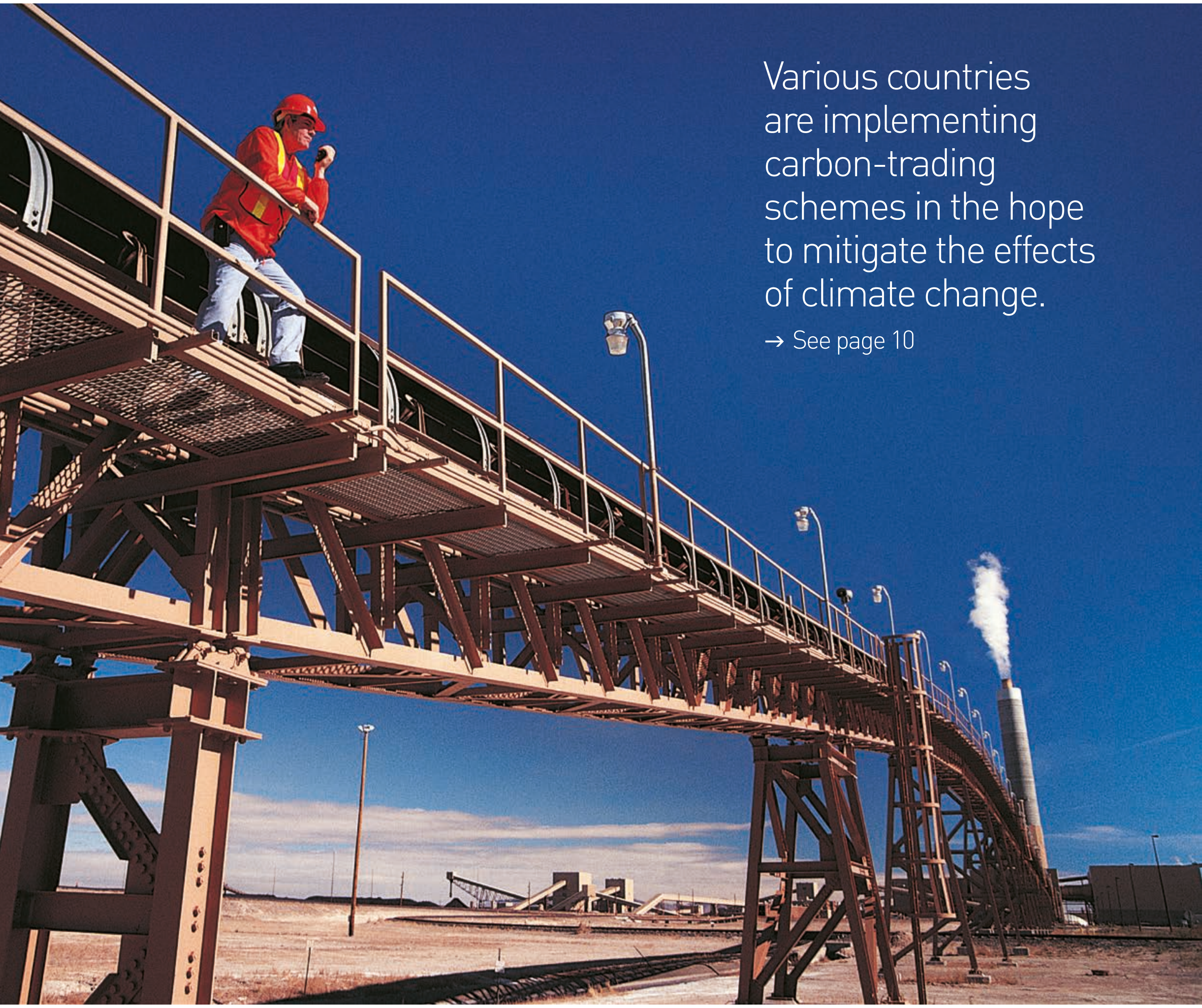
HERMES | Equity Ownership Services

Q1 | Public Engagement Report 2013



Various countries are implementing carbon-trading schemes in the hope to mitigate the effects of climate change.

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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 Q1 2013.

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.

What is EOS?

Hermes Equity Ownership Services (EOS) helps institutional share-owners around the world to meet their fiduciary responsibilities and become active owners of public and private 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 32 investors with roughly 161bn. USD* in assets under stewardship.

Hermes has the largest stewardship resource of any fund manager in the world. Our 32 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) and other Stewardship Codes. 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.

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

We escalate the intensity of our 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.

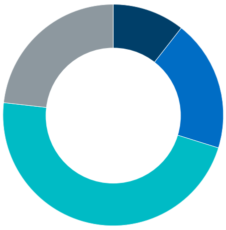
We would be delighted to discuss EOS with you in greater detail.
For further information please contact:
Colin Melvin on +44(0)207 680 2251.

* as at 31 December 2012

Engagement by region

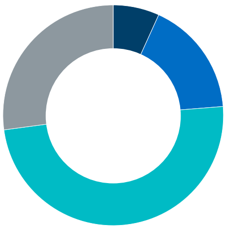
Over the last quarter we engaged with 201 companies on a range of 397 social, environmental, business strategy and governance issues. EOS' holistic approach to engagement means that we will typically engage with companies on more than one issue simultaneously. The engagements included in these figures are in addition to our discussions with companies around voting matters.

Global.
We engaged with 167 companies over the last quarter.



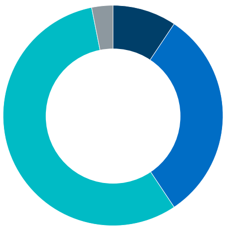
- Environmental **10.60%**
- Social and ethical **19.20%**
- Governance **46.99%**
- Strategy & risk **23.21%**

Asia.
We engaged with 24 companies over the last quarter.



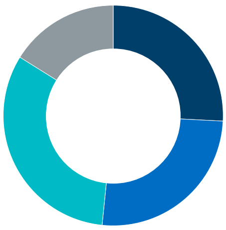
- Environmental **6.78%**
- Social and ethical **16.95%**
- Governance **49.15%**
- Strategy & risk **27.12%**

Australia & New Zealand .
We engaged with 12 companies over the last quarter.



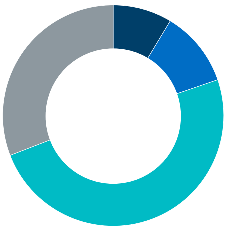
- Environmental **9.38%**
- Social and ethical **31.25%**
- Governance **56.25%**
- Strategy & risk **3.13%**

Emerging & Frontier Markets.
We engaged with 16 companies over the last quarter.



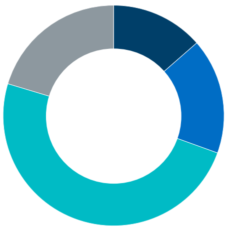
- Environmental **25.81%**
- Social and ethical **25.81%**
- Governance **32.26%**
- Strategy & risk **16.13%**

Europe.
We engaged with 49 companies over the last quarter.



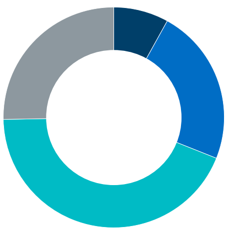
- Environmental **8.64%**
- Social and ethical **11.11%**
- Governance **49.38%**
- Strategy & risk **30.86%**

North America.
We engaged with 33 companies over the last quarter.



- Environmental **13.56%**
- Social and ethical **16.95%**
- Governance **49.15%**
- Strategy & risk **20.34%**

UK.
We engaged with 33 companies over the last quarter.

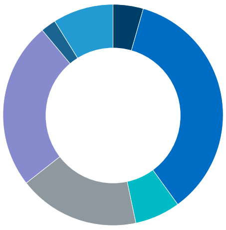


- Environmental **8.05%**
- Social and ethical **22.99%**
- Governance **43.68%**
- Strategy & risk **25.29%**

Engagement by issue

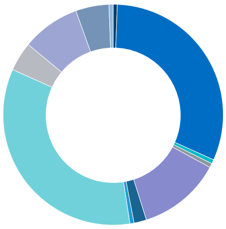
A summary of the 397 issues on which we engaged with companies over the last quarter is shown below.

Environmental.
Environmental issues featured in 10.60% of our engagements over the last quarter.



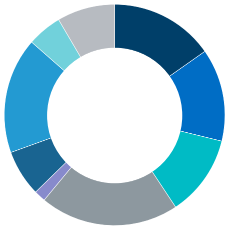
- Biodiversity **4.44%**
- Climate change/carbon intensity **35.56%**
- Forestry **6.67%**
- Health and safety **17.78%**
- Other environmental **24.44%**
- Waste **2.22%**
- Water stress **8.89%**

Governance.
Governance issues featured in 46.99% of our engagements over the last quarter.



- Accounting or auditing issues **0.61%**
- Board structure **31.10%**
- Committee structure **0.61%**
- Conflicts of interest **0.61%**
- Other governance **12.20%**
- Poison pill **1.83%**
- Related-party transactions **0.61%**
- Remuneration **34.15%**
- Separation of chair/CEO **4.27%**
- Shareholder communications **8.54%**
- Succession planning **4.88%**
- Voting rights – not 1 share 1 vote **0.61%**

Social and ethical.
Social issues featured in 19.20% of our engagements over the last quarter.



- Bribery & corruption **15.25%**
- Community relations **13.56%**
- Corporate culture **11.86%**
- Employee relations **20.34%**
- Licence to operate **1.69%**
- Operations in troubled regions **6.78%**
- Other social & ethical **16.95%**
- Political risk management **5.08%**
- Supply chain (inc child/other labour issues) **8.47%**

Strategy & risk.
Strategy & risk issues featured in 23.21% of our engagements over the last quarter.

- Business strategy **40.74%**
- Capital structure **2.47%**
- Returns to shareholders **2.47%**
- Risk of management **54.32%**

Focus on key issues

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.

Bribery and corruption

Advocating Woolf's reforms to affected companies

Corruption scandals at banks and other companies reveal that serious wrongdoing persists in some of the world's largest companies despite increased legislative efforts to prevent bribery and corruption. Hermes Equity Ownership Services continues to combat corruption including by encouraging companies to learn from the Woolf Report and apply its recommendations to their industries and circumstances.

Overview

Bribery and corruption is a brake on economic activity. The corrupt steal wealth from companies and public bodies for their own enrichment. Moreover, corruption distorts markets, stifling innovation and fair competition. Such behaviour slows economic development and has a malevolent effect on civil society. This often makes it even harder for businesses to prosper and affects ordinary people – including the beneficiaries of pension funds – particularly when corruption is endemic. Bribery, meanwhile, is beginning to have potentially catastrophic effects on companies. Convictions can now preclude companies from public contracts. Even without an admission of guilt, pharmaceutical companies have reached settlements costing billions of dollars as a result of alleged dubious sales practices in the United States (US). News Corporation has already faced legal costs as well as settlements totalling hundreds of millions US dollars – and the renowned phone-hacking scandal is far from over. The United Kingdom (UK) regulator has prevented News Corporation from being able to take full control of its associate television company, BSkyB, because of the grievous wrongdoing. The London Interbank Offered Rate (LIBOR) scandal, which may still be in its early chapters, has confirmed many peoples' scepticism about the probity of the UK banking industry.

Internationally, we see legislative moves to clamp down on the effects of bribery and corruption. The US enacted the Foreign Corrupt Practices Act in 1977 and has a reputation for enforcing provisions that extend to non-US firms. Other countries have or are passing legislation with similar effects and the example of the UK's Bribery Act 2010 demonstrates how such legislation has focused boardrooms on actively managing the risks associated with this crime. Legislation, reputational risk and the restricted capacity to do business as a result of being suspected of bribery have compelled us to engage companies to prevent catastrophic losses. We have had some success in making it clear that the short-term gains that some companies think may justify the risks are unacceptable to their long-term shareholders.

The Woolf Report

Amid BAE Systems' well-documented episodes of bribery and corruption, the chairman commissioned the Woolf Report to develop best practice in combating these problems. Significantly, before the Woolf Report was written, he publicly committed to implementing all of its recommendations in full. This helped the company restore its reputation among customers as it faced an existential crisis. The published recommendations are far-reaching, demanding and can only be achieved through committed board leadership seeking to implement formal systems and controls that ensure the culture of the company and its value chain meet the highest standards.

Engagement on bribery and corruption

We spoke at the 2012 annual general meeting of a large US company that had publicly admitted to extensive corruption within one of its subsidiaries. We suggested that the board consider adopting the recommendations contained within the Woolf Report, which has become the global gold standard for companies wishing to adopt the highest levels of anti-corruption practices and ethics. The company's chair publicly committed to do so regardless of any legal sanctions the company might face. We had proposed this to the chair of the company's governance committee in a private meeting beforehand.

This public exhortation to adopt best practice was unusual due to the legal and reputational sensitivities of the issue. Most of our work on this topic is conducted through our usual approach of private dialogue. For example, we have suggested to a multinational retailer and a number of defence companies dealing with publicised cases of bribery and corruption that they make similar commitments to implement suggestions made in the Woolf Report. Meanwhile, engagement with a number of pharmaceutical companies has focused on ensuring that pay incentives for their sales force are aligned appropriately and do not encourage inappropriate dealings.

In a different approach, we have confidentially brokered meetings between the chair of a company who has led a systematic campaign to implement best practice within the organisation and companies that are facing similar problems. While these conversations must remain private, we believe that peer-to-peer discussions between some of the world's largest companies can help to drive real, permanent change and encourage wider best practice.

The defence industry is at acute risk of widespread unethical behaviour. We have spoken at a private meeting of international defence companies to outline the importance of best-practice standards. We have also contributed to a working group with participants from a European country's defence companies. We have engaged intensively with a French defence company, including its chair, resulting in a transformation of its practices and public commitments to further improve them. We are also publicly associated with tackling bribery and corruption at a large German company with significant defence interests.

Importantly, we have supplemented our individual engagement work with participation in the Principles for Responsible Investment (PRI) bribery and corruption group. The group targeted companies in high-risk sectors and poor disclosure. Following engagement, many of the companies have substantially improved their disclosure, indicating that they may well be improving their management of this risk. We continue to work with the PRI group to engage with companies from around the world with significant bribery and corruption risk.

Since the onset of the financial crisis, our engagement with the banking industry around the world has intensified. We have been prominent in public policy work to improve regulation of the industry but have also engaged with companies on risk management, culture and misaligned incentives. All of these elements, if they are as sub-optimal as they have often been proven to be, lead to the possibility of corruption.

The LIBOR scandal has depressingly shown how investment banking has systemic agent-principal problems leading to endemic and corrupt behaviour. We are encouraging bank boards to set the tone from the top and respond to increased regulation not only with legal compliance but with a revolution in culture so that their activity serves their customers and clients rather than their own employees. Our engagement with the largest banks continues across the world – including regions that have not yet suffered from crises within their banking industries to encourage them to learn lessons from the US and Europe.

Managing bribery and corruption risk is an issue of vital importance to the value of individual companies and, on a macroeconomic level, to the development of the world economy. For this reason, we continue to work with individual companies, industry bodies and in public policy forums to help combat the blight caused by bribery and corruption.

Tim Goodman
Associate Director - North America

Japan

Delivering value from corporate governance

Hermes EOS focuses on the value and quality of governance in Japan, where more and more Japanese companies are taking the positive step of voluntarily appointing independent directors.

Overview

An increasing number of Japanese companies are voluntarily appointing independent directors to their boards. It is very encouraging that around 70% of the Tokyo Stock Price Index (TOPIX500) companies have already appointed one or more outside directors. Independent directors are expected to ensure the creation of long-term value, and to advise and support the strategic decision-making of the company's executives, thus improving the performance of the company.

We believe that statutory auditors cannot effectively fulfil the roles that independent directors carry out. We therefore continue our engagement with Japanese companies on issues such as board accountability and effectiveness, with the initial focus on the value and quality of governance. Hermes EOS encourages companies to pursue strategic reforms of corporate governance, and to demonstrate a clear commitment from the top to essential changes in corporate culture to support sustained growth and profitability. We also urge more Japanese companies to consider providing better board-level access for shareholders to discuss strategy, capital policy and corporate governance-related concerns.

At the public policy level, we remain concerned about the lack of formal progress in building consensus around minimum standards and setting aspirational targets for companies. We are therefore working closely with Japanese regulators and policy makers, pursuing the development of a substantive Corporate Governance Code to facilitate constructive dialogue between companies and their shareholders.

Improving board independence and accountability

Some 97% of the companies listed on the Tokyo Stock Exchange (TSE) are adopting the statutory auditor system ("Kansayaku", a two-tier board system). The majority of the statutory auditor board is required to consist of external statutory auditors. Under current regulations, there is no requirement for the appointment of outside directors, although an increasing number of Japanese companies is doing this voluntarily. About 70% of TOPIX500 companies have already appointed one or more outside directors, while the number is as high as 82% in the TOPIX100.

In order to optimise the long-term value of companies, an effective system of checks and balances is required at the top. The board therefore should be made up of members with an appropriate and diverse range of competencies, knowledge and experience. These include leadership skills to move the company forward, expertise to make decisions, and independence to challenge and hold executive management to account.

Independent directors, who are in a position to exercise objective and fiduciary judgment, are best positioned to do the latter. They are expected to direct a company in a way that ensures the creation of long-term value, and to advise and support the decision making of the executives. While we acknowledge the valuable contributions that statutory auditors make to companies, they cannot fulfil the roles of independent directors.

Hermes EOS has engaged with many Japanese companies on matters of board structure and accountability. We held a series of dialogues and meetings with a major automobile manufacturer to discuss our governance and risk-management concerns. Following our engagement, major progress was made in 2011, reducing the number of board directors from 27 to 11. The company has recently announced the appointment of outside directors (including one outside director that is not a Japanese national) to the board for the first time. We welcome this significant step forward, particularly given the company's leading position in Japan.

In another instance, a large consumer electronics company is appointing an additional female independent director to the board, following our engagement effort to address a lack of independence and diversity on the board.

We will continue advancing our engagements in Japan on board accountability and effectiveness, with the initial focus being placed on the value and quality aspects of governance practices. This includes what companies should aim for beyond compliance; such as how to acheive better accountability, and why this would benefit the company's stakeholders in the long term if the goverance reforms are appropriately made.

Effective communication with shareholders

We encourage Japanese companies to pursue effective and strategic reforms of corporate governance, and to demonstrate a clear commitment to essential changes in corporate culture to support the company's sustainable growth and strategic development. We will continue to urge Japanese companies to enhance board accountability, independence and diversity.

A board with appropriate and more diversified skills and experience should make better decisions, especially on key strategic matters and capital management issues. In general, we think there is still a significant potential for Japanese companies to improve board accountability and communication with their shareholders. Board access for shareholders remains rare in Japan. At the end of 2012, EOS met with the chair of a remuneration committee of a Japanese company to progress discussions on corporate governance and strategy. It is exceptional for a shareholder to be able to access an independent director in Japan, and this is a major step forward in our engagement. The meeting helped us gain a better understanding of the board dynamics and to be able to discuss our concerns directly with the board. We therefore urge more Japanese companies to provide better board-level access for shareholders.

At a recent roundtable with the Working Group on Corporate Governance Dialogue established by the Ministry of Economy, Trade and Industry (METI) of Japan, we shared our views and engagement experience with companies in other major markets. We encouraged the board and top management of Japanese companies to be more open and accessible for shareholders in discussing its vision and thoughts particularly on strategy, capital policy and corporate governance-related concerns.

EOS also met with chairman of the Japan Investment Advisers Association (JIAA) and other representatives of JIAA to discuss the roles and responsibilities of institutional investors in promoting corporate governance. The JIAA has established a corporate governance study group on related topics, including fiduciary duties. We thus questioned the views and participation of asset owners such as Japanese pension funds in these discussions, and shared various approaches to engagement observed in Europe and other developed markets. EOS will continue to work closely with policy makers and domestic investors, to help Japanese companies communicate more effectively with investors, both domestic and foreign.

Progress in regulatory reforms in Japan

Since 2010 EOS has held ten meetings with senior representatives of the TSE to discuss effective corporate governance. We regularly meet with the Financial Services Agency (FSA) and METI. Last year, we responded to Japan's Ministry of Justice regarding its proposals on amendments to the Companies Act.

While we welcome a number of the amendments to the Act, such as strengthening the definition of outside directors, it was disappointing to learn that the appointment of outside directors was not made mandatory. We remain concerned about the lack of progress in building consensus around minimum standards and setting aspirational targets for companies.

Japan is one of the very few major financial markets that does not have a best practice Code on Corporate Governance. It is essential to develop a substantive Corporate Governance Code with a "comply or explain" approach to encourage meaningful dialogue between companies and shareholders on business and corporate governance questions. Such an approach would help distinguish companies that are committed to good practices from those that are not.

Karin Ri
Associate Director - Asia

Life after Kyoto: the global carbon market in 2013

The protracted search for a cost-efficient solution to climate change

Various countries are implementing carbon-trading schemes in the hope that they will provide a cost-efficient way to mitigate the effects of climate change. Investors need to be aware of the implications for the performance of companies in different sectors.

Overview

Carbon-trading schemes aim to provide incentives for companies to reduce emissions. A carbon price strives to internalise the cost of climate change within polluters' economic activities and can increase the financial expenses of doing business. Proponents hope that a market-driven solution will provide a more cost-efficient means of de-carbonisation than a straightforward tax on emissions.

In the absence of a global and binding commitment, a number of countries and one state – including Australia, China and California – have introduced "cap and trade" schemes of varying scope and ambition. The largest is the European Trading Scheme (EU ETS). Launched in 2005, it has managed to deliver some emission reductions, but its overall level of success is questionable. Along with a number of design flaws specific to the scheme, it has also shown some of the vulnerabilities inherent in carbon trading. The scheme suffers significant oversupply and is at present not able to support the carbon price nowhere nearly the envisioned levels. Its future as a policy instrument is uncertain following the rejection of proposals to cancel out some of the supernumerary permits. Investors should be aware of the political and financial outcomes in such certificate-trading programmes because they are likely to remain the preferred policy in most parts of the world.

The carbon market and its health will impact sectors of the economy in different ways. Political and administrative decisions will move markets and influence the trading of certificates and the performance of underlying companies. In this article, we assess the design of the EU ETS, the implications of the different scenarios for its proposed restructuring, and the outlook for the rest of the world's carbon markets.

Even though many of the world's largest states have acknowledged climate change, a global and binding agreement to replace the Kyoto Protocol seems increasingly unlikely. A global market for carbon trading – if sufficiently robust to reflect the environmental impact of carbon and create sufficient incentives for de-carbonisation – may be capable of delivering some of the 2005 agreement's objectives.

Flexibility mechanisms of the Kyoto Protocol

The Kyoto Protocol created three "flexibility mechanisms" to lower the costs of achieving its objectives: emissions trading, the Clean Development Mechanism (CDM) and Joint Implementation (JI).

The JI, which grants credits for investments in projects that reduce carbon emissions, and the CDM, whose emission-cutting projects allow developing countries to meet part of their targets by buying Certified Emission Reduction Units, are project-based initiatives. The emissions-trading mechanism allowed signatories of the Kyoto Protocol to create local markets to trade permits for carbon and other greenhouse gas emissions.

In 2012, Australia introduced a market driven by a floor price for carbon (a de facto a carbon tax). This is due to be revised in 2014 because the scheme will be aligned and connected with the EU ETS. China has 13 local carbon-trading schemes, and the USA hosts a variety of national markets for pollutants other than carbon. California introduced a carbon-trading scheme in late 2012 as part of its climate policies. Most notably, the UK unilaterally introduced a floor price for carbon, effective from April this year.

The European carbon market

Phase I of the ETS. So far, the world's most ambitious attempt to establish a market for carbon is the EU ETS. Operational since 2005, it is the largest carbon market and its third phase of trading is due to start this year. In its Phase I period from 2005 to 2007, the EU ETS covered about 40% of Europe's total emissions. The spot price for carbon peaked at €30 per tonne before collapsing after the European Commission confirmed that too many permits had been issued.

Price collapse in Phase II. Phase II, which ran from 2008 to 2012, saw more countries join the scheme and the introduced recognition of credits used in the CDM and JI. The carbon price was extremely volatile throughout this period. After a temporary peak of more than €20 per tonne, the price of carbon fell to less than €10 per tonne and remained near this level for much of the period. Towards the end of 2012, it collapsed to less than €4 per tonne. This was caused partly by unmitigated oversupply, which first became noticeable in Phase I. The economic crisis put further strain on demand, which had originally been modelled on very optimistic assumptions of economic conditions. In addition, because most of the demand for CDM units also came from the EU ETS, the price for CDM credits ended 2012 at less than €2 per tonne. Furthermore, the scheme proved vulnerable to exploitation: up to 90% of demand from some countries stemmed from transactions that were essentially instances of Value-Added Tax fraud.

Reform proposals. By December 2012, the need to reform the EU ETS was clear. The Commission launched a consultation outlining six proposals for reform. The future state of the scheme has significant implications – not only for the world's largest carbon market but also for the effective internalisation of the environmental effects of carbon into the world's economy.

The most radical solution proposed by the consultation was the introduction of a floor price for carbon – similar to the solution introduced in the UK on 1 April 2013. Others involved changes to rules that govern the supply side: tightening the overall emissions cap and cancelling some of the surplus permits in the market. Ceasing recognition for credits under other mechanisms such as the CDM, JI and the Australian scheme, and adding new sectors to the ETS, were also proposed.

An investor's portfolio would be affected by any of these solutions. A floor price for carbon would support investment in low-carbon technology but significantly constrain manufacturing industries, chemicals companies and most utilities. Revising emissions targets while cancelling permits is supported by most of the utilities sector but it would not entirely remove uncertainties for investors in businesses with low carbon intensity. The chemical industry also views this as acceptable because it creates significant additional costs for the sector. Finally, repealing the recognition of credits from other mechanisms and international schemes would likely impede the creation of a worldwide carbon market.

The more ambitious options to strengthen the scheme are very strongly dependent on political consensus within the EU. Shortly after the consultation closed, the EU Parliament had to vote on postponing a proportion of the surplus permits, a process known as "backloading". This would have provided short-term support for the functioning of the EU ETS. Businesses and politicians alike saw the vote as an important signal for the level of commitment to the scheme and its future as a policy instrument. The EU Parliament rejected the proposals by a narrow margin, thus leaving the carbon market oversupplied with permits and the viability of the EU ETS more uncertain than ever.

Implications for investors

The complexity of national solutions to combat climate change means that investors should decide how strong they want international instruments for emissions trading to be. For example, German subsidies for renewable energy businesses have enabled the sector to generate about a third of energy production but simultaneously played a part in undermining the carbon price. The UK's solution of a floor price for carbon may help to provide certainty in the domestic market. However, any domestic emission reductions can potentially be offset by emission increases elsewhere in Europe if the overall emissions cap under the EU ETS remains the same. A strong and functional EU ETS would remove the current fragmentation of the market, but after the rejection of the backloading proposals, the political case for it has been weakened

Economic consensus appears to be that a floor price for carbon most effectively internalises environmental costs but cap-and-trade schemes provide the most cost-effective solutions. These schemes, however, need sufficient coverage to be effective. In a political landscape shaped by the diverging interests and lobbying efforts of industry associations and national governments, the support of investors and asset owners can become an important factor for the acceptance of effective solutions.

Michaela Zhirova
Associate - Europe

Procrustean beds

Let companies judge what information should be reported

The directors and senior management of companies use corporate reports to show how effectively how they nurture and enhance the assets that shareholders entrust them with. What matters enough to be disclosed in corporate reports is important to the business model, strategy and performance of companies.

Overview

Theseus, the Greek hero, is famous for triumphing over the Minotaur in the labyrinth. Before that feat, however, he defeated six evil beings on the road from his mother's home to meeting his father in Athens. The last of them was Procrustes, an ostensibly charming host who welcomed all travelers and insisted on giving them the most generous hospitality. He fed them well and insisted they stay the night in his remarkable iron bed that fitted anyone.

Procrustes, however, was sinister. To ensure that his bed fitted anyone, he chopped the legs off people who were too tall and stretched shorter people on the rack. This torturous treatment proved fatal for his victims. There is a danger that reporting frameworks are doing the same: companies are forced to hack up or stretch their material to fit the iron bed of reporting frameworks. Such manipulations can mask underlying realities, so that comparisons between companies can be made, but only between false incarnations.

The nature of reporting: why and for whom

The directors and senior management of companies use corporate reports to show how effectively they nurture and enhance the assets that shareholders entrust them with. They can be held accountable for their actions and for any deficiencies. What matters enough to be disclosed in corporate reports is important to the business model, strategy and performance of companies. This relationship also applies to narrative reporting, financial reports and notes to accounts. The most successful governance and sustainability reporting is also framed in this way. Disclosures should include information that is important to corporate business models. This will usually require some discussion of long-term factors and pressures, which are occasionally neglected. Regulators seem to share this view: recent disclosure reports from the European Financial Reporting Advisory Group and the Financial Reporting Council produced a set of principles for determining the nature of information that should be shown. The first is that disclosures should be entity-specific.

Companies should understand what matters to shareholders when deciding what information to report. This does not mean that other parties, such as bond investors or the wider public, are unimportant: accounts need to have a focus or else they risk becoming more challenging and sprawling than they already are. Key information may be hidden in plain sight amid masses of additional material. By focusing on shareholders' needs, companies can provide reports that are more communicative and reveal information rather than simply disclose data. This disclosure of relevant, focused information should satisfy the needs of all other users as well.

We seek communication, not compliance. In our view, compliance obstructs clear accountability. One frustration that companies and investors share about current accounting practice is that information about performance within businesses is clouded by volatility in the valuations of assets and liabilities from year to year. It is not that this volatility is unimportant, but it is information that is of a different nature to understanding the underlying business. The significant level of pro forma accounting should be seen as a strong indicator that there is a problem with performance reporting. No wonder that the International Accounting Standards Board (IASB) got a clear response to agenda consultations that this is an issue which needs to be addressed urgently. We strongly hope that the IASB takes this project forward in the near future.

This need for communication rather than compliance – or freedom from the Procrustean bed – is the focus of our approach towards all company reporting matters. It underlies our approach to the Global Reporting Initiative, where we have worked to make the standards much more flexible and responsive to sector-specific and company-specific issues. We are taking a similar line with other initiatives in this area, from the Sustainability Accounting Standards Board to specific carbon-intensity disclosures. It drives our approach to management disclosure and analysis – or management and the board's perspective of the performance of the business – and our selective arguments for light-touch regulation that does not require lawyers and auditors to become so closely involved, giving primacy to compliance statements.

We are communicating this to the IASB, its country-level equivalents, and the IAASB and its local equivalents on auditing standards. We are encouraging them to emphasise the need for disclosures to be made only when they are material and relevant to the reporting company.

Understanding individual companies

Shareholders need to first understand the business in which they are invested. Making comparability the focus of reporting standards would upturn the purpose of accounts.

Furthermore, investors should make comparisons and not force the cost and burden of comparability on companies. Imposing the burden of comparability would actually reveal less by forcing companies into the Procrustean bed rather than asking them to reveal genuine, entity-specific information. This information can be used to properly hold directors to account. It must be the focus of reporting.

More flexible, less prescriptive standards will require all parties to exercise professional judgment about what must be communicated and what can be left aside. In the initial stages of producing reports, directors must seek to communicate rather than just comply. Auditors' requirements should not simply be that every company complies with a rigid disclosure checklist. Investors need to exercise judgement and not simply call on companies to disclose information that would be useful.

Regulators must help too. First, they must write standards that allow appropriate flexibility and emphasise the importance of materiality and entity-specific information. Second, investigations of company accounts and auditing work should reinforce the importance of this type of information rather than conveying that compliance and checklists are what they seek as evidence of an effective process and delivery. It is delivery that matters, not process. Reliance on professional judgment will mean that mistakes are occasionally made. But this would be better than the current framework, where, by default, errors are made in every single case and companies are deformed to fit an inappropriate iron bed.

Investors will find useful information in circumstances where management and directors have failed to exercise judgement effectively. Company accounts often reveal a lack of will to communicate and a lack of a controlling mind of the corporation. Boards which imply to the readers of their accounts that they do not clearly understand their business model, strategy and delivery probably reveal information that is easily as useful for investment decision-making and for stewardship as companies that deliver reports that clearly elucidate their position and performance. Companies that report poorly are likely to find themselves less investable, less attractively valued, and facing more vigorous engagement from active shareholders.

Flexibility reveals more than constraints ever could. No one fitted the original Procrustean bed: even its owner failed to fit, as Theseus showed by ensuring the bandit enjoyed a taste of his own treatment by chopping his legs – and head – off to make sure that he could lie in that cruel bed. A one-size-fits-all approach risks being a one-size-fits-none. Giving companies the freedom to disclose information as they see fit, while this will at times lead to the wrong material being disclosed, is better than a framework that obliges every company to in some way disclose the wrong things.

This opinion piece is drawn from a presentation given to the IASB's Disclosure Forum in January 2013 (see www.ifrs.org/Meetings/Pages/IASB-Disclosure-Forum-January-2013.aspx).

Paul Lee
Director

Strategic engagements

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

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 recent engagements

We filed a shareholder proposal at a North American telecommunications company requesting the appointment of an independent chair. We had multiple productive and constructive discussions around the company's current board structure, governance practices and leadership as part of testing the sufficiency of its efforts in this regard. We tested the functioning and scope of the existing approach and gained some comfort that the current presiding director is empowered with a full set of powers in line with what we would expect for such a role to be able to provide an effective counter-balance to the combined chair/CEO. We tested the dynamic between the CEO and the current presiding director as well as with the other independent directors to establish the effectiveness of the current structures in practical terms. We acknowledged the robust picture the company was able to provide which depicts a healthy amount of board challenge and a particularly strong individual occupying the presiding director role at present. We iterated our position that the company should further distinguish the presiding director position both through the granting of additional powers and the rebranding of the position to lead independent director to reflect its pivotal nature, denote the stability of the position, and avoid confusion. Overall we are encouraged by the company's apparent desire to engage in constructive dialogue with us on this issue and we are optimistic about the prospects for future engagement and settlement.

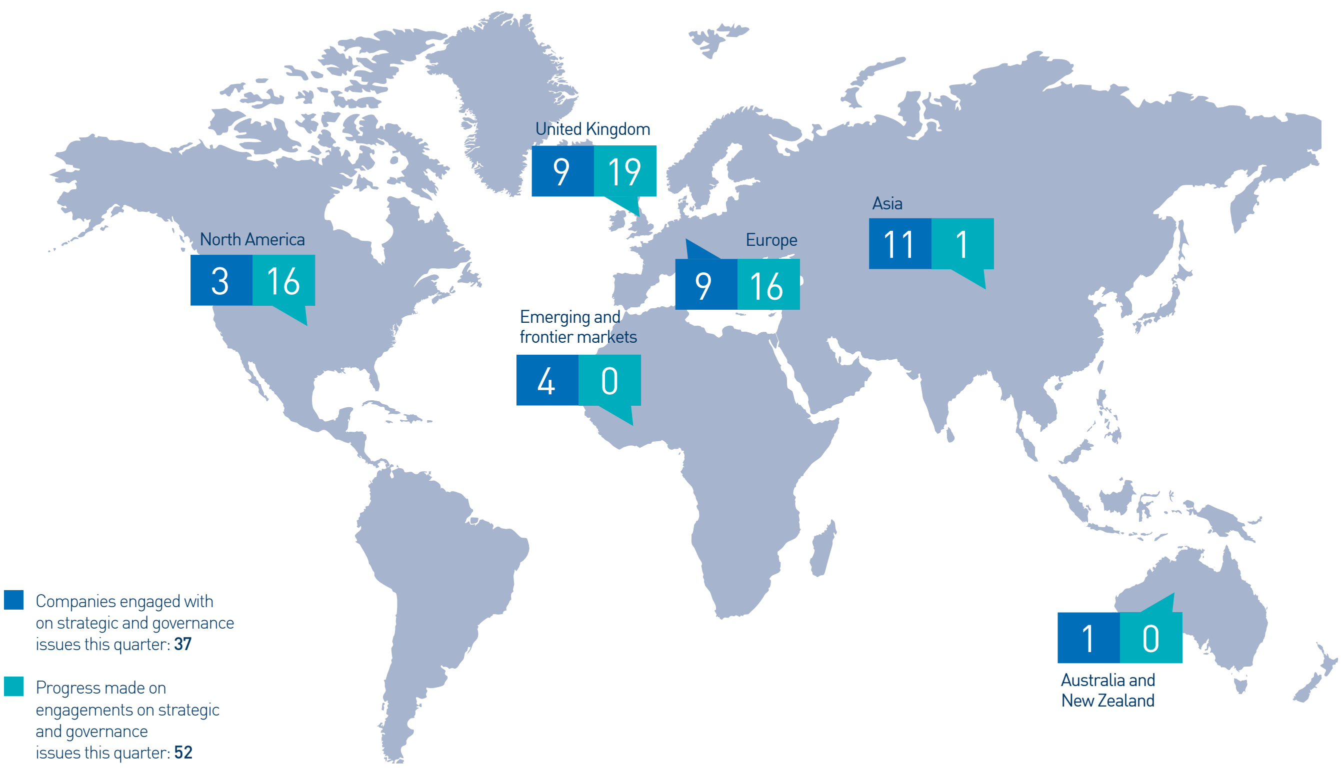
We had a conversation with senior executives of a Japanese manufacturing company about corporate governance, which followed an earlier letter to the board. The company has been reluctant to implement governance reforms and has been unresponsive to attempts at engagement. In the letter we had expressed concerns about the lack of independence on the board - which consists entirely of executive directors. While the company acknowledges the benefits of having independent directors, it nevertheless suggested that the downsides outweigh these and therefore stated that it does not intend to appoint any in the near future. We challenged these views and reiterated the importance of having sufficient board independence. We however gained some comfort that the company is considering reducing its board size; a move which reflects our earlier calls. In order to send the company a stronger message, we plan to work together with other investors particularly ahead of the forthcoming AGM.

We travelled to Russia to meet with senior executives as well as the head of the health, safety and the environment department of a Russian oil and gas company to follow up on our report which provided the company with feedback and comments on its environmental risk management systems and reporting, as well as the areas where we believe that improvement is needed. The company still lacks challenging reduction targets and objectives with regards to environmental and health and safety issues, and its reporting continues to be sub-standard. Despite having provided specific feedback and comments to the company, it still seems to be rather reluctant publicly to disclose some data. We raised concerns about the slow improvements in reporting and disclosure despite our multiple conversations and feedback over the last two years. The company confirmed it will be publishing its next corporate social responsibility report later in 2013 and we offered to provide, again, best in class examples of peer reporting, highlighting the short- and long-term targets peers have set in terms of labour policy and environmental issues, as well as relevant Global Reporting Initiative measures for the oil and gas sector.

We met with the chair of the remuneration committee and a member of the audit committee of a European bank. We probed the functioning of the board, pressed for enhanced disclosure of the board evaluation process and challenged the skill-sets of directors. We also pressed for the appointment of an independent vice-chair and an increased level of independence. We suggested the use of third party experts to support independent board members' considerations of key strategic decisions and financial deals. We reviewed the remuneration policy in detail and pressed for better disclosure, given that current transparency is no better than the bare minimum. We agreed to send a letter to the board to further press our points and to set up a meeting to discuss corporate social responsibility integration at the bank.

We met twice with a UK listed mining company in order to provide feedback on its recent sustainability reporting; to press the company on its emission reduction activities; and to understand further how it is dealing with water stress in its operations, which vary from desert locations to highly populated agricultural areas. Having provided feedback on the company's sustainability report, we were given an opportunity to preview the mineral subsidiary's new environmental guidelines booklet, which were yet to be released internally. As part of our involvement in the Carbon Action Project, we highlighted our concerns about the lack of carbon reduction targets and were told that although the company is developing a strategy, it has been experiencing difficulties in establishing targets, as the business relies on the national electricity grid. Potential solutions to the problem include solar, wind and geothermal energy, through which the company hopes to make efficiency gains. Because no specific capital has been set aside for this area, however, we will continue to push the company for sensible targets. We also tested the approach to water stress and were assured that it is keenly aware of the local situations around its assets. It is also working with the Mining Council to finance water stress research, and learnt that it is likely that sea water will be increasingly relied upon as a source. We will also continue to push the company on this issue to ensure it is adopting the best practices for its operations and local water availability.

Strategic engagements map: Q1 2013



Highlighted sample activities

EU discussion on company law and corporate governance action plan

We were one of only five asset owner representatives to have a five-hour roundtable discussion with European Commission officials. This was the first of five such consultative meetings, each of which will feature a different sort of stakeholder in the corporate governance chain. We were able to shape the discussion around the issues of fund manager accountability to asset owners and the need for a Europe-wide approach to stewardship codes; we also talked through a range of other ways in which fund managers could be made more properly transparent and accountable to their clients. We talked about challenges to cross-border voting, flagging not least the issue of the re-emergence of share blocking in Germany. We noted the value of the proxy voting agencies but shared concerns about the conflicts inherent in their business models. And we talked about concrete ways in which companies can be made more accountable to their owners, not least in the areas of remuneration and related party transactions. We were also able to share our views with a participant in one of the later roundtables such that our perspectives are likely to be reflected back to the Commission once again.

Financial Reporting Disclosure Forum

We provided the keynote investor address to a significant gathering to consider the issue of disclosures in corporate reporting. Hosted by the International Accounting Standards Board, the participants also included significant regulators from across Europe and the US, so this was a major opportunity to influence thinking on the issue worldwide. We highlighted the fact that investors tend to believe both that there is too much disclosure and that important information is missing, and worked to explain this apparent discrepancy. We emphasised the need for disclosure of what is genuinely material - and made clear that materiality must be judged against the business model and strategy of the company as well as the need for the directors to be properly accountable to the current shareholders. And we urged the application of flexible frameworks such that directors and auditors can exercise professional judgements as to what disclosures are genuinely material in the company's specific circumstances. We called on regulators to foster this through both standard-setting and their investigatory roles. Our comments helped frame the discussion for the rest of the day and we followed up rapidly to the IASB with our outline of what we believe are the necessary next steps.

PRI publication on fund manager accountability to asset owners

We welcome the publication by the Principles for Responsible Investment of a guide for asset owners on how to enhance the accountability of their fund managers. We have worked closely with the PRI staff member who wrote this document, and shared the lessons learned through our work on the ICGN's Model Mandate Initiative. The Model Mandate, whose drafting we led, features heavily in the PRI document, but more importantly this new document reflects the framework we shared with the PRI of how accountability can be approached and delivered. We are also supporting the promotion of this document in various forums.

Other work this quarter included

Promoting best practice

- Alongside Dutch fund PGGM and a coalition of other investors gathered through the PRI clearinghouse for engagement, we wrote to the 28 banks which the Financial Stability Board considers to be globally systemically important to commend to them the guidance in the report from the Enhanced Disclosure Task Force.
- We participated in our first meeting of a key OECD Committee with a significant role in helping the organisation redraft its corporate governance principles, which are in effect the global baseline standards.
- We took part in a roundtable discussion among a group of investors, hosted by PricewaterhouseCoopers, on pay in the banking sector. We had pressed that bank business models should be a key feature of the discussion and were delighted to find that the 25% limit on compensation ratios (the level of staff pay as a proportion of overall revenues), put forward in our thought piece Epidemiology, formed a significant feature of the PwC framing presentation.
- Together with a number of other mainly US investors we co-signed a letter co-ordinated by the NGO Conflict Risk Network encouraging better disclosure from US companies regarding their operations in Myanmar (Burma).
- We had a lengthy meeting with the chair of the corporate law committee of the Keidanren (Japan's business federation), and a group of his colleagues from the Keidanren. The Keidanren is highly influential in Japan and establishes consensus in the business community on a variety of important domestic and international issues.
- We had a lengthy meeting with the executive managing director of the Japan Audit and Supervisory Board Members Association and other senior representatives to discuss the responsibilities and roles of statutory auditor. The Association (formerly the Japan Corporate Auditors Association, established in 1974) currently has about 5,800 corporate members and about 7,600 registered audit & supervisory board members.
- EOS held two roundtable discussions in Japan with Japanese company executives to discuss corporate governance practices. Over 20 company representatives participated in the active and constructive discussions. We explained our voting polices in detail and what we aim for through the process of exercising shareowners' voting rights.
- We spoke at an event organised by the British Embassy in Moscow to discuss carbon reporting in the light of the new regulations coming into force in the UK requiring all quoted companies on the London Stock Exchange to report on carbon emissions at all their operations, including those overseas.
- We met with the president of the Federation of Brazilian Banks to discuss government interference, remuneration issues and lending practices. We discussed the recent government intervention to reduce interest rates and the impact this may have on the industry.
- We met with the chair of the German Corporate Governance Code Commission to discuss its recent proposals regarding remuneration. We gave evidence to the Commission's working group on remuneration last year and are broadly pleased with these

proposals, which will enhance transparency for supervisory boards and shareholders; as well as encourage company-specific caps on remuneration.

- We took part in an investor group meeting of the 30% Club, which aims to increase boardroom diversity, to discuss progress following a successful public event in late 2012.

Public Policy

- Through our role on the Audit and Assurance Council, we helped draft a letter to the International Ethics Standards Board for Accountants in response to its consultation on how corporate accountants and auditors should respond to evidence or allegations of illegal acts being carried out within the audited company.
- As participants in the Corporate Reporting Users' Forum, which tries to influence accounting standard-setting, we met with the chair and another member of the International Accounting Standards Board. The focus of our discussion was the conceptual framework, the overarching principles under which accounting standards are set, and the primary focus for the Board for the next few years -- on which it is expecting shortly to produce early proposals.
- Through our membership of the Canadian Coalition for Good Governance public policy committee, we responded to the Toronto Stock Exchange's proposed rules for emerging market issuers seeking a listing.
- We met with senior representatives of Japan's Ministry of Economy, Trade and Industry (METI) to discuss corporate governance reforms in Japan. We welcomed METI's efforts to improve dialogue between companies and investors, by establishing a new Corporate Governance Dialogue Working Group, with the aim of helping Japanese companies to communicate more effectively with investors.
- We met with the vice-chair and chief regulatory officer of the Japan Securities Dealers Association in Tokyo to discuss concerns relating to capital-raising practices.
- We spoke with the head of corporate governance of the Russian exchange to follow up on our recommendations on related party transactions and on the new listing segment of the exchange. The exchange acts as an intermediary between the market and the regulator, the Federal Financial Markets Service, and we welcomed the news that the exchange had relayed our letter on related party transactions and considered our recommendations.
- We spoke with the head of strategic development and sustainability to follow up on our discussion on the Mexican stock exchange's sustainability index as well as current corporate governance requirements and voting procedures in the Mexican market.
- We wrote to South Africa's Department of Mineral Resources with regard to proposed changes to the overarching legal regime for minerals rights in the country.
- We responded to an EU consultation on changes to the European carbon emissions trading scheme. Following the collapse of the price for carbon permits in 2012, the need for change before the next phase of the scheme is clear.
- We welcomed the publication by the Financial Reporting Council of a consultation proposing a radical shake-up of the auditor report in the UK. As a member of the Audit and Assurance Council, we have helped design this new approach to auditor reporting and believe that this will finally be a form of auditor report both that is worth reading and that will deliver to shareholders valuable insights and information.
- We took part in a Financial Reporting Council roundtable discussion on audit tendering. Bringing together investors with auditors, finance directors and audit committee chairs, the meeting was intended to help the FRC develop best practice guidance on audit tendering, which is now a comply or explain requirement in the UK.
- We had a lengthy meeting with the UK department of business to discuss the forthcoming regulations on remuneration reporting, which we feel are becoming overly complicated and unhelpful.

Working with other shareholders

- We met with a group of global investors to discuss effective engagement with Japanese companies. Instead of leading simply on voting policy matters, we suggested that an initial focus be placed on discussing the value and quality aspects of governance practices, including what to aim at beyond compliance, how to approach to achieve better accountability, and why this would benefit all stakeholders in the long term if done appropriately and strategically.
- We presented the asset owners' perspective at a vigorously debated roundtable meeting hosted by the Financial Reporting Council on the vexed issue of beneficial owners having the power to vote the shares attributable to them held within pooled fund vehicles. This has become a matter on which fund managers are showing very different degrees of flexibility: some are willing to permit it, at least for large clients, while others are blankly refusing any requests.

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. At larger companies or those where clients have a significant stake, we seek to have dialogue ahead of voting against or abstaining on any resolution.

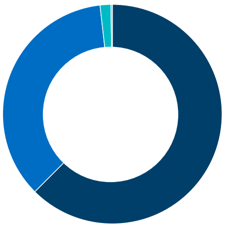
In most cases of a vote against we follow up with a letter explaining our concerns. We maintain a database of voting and contact with companies and if we believe further intervention is merited, we include the company in our main engagement programme.

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

Overview

Over the last quarter we voted at 1,287 meetings (9,885 resolutions). At 460 of those meetings we opposed one or more resolutions. We voted with management by exception at three meetings and we abstained at 20 meetings. We supported management on all resolutions at the remaining 804 meetings.

Global.
We voted at 1,287 meetings (9,885 resolutions) over the quarter.

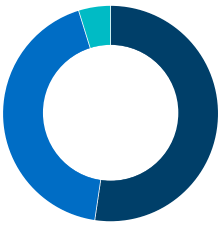


- Total meetings voted in favour **62.50%**
- Meetings where voted against (or voted against AND abstained) **35.70%**
- Meetings where abstained **1.60%**
- Meetings where voted with management by exception **0.20%**

Asia
We voted at 459 meetings (2,924 resolutions) over the quarter.

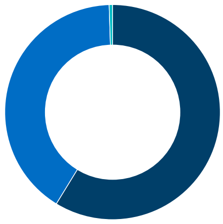
- Total meetings voted in favour **52.70%**
- Meetings where voted against (or voted against AND abstained) **47.30%**

Australia & New Zealand
We voted at 21 meetings (80 resolutions) over the quarter.



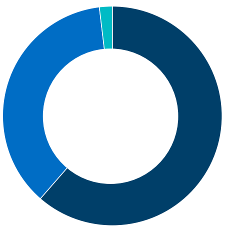
- Total meetings voted in favour **52.40%**
- Meetings where voted against (or voted against AND abstained) **42.90%**
- Meetings where voted with management by exception **4.80%**

Emerging & Frontier Markets
We voted at 211 meetings (1,581 resolutions) over the quarter.



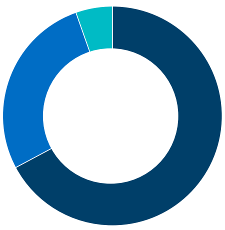
- Total meetings voted in favour **58.80%**
- Meetings where voted against (or voted against AND abstained) **40.80%**
- Meetings where abstained **0.50%**

Europe.
We voted at 158 meetings (1,791 resolutions) over the quarter.



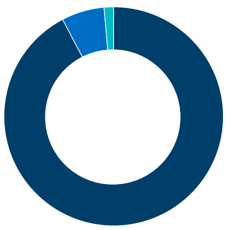
- Total meetings voted in favour **61.40%**
- Meetings where voted against (or voted against AND abstained) **36.70%**
- Meetings where abstained **1.90%**

North America.
We voted at 296 meetings (2,135 resolutions) over the quarter.



- Total meetings voted in favour **67.20%**
- Meetings where voted against (or voted against AND abstained) **27.40%**
- Meetings where abstained **5.40%**

UK.
We voted at 142 meetings (1,374 resolutions) over the quarter.



- Total meetings voted in favour **92.30%**
- Meetings where voted against (or voted against AND abstained) **6.30%**
- Meetings where voted with management by exception **1.40%**

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