

Public engagement report

Q1
2012

Q1

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 2012. The report also provides information on our voting decisions and the steps we have taken to promote global best practice, improvements in public policy and collaborative work with other shareholders.

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What is EOS?

Hermes Equity Ownership Services (EOS) helps institutional shareowners around the world to meet their fiduciary responsibilities and become active owners of public companies. EOS' team of engagement and voting specialists monitors its clients' investments in companies and intervenes where necessary with the aim of improving performance. EOS' activities are based on the premise that companies with informed and involved shareholders are more likely to achieve superior long-term performance than those without. Through pooling resource with other like-minded funds to create a stronger and more representative shareholder voice, our joint company engagements can be more effective. We currently act on behalf of 24 investors with roughly 143 bn. USD* in Assets under stewardship.

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

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

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

*as at 31st of December 2011

How does EOS work?

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

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

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

At any one time there are many companies included within our engagement programmes, meaning that significant additional resources are dedicated to these situations. All of our engagements are undertaken subject to a rigorous initial assessment and ongoing review process to ensure that we are focusing our efforts where they can add most value for our clients.

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

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

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

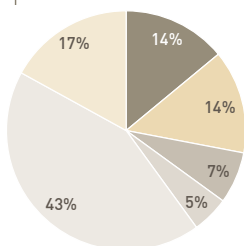
For further information please contact Colin Melvin on +44(0)207 680 2251.

Engagement by region

Over the last quarter we engaged with 184 companies on a range of 317 social, environmental and governance issues. EOS' holistic approach to engagement means that we will typically engage with companies on more than one issue simultaneously. The engagements included in these figures are in addition to our discussions with companies around voting matters.

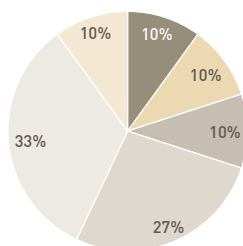
North America

We engaged with 20 companies on a range of 42 issues over the last quarter.



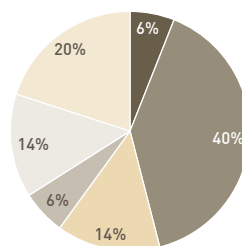
Asia Pacific

We engaged with 15 companies on a range of 30 issues over the last quarter.



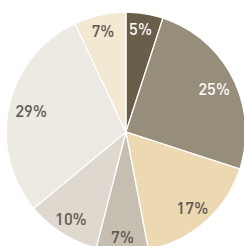
Australia & New Zealand

We engaged with 27 companies on a range of 35 issues over the last quarter.



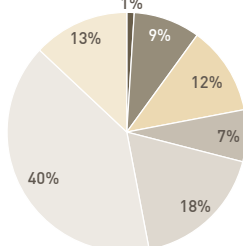
Emerging & Frontier Markets

We engaged with 39 companies on a range of 69 issues over the last quarter.



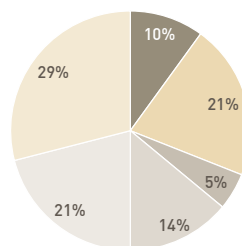
Europe

We engaged with 39 companies on a range of 68 issues over the last quarter.



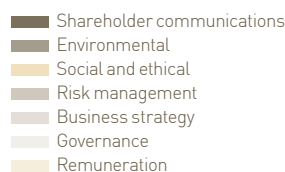
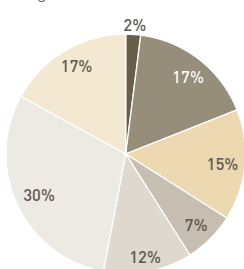
UK

We engaged with 44 companies on a range of 73 issues over the last quarter.



Global

We engaged with 184 companies on a range of 317 issues over the last quarter.

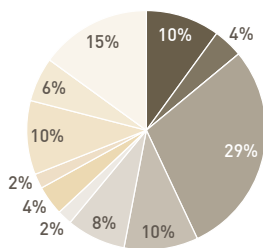


Engagement by issue

A summary of the 317 issues on which we engaged with companies over the last quarter is shown below.

Social and ethical

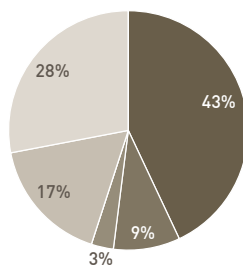
Social and ethical issues featured in 15% of our global engagements over the last quarter.



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

Environmental

Environmental issues featured in 17% of our global engagements over the last quarter.



- Climate change/carbon intensity
- Water stress
- Waste
- Forestry
- Biodiversity

Other engagement

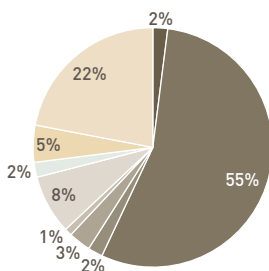
Shareholder communications featured in 2% of our engagements over the last quarter.

