Portsoken Street, London, E1 8HZ.

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

20172710PR