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

Remuneration featured in 17% of our engagements over the last quarter.

Governance

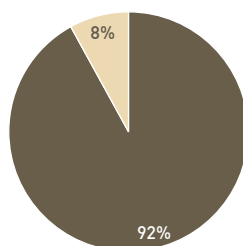
Governance issues featured in 30% of our global engagements over the last quarter.



- Accounting or auditing issues
- Board structure
- Committee structure
- Related party transactions
- Conflicts of interest
- Succession planning
- Voting rights - not 1 share 1 vote
- Separation chair/CEO
- Other governance

Business strategy

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



- Business strategy
- Capital structure

Business strategy and board structure

Strategic engagements

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

Statistics

Number of companies engaged with on strategic matters this quarter:	52
North America	8
Asia	7
Australia and New Zealand	4
Emerging and Frontier Markets	13
Europe	12
UK	8
Number of significant steps forward in strategic/governance engagements this quarter:	13
North America	2
Asia	1
Australia and New Zealand	0
Emerging and Frontier Markets	5
Europe	1
UK	4

Overview

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

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

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



Examples of successful engagements

We reached a settlement with a **North American food retailer** with global operations, following our submission of a shareholder proposal seeking the declassification of the board earlier this year. We are encouraged that the board has finally decided to respond appropriately by introducing a management resolution supporting declassification at the upcoming AGM following the 76% support received by a similar shareholder proposal at last year's annual meeting. We considered the board's previous failure to implement this policy despite support from an overwhelming majority of investors to be a clear example of the need for increased accountability to shareholders and are pleased that the company has decided to take appropriate action. The election of directors is the primary avenue by which shareholders in the US can influence corporate policies and hold the board accountable. Going forward each director will be required to stand for election annually, giving stockholders an opportunity to register their views.

We visited the headquarters of a large **electrical appliance retailer in Asia** to discuss strategy and corporate governance. We talked through the group's strategic initiatives to strengthen the business and differentiate its products, and also discussed alternative approaches to business developments that do not involve related party transactions. We particularly tested the major risks in its significant expansion plans, both within its home market and globally, and won reassurance as to the discipline to be applied in any M&A. On corporate governance, we welcomed the progress on board structure, with an increased number of independent non-executive directors and improvement in the composition of key committees in compliance with the requirements of the local Corporate Governance Code. We further addressed the importance of board access for shareholders in order to gain a higher level of understanding and confidence that an effective and accountable board is ensuring sufficient protection of minority shareholders.

We met with two executive committee members and one non-executive director from an **Australian extractives company**. We emphasised the need to maintain capital discipline and to focus on existing organic opportunities rather than becoming involved in major mergers and acquisitions. We were pleased that the executive responsible for M&A was also responsible for divestments and that this dominated his workload currently. We were also able to discuss the manganese operation and, whilst the division head was looking for investment from the board, he was also rationalising and disposing of assets. We continue our engagement through an imminent meeting with the chair.

We met with senior management of a **conglomerate in the Emerging Markets region** and held an in-depth discussion on how the board operates, challenging over the apparently cosy and somewhat complacent board. With the founder having handed over the chair to his son several years ago we pressed to understand how the dual role of CEO/chair serves the interests of all shareholders. With a dominant chair likely to be exercising veto rights, we questioned whether the vice chair was a robust individual who has the skills and experience to challenge on strategic decisions. Given the company's growing presence in overseas casino markets we encouraged the nomination committee to consider the appointment of a non-executive with relevant experience to be able to oversee effectively the growth in this area. The company acknowledged the value of this and agreed to take the recommendation to the nomination committee. We also questioned the succession plan for the chair and vice chair, and expressed the importance of ensuring that the next generation of non-executives provides a high level of scrutiny. We agreed to follow up in writing to the nomination committee on the board issues and also discussed the possibility of a meeting with the vice chair.

We met with the chair of a **European chemical and pharmaceutical company** to continue our engagement on its governance, particularly regarding board refreshment. We discussed proposals for a former executive to join the board, and while in the circumstances we believe this is appropriate we raised strong concerns about the number and nature of his other board commitments. We received helpful assurances in this regard. We welcomed the news that it is proposing to adopt the model for supervisory board pay which we have been actively promoting. This will drive alignment with shareholders rather than executives through fees being reinvested in the company's shares. The chair is also considering applying this model at two other major companies in Germany, which could herald a real breakthrough in supervisory board compensation practice.

We met the new senior independent director of a **UK bank** to understand the board's perspective on the strategic priorities facing the bank as well as to progress ongoing discussions on the board and executive remuneration. We were assured that the company had worked hard on refining and limiting its definition of proprietary trading to minimise risk within its market making activities to acceptable limits. We suggested that banks did not afford a sufficient return to shareholders but rather paid out too much in employee pay. He recognised remuneration was an issue exacerbated by the political interest and focused his comments on how the bank was seeking to pay only the best performers well and not others. We raised our long-standing concerns about the board structure and membership. While he agreed with some of our analysis he did attempt to allay some of those concerns.

Board leadership

Separation of chair and CEO in the United States

Historically, boards of US companies have combined the chair and CEO roles, falling short of best practice corporate governance in other regions of the world. Since the financial crisis, investors have strongly encouraged more independent board leadership in order to build effective checks and balances within organizations, develop trust among investors and safeguard the long term interests of shareholders. As a result, we have seen a significant increase in the creation of a separate chair role and the strengthening of the lead director role amongst US companies. We will work to ensure that this positive momentum will continue and lead to lower corporate governance risk and ultimately better company performance.

Statistics

Number of companies engaged with:	12
Number of companies where substantive change sought:	7
Number of these showing progress so far:	1



Overview

The separation of the roles of chair and CEO is a cornerstone of sound corporate governance and independent board leadership. In our experience from global corporate engagements the benefits include ensuring companies are being run in the interests of shareholders and that there exists an appropriate balance of power on the board.

Shareholders rely on an independent chair and other independent directors to represent them on the board and provide an objective view of the company's strategy and performance, taking appropriate action where necessary. By doing so it serves to increase executive management's accountability as well as to build trust between the company and its shareholders. This is particularly critical for those companies most affected by the turmoil following the financial crisis and whose senior employees have been highly remunerated. In our view, a combined CEO and chair role gives too much power and responsibility to one individual within the boardroom. A separate and preferably independent chair serves to distribute the power and ensure robust support of a strong CEO whilst allowing the board to more effectively transition senior management changes.

While the separation of roles is required in numerous markets, such as Germany, and has become a dominant practice in others like the UK and Canada, companies in the US have lagged behind global best practice. This is now changing: a separate chair has been appointed in over 40% of US companies relative to closer to 25% ten years ago (Source: Spencer Stuart 2011 Index Report). In many of these cases, the chair appointed has also been independent rather than simply the previous CEO. Lead director roles are now the norm and increasingly, where there is no independent chair, they have meaningful powers similar to that of an independent chair.



Issues and companies

Promoting better corporate governance

EOS has been actively engaging US companies to split the roles of chair and CEO for several years. This engagement has included private discussions with companies, the filing of shareholder resolutions at specific companies and the selective support given to resolutions tabled by other US and overseas investors. We have also had an active dialogue with a number of like-minded investors as well as lobbying US investor and regulatory forums. Engagement activity has been across industries though with a particular focus in banking and financial services companies which have been most affected by the financial crisis.

A typical and understandable argument put forward by some company boards for not separating the roles has been that by having them combined the company can speak with one voice and that there is clarity internally as well as externally on who is running the company. We have therefore made clear in our discussions that we see the roles as separate: we view the chair as running the board and the CEO as running the company. We have emphasised that it is critical that the chair, whilst needing to take an independent line from the CEO, should complement and be able to have a constructive and productive working relationship with the CEO. In many ways, whilst a board with an independent chair can more easily facilitate necessary management changes, a performing CEO is more secure in a challenging environment with a strong independent chair on the board.

Implementing change

EOS recognises that depending on a company's specific circumstances moving immediately to the appointment of an independent chair may not always be appropriate or optimal. In such cases, EOS will press for the nomination of an independent lead director responsible for ensuring a constructive dialogue with shareholders, representing their interests and challenging the chair/CEO when appropriate. Where there is already a lead director on the board, EOS advocates a strengthening of the role to ensure that the lead director is sufficiently empowered to hold the CEO to account and to liaise with shareholders. We then closely monitor the succession planning in order to ensure that the leadership structure changes to separation of the chair and CEO roles over time or upon the succession of the current CEO.

Furthermore, we believe that separating the chair and CEO roles, while a necessary first step, is not in itself sufficient. Independence is also key for the chair to appropriately fulfil their duties, including challenging the CEO. A former CEO or a significant shareholder can be conflicted and may not be able to act objectively. EOS therefore also actively engages with companies where the chair lacks independence.

Collaborative progress

Complementing behind closed door company discussions, EOS has selectively filed shareholder resolutions at specific US companies as a mechanism of catalysing the separation of roles. A good example of this is the case of Moody's where we filed together with a US labour union fund non-binding resolutions to separate the roles of chair and CEO from 2009 to 2011. Following 33% shareholder support for the proposal in 2010 and a majority of 56% in 2011, we filed a binding proposal ahead of the 2012 AGM. In early 2012, subsequent to productive discussions and a constructive dialogue with Moody's executive chairman and board of directors, the company agreed to split the roles of CEO and chairman in exchange for the withdrawal of our binding shareholder proposal. We believe that this is a particularly important step in the case of Moody's given the significant influence that its credit ratings have, along with their ability to impact the stability and functioning of global financial markets, and congratulate the board for making the decision.

Amongst the banks, we are also pleased to see the appointment of an independent chair at Bank of America and the strengthening of lead director roles at a number of other major US banks. However we believe change to be both necessary and, given continuing investor pressure, inevitable and so continue to engage with these banks to adopt best practice on this important governance issue.

The trend in the US towards increased separation of the chair and CEO roles and stronger board independence across industries is welcomed by investors. It is key to continue this positive momentum through ongoing constructive dialogue and engagement with company representatives.

US companies affected by these issues include: Freeport McMoran, General Electric, Goldman Sachs, Johnson & Johnson, JP Morgan, Kraft, McGraw Hill, Moody's, News Corp, Occidental Petroleum, Pfizer, Prudential Financial, Whole Foods.

Controversial weapons

Transparency in the defence industry

Following the identification of companies involved in controversial weapons, EOS now focuses on encouraging those companies to enhance their public disclosure in order to facilitate investors' assessments of compliance with treaties, conventions and individual policies.

'The proactive exclusion of companies associated with controversial weapons is a growing practice by institutional investors who recognize the reputational risks associated with such activities.'

Overview

The increased scrutiny on the topic of controversial weapons over the last few years has contributed to the more accurate identification by stakeholders of the companies involved. Issuers associated with landmines, cluster munitions, nuclear and other controversial weapons face not only the challenges of complying with international treaties and conventions that their home and client countries adhere to, but also with increased social and ethical standards embedded in global investors' policies that may cause them to be excluded from their portfolios.

As technology advances and weaponry becomes more sophisticated, investors encounter new difficulties in assessing companies' involvement in controversial weapons, given that compliance or breach is nowadays in many instances determined by individual components and their functionality, as opposed to the actual final product. This is usually the outcome of increased collaboration amongst several companies in the manufacture of a single weapon.

EOS assesses the role each collaborating company plays in the manufacture, assembly, and/or maintenance of controversial weapons and whether such a role is key to the process and end product and therefore in breach of relevant conventions and stakeholders' policies. In addition, we continue to encourage issuers to produce clear, publicly available disclosures on their stance regarding controversial weapons in an effort to mitigate reputational risks to issuers and investors alike.





Issues and companies

Reputational risk

The proactive exclusion of companies associated with controversial weapons is a growing practice by institutional investors who recognize the reputational risks associated with such activities. Also, in certain countries, regardless of their signatory status to different treaties and conventions, there has been an unofficial change in policy regarding the use of weapons such as landmines and cluster munitions. Through our engagement with a number of manufacturers of these armaments we have obtained confirmation that they have not received new requests for production for some years and that they do not anticipate new future orders. This is all in addition to the official changes brought upon by various states signing the relevant treaties.

Our engagement work shows that companies are now more open to dialogue with stakeholders but unfortunately continue to shy away from issuing public statements regarding their involvement in controversial weapons, for fear that this may put them at a disadvantage with their peers. This makes the assessment of the companies unnecessarily complex and resource intensive and often results in a single company being classified in different ways by various investors. That said, we are currently working closely with three US weapons manufacturers aiming to get that key first mover to produce a public statement.

Public disclosure

In a recent engagement call with a US defence company, we were pleased with their receptiveness to our feedback regarding the benefits to both the company and its investors of a public statement regarding their stance on cluster munitions. It became apparent through our dialogue that this is a current topic of debate within the company itself and that there is a growing internal recognition of the benefits of our request. We were reassured that our feedback will be passed on to the company's policy committee for further discussion and we agreed to a follow up the conversation subsequent to the board's debate on this topic.

Through our recent engagement with another US weapons manufacturer we learnt that while the company continues to engage in dialogue on the topic of controversial weapons when specifically requested by interested parties, it still refrains from providing a clear statement that is widely available without the need for direct engagement. The company argues that additional public disclosure such as a statement on the website would risk leaving it up to interested parties to draw their own conclusions and that these have not always been accurate and have caused the company to be misjudged. We countered this rebuttal by suggesting that the key to avoiding inaccurate judgements relies in the thoroughness and robustness of the disclosure.

Also recently, as part of our escalated engagement with a prominent North American defence company we were informed that it will very likely produce a public statement once it is certain that no new orders will be placed under its two remaining contracts involving controversial weapons. It is our understanding based on our dialogue with the company that these contracts are due to expire this year and that, if new orders were received under these contracts, the company anticipates that deliveries of such orders would not extend beyond 2013. No production orders have been received under these contracts since 2001.

Overall, while the assessment of issuers associated with controversial weapons has become increasingly technically complex, we find that companies, particularly traditional US disclosure laggards, are becoming progressively more open to dialogue. Changes to policy at country and investor level, the growing reputational risk, and active engagement continue to be fundamental drivers of much needed enhanced transparency in the defence industry.

Executive Remuneration

FTSE 100 and pension fund seminar on executive remuneration

On 27th February Hermes Equity Ownership Services and the National Association of Pension Funds (NAPF) hosted a meeting with representatives from 44 FTSE 100 companies and 42 occupational pension funds to consider solutions to the problems associated with executive pay. The discussion focused on how long-term investors can best support companies in improving remuneration practices through engagement and considered use of their voting powers.

‘Remuneration committees should explain the rationale behind their chosen policy and practices.’

Overview

Hermes EOS and the NAPF were delighted that the Rt. Hon. Vince Cable MP, the Secretary of State for Business, Innovation and Skills was able to join the meeting for part of the discussion. It was clear from the seminar that the perspectives of pension funds as long-term owners had generally not reached remuneration committees. We intend to ensure that their voices are heard more clearly.

Encouragingly, there was an appreciation of the pension fund perspective and willingness to debate far-reaching reform amongst many remuneration committee members present. We are delighted with this important first step and intend to build on our initial success by encouraging significant improvements in remuneration practices, with long-term owners of companies supporting remuneration committee chairs in achieving change.

The seminar included plenary panel discussions and small working groups that debated specific concerns around executive remuneration.





Proposals for reform

The discussion paper presented by Hermes EOS *Proposed Reforms to UK Executive Remuneration* highlighted a number of ideas including the need for boards, their nomination and remuneration committees to recognise that motivation does not solely arise from pay and ensure that succession, recruitment and retention discussions focus on matters other than pay.¹

EOS suggested that longer-term alignment should be achieved by the ownership of shares for the long-term, even after executives have left the company. We advocated the use of claw-back mechanisms by remuneration committees where the outcome of the awards does not properly reflect actual performance, or breaches of behavioural standards or policies by the individual or more widely in the organisation.

Other measures should be used in preference to earnings per share (EPS) for assessing performance, while fixed pay for directors and senior management should increase by no more than the average that is awarded in the rest of the organisation. There was clear consensus that remuneration schemes have become too complex, making them less able to motivate directors and management: the best alignment with long-term owners is long-term ownership of shares by board members, as agents of the owners. Rewards should be in the same currency as the capital invested by the owners – that is, in shares.

Lastly, consultations should be more timely, wider and deeper and should ensure that the owners' views are taken sufficiently into account. Remuneration committees should explain the rationale behind their chosen policy and practices, and in particular, how they are aligned to achieve the strategy taking into account the interests of the company's owners.

Observations from the seminar

Remuneration committee members found it very useful to be exposed to the views and concerns of pension fund representatives in relation to executive remuneration, often for the first time. Pension funds' voices are often not heard sufficiently clearly or directly and this needs to change. Improving stewardship by funds will also involve greater accountability of their fund managers on matters such as pay.

There was agreement that the growing complexity of remuneration actually encouraged the trend of de-linking pay from performance and reduced the incentive effect of remuneration structures. This phenomenon could also be one of the causes of the increases in pay, as complexity encouraged discounting of the value of awards by executives. The typical three-year vesting period of long-term incentive plans (LTIPs) was identified, in addition, as being insufficient.

1 www.hermes.co.uk/Portals/8/Pay_discussion_document_2012.pdf

It was agreed that the achievement of long-term success will require alignment with long-term owners and companies' employees. It is the responsibility of company boards to drive the right culture and behaviours through the organisations.

Next steps

The NAPF will be setting up a working group to move the agenda forward for pension funds who want to assist companies to change pay practice. Such collaboration will enable funds of all sizes to develop and refine their policies on executive pay, recognising that many of the UK's largest funds are active long-term owners already. The group will work closely with remuneration committees and boards to ensure that executive remuneration is better aligned with the long-term interests of pension funds and the behaviours and culture that the board wishes to instil throughout the organisation.

The working group initially intends to identify and work with those remuneration committees at companies that it believes, or have themselves indicated, are most amenable to considering significant reform of their remuneration policy and practices. In addition it plans to test the mooted voting hurdle of 75% by seeking to engage with all companies in the FTSE 350 whose remuneration report fails to achieve this level of acceptance.

The NAPF also recognises the need for pension funds to hold their asset managers to account for their exercise of stewardship responsibilities and will be exploring what practical steps it can take to support its fund members in doing so.

Proposals from the Department of Business, Innovation and Skills (BIS)

Hermes EOS and NAPF recognise that the government is committed to the reform of executive pay and would like to encourage pension funds to become more active owners of the companies that they invest in. BIS's intention is to improve the way in which executive directors are paid.

The seminar is the beginning of our response to helping solve the problem of executive pay and we believe that by building a coalition for action on pay and engaging with companies around these ideas we will succeed in greater reform than the changes that will be achieved solely by BIS's reforms.

Overfishing

Sustainable supply chains in the global fishing industry

The decade-long mismanagement of the world's fish stocks has resulted in a situation that is neither environmentally nor economically sustainable. The fisheries industry is, as a whole, loss-making, dependant on subsidies and riddled by overcapacity. Failure to preserve fish as a resource destroys value on a global scale and could heavily affect companies operating in the processing sector, food producers, and large retailers.

Statistics

Number of companies targeted through collaborative engagement:	40
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Number of engaged to date:	28
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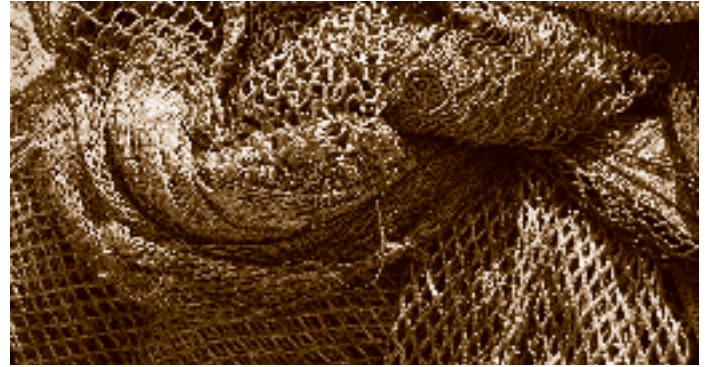
Number of these showing progress so far:	9
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Overview

Fish, as a resource, holds significant economic value not only for the economies of coastal nations, but also for international companies active in the processing and retailing sectors. Depletion of this resource would put a significant source of revenue for these companies at risk. However, efforts at sustainable management of fish stocks at an international level have seldom been successful so far. As overfishing is to a large extent caused by illegal fishing, part of the problem lies in the lack of sufficiently stringent legal measures or lack of implementation of the existing laws. The increasing scarcity of fish has set an incentive to fish illegally even for legitimate fisheries, whose business model is already under pressure from the low consumer price of fish. The fact that many of the biggest buyers of fish do not have appropriate sourcing policies exacerbates the issue.

While a definite solution to the overfishing problem can be expected only through broad engagement with all stakeholders, there are meaningful steps that investors can take. A current UN PRI collaborative initiative aims at establishing an understanding of current sourcing practices. This is a useful first step towards effecting meaningful change in the management of fish supply chains.





Issues and companies

Short-termism

One astounding aspect of the overfishing problem is that the short-term thinking prevalent over the last decades has brought not only fish stocks, but also the fisheries industry close to collapse. While the ecological damage resulting from overfishing is well-documented, the economic damage in terms of missed benefits is equally disastrous. The 2009 'Sunken Billions' report by the World Bank estimates this economic damage at about \$ 50 billion per year.¹ Since 1950, global marine catch has risen more than six fold, from 15 million tonnes per year to approximately 95 million tonnes per year. However, with commercially valuable stocks becoming exhausted, this catch is predominantly composed of species which fifty years ago would have not been considered worth fishing.

Fishing represents a significant proportion of GDP for many coastal nations, and collapse of stocks can have major disruptive effects upon a country's economy. Two of the most striking examples are the crash of Peruvian anchovy stocks in the 1970s and the depletion of Canadian cod stocks off the coast of Newfoundland, which resulted in an indefinite moratorium over fishing on the Grand Banks.

Fish also holds significant economic value as a major source of revenue for food producers, processing companies, and retailers. These sectors would be among the most affected by shortfalls due to overfishing.

Illegal fishing and sustainable pricing

In short, both the industry and the fish are in dire straits caused by lack of sustainable management. But why has it proven so hard to change the status quo even though it holds very little benefit for any of the stakeholders?

There are two reasons. The first is that, according to a report by the Fisheries Centre at the University of British Columbia, evidence points towards the fact that a large proportion of all fish caught globally is caught illegally.² It is then sold on the spot market, making its origins difficult to track. Alternatively, the illegal catch is fed into the global supply chains at the processing stage, a practice known as 'fish laundering'. This is possible mainly because international laws regulating fishing are very hard to implement. A large proportion of the world's catch is harvested in the territorial waters of failed or troubled states which do not have the resources to ensure adherence to licences and applicable laws. This is a regulatory problem, and a possible solution would be to treat illegal fishing as an international crime.

The second reason is the low consumer price of fish despite its increasing scarcity. At the current supplier prices, it is no longer economically viable for many fisheries to adhere to the terms of their licences. Supplementing harvests with illegal catch is not uncommon even for licensed fishing enterprises who sell certified stock.

This is a problem which large food retailers, who are among the largest buyers of fish, are capable of addressing. The first step is to have an appropriate sourcing policy, sourcing only fish with traceable origins and refrain, as far as possible, from buying on the spot market. The second step is to price fish at a level that represents its actual value, and makes it possible for certified fishing enterprises to survive without supplementing with illegal catch.

Stakeholder collaboration

For investors, engaging with large food producers and retailers is a logical first step. At present, Hermes is participating in a collaborative engagement via the UN PRI which targets precisely these actors. This initiative aims primarily at building understanding about sourcing policies and best practices in retail, and as such provides the necessary background for further engagement. Furthermore, we have built contacts with academic experts in the field of overfishing to keep on top of regulatory developments and their potential effect on relevant industries.

However, supply chain management is only one aspect of the overfishing problem. What is needed is the participation of all stakeholders: industry, government, retailers, and investors. It is only this type of broad-scale engagement that provided a relative, and rare, conservation success in the case of the Patagonian toothfish. Illegal fishing for this lucrative species has all but ceased due to a range of port measures introduced in 2005 as a result of the efforts of all groups concerned. There is hope that the value represented by the world's fish stocks can be preserved, mainly due to ocean ecosystems' remarkable ability to recover. However, it is essential not to leave it too late: despite a fishing moratorium of over twenty years, the Canadian cod stocks have not returned.

Companies affected by issues in this area are: Tesco, M&S; Delhaize; Whole Foods; Carrefour; Unilever; Sodexo; Sainsbury; Metro AG; Nestle; Tyson Foods; Yum! Brands; Axfood AB; Morpol ASA; Ahold; McDonald's; Mitsubishi; Nichirei.

1 'The Sunken Billions: The economic justification for fisheries reform', World Bank and Food and Agriculture Organization, 2009.

2 'The Global Extent of Illegal Fishing', Fisheries Centre at the University of British Columbia, 2008.

Public policy and best practice

Protecting and enhancing value by promoting better regulations

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

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

Overview

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

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

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





Highlighted sample activities

Launch of Model Mandate Initiative

As a culmination of two years' work, the Model Mandate Initiative document was formally launched by the International Corporate Governance Network. The product of a working group of the ICGN's Shareholder Responsibilities Committee, chaired by an EOS staff member, the Initiative provides draft clauses for contracts between asset owners and their fund managers which seek to align the interests of the parties more closely. By reasserting the fiduciary duty of fund managers and seeking to lengthen the time-frame on which the fund managers focus, the Model Mandate hopes to deliver better long-term performance for their clients. We also had the opportunity to present the ICGN Model Mandate project at the NAPF's leading event, its investment conference.

FTSE 100 Remuneration workshop with pension funds

We both organised and hosted a significant working seminar on executive remuneration between representatives of around 40 FTSE 100 companies, mainly remuneration committee chairs, and representatives of pension funds, including some from outside the UK. EOS held a joint press conference with the National Association of Pension Funds to update the media about the seminar.

Meeting with IAASB on auditor reporting

We met with the incoming and outgoing deputy chairs of the International Auditing and Assurance Standards Board, which sets global standards for audit. We welcomed the news that the IAASB has responded to calls from us and others to enhance significantly the quality and value of auditor reports, and is now accelerating this work, setting aside other projects in order to give it full priority. We were the only investor to present to the Board's working group on reporting – which was led by the new deputy chair.

Meeting with senior officials of Singapore Exchange

We met with senior Singapore Exchange executives responsible for overseeing regulation including the listing rules. We welcomed the ongoing improvements to the Listing Manual, particularly the implementation of the amendments in late 2011 which included a new requirement for the disclosure of audit fees in addition to non-audit fees – an issue EOS had been pressing for some time. We were pleased that the Exchange acknowledged EOS's work to promote good corporate governance in Singapore.

Mexican Stock Exchange

We spoke with senior executives of the Mexican Stock Exchange, including the head of legal, to discuss corporate governance issues as well the Exchange's recently launched sustainability index. Our comments were well received and the Exchange showed an interest in working with us going forward, offering a meeting with the head of sustainability.

Public policy and best practice continued

Other public policy work this quarter included:

Companies Acts and equivalents

- Responded to Japan's Ministry of Justice with regards to its interim proposals concerning amendments to Companies Act in Japan, which open the door to significant governance improvements.
- Met with Senior executives of Tokyo Stock Exchange seeking views from EOS on the proposed amendments to the Company Act in Japan.
- Met with representatives of the Department of Business on the Kay review on long-termism, narrative reporting and executive pay.
- Wrote to the Secretary of State for Business on the issue of binding remuneration votes, in combination with three of the UK's largest pension funds.
- Responded to the Competition Commission's Issues Statement, the first step in its investigation of competition, or the lack of it, in the market for audit services.
- Took part in a roundtable meeting in Brussels regarding the European Commission's plans for reform to the IORP Directive, which sets EU standards for occupational pension funds.

Securities Laws and Regulations

- Wrote to the Tokyo Stock Exchange in response to proposed amendments to the Listing Rules which would lead to enhanced disclosure.
- Met with senior executives responsible for corporate governance and regulation at the Malaysian stock exchange.
- Wrote to the Malaysian Securities Commission to reiterate our views about some of the recommendations in the Corporate Governance Blueprint.
- Met with senior officials of Malaysia's securities regulator to exchange views about corporate governance practices and ongoing discussions at the public policy level.
- Responded to a consultation from the European Securities and Markets Authority (the overall standard-setter for EU financial markets) regarding proposed reforms to the Prospectus Directive.
- Responded to a discussion document from ESMA on the important question of materiality in financial reporting.
- Responded to a consultation from the Public Company Accounting Oversight Board, which sets standards for the audit of US companies, on proposed changes to enhance the disclosure around those who carry out the audit.
- Met with senior officials responsible for Indonesian accounting standards and disclosure and discussed corporate governance and the regulatory framework.
- Responded to the Indonesian Ministry of Finance's consultation on revising the regulations on company reporting.

Codes of best practice

- Chaired the working group that produced the Quoted Companies Alliance's remuneration committee guide.
- Met with senior executives of the Hong Kong Exchange to discuss the proposed Reporting Guide for environmental, social and governance matters.

- Provided our views to Japan's Ministry of Trade & Industry about the relationships between Japanese companies and shareholders.
- Invited to a roundtable meeting hosted by the Netherlands Embassy and Indonesia Netherlands Association to discuss corporate governance in the Indonesian banking sector.
- Participated in the South African UNPRI engagement working group seeking clarification from the local takeover regulator on the parameters for shareholder collaboration.
- Met with a UN Development Programme representative based in Indonesia who has been specialising in regulatory and political reform (including addressing corruption).
- Participated in a multi-stakeholder consultation for the Access to Nutrition Index draft methodology.
- Further meeting with senior European Commission officials to discuss the developing plans regarding corporate governance, in follow up to the Green Paper published in 2011.
- Participated in the inaugural meeting of the Investor Relations Society's governance forum.
- Spoke to representatives from the FRC's Financial Reporting Lab along with an executive from Cairn Energy on the company's proposals to make changes to the notes to its accounts in order to increase their usefulness and readability.
- Had a lengthy discussion with a large group of Competition Commission staff as part of its ongoing investigation into the market for audit services.
- Responded to the FRC's consultation on going concern, confirming that the FRC should seek above all to improve the quality of disclosure to encourage better behaviour.
- Took part in the latest meeting of the shareholder affairs committee of the NAPF, which considers governance and stewardship matters on behalf of the UK pension fund association.
- Participated in investor steering group meetings of the 30% Club, the group that is encouraging public companies to appoint more women as directors.

Global standards

- Met with staff from IASB, the international financial reporting standard-setter, to discuss its first post-implementation review of one of its standards, IFRS 8 on segmental reporting.
- Met with two members of the IAASB to discuss the forthcoming meeting of the board which will be devoted almost entirely to the issue of auditor reporting.
- Responded to the consultation from the International Accounting Standards Board and the Financial Accounting Standards Board (respectively the global and US accounting standard-setters) regarding accounting for investment companies.
- Responded to joint consultation from IASB and FASB on their revenue recognition proposals. Having had lengthy involvement (and helping to avert some initial unhelpful proposals) we were largely supportive of these.
- Met with a senior adviser to the European Commissioner on climate change to discuss practical ways in which we can support the development of appropriate regulation.
- Responded to a consultation on principles for the supervision of financial conglomerates, issued by the Joint Forum, a grouping that brings together IOSCO, the Basel committee and the International Association of Insurance Supervisors.

Hermes votes at general meetings wherever practicable. We take a graduated approach and base our decisions on annual report disclosures, discussions with the company and independent analysis. We inform companies before we vote against or abstain on any resolution, usually following up such votes with a letter. We maintain a database of voting and contact with companies and if we believe further intervention is merited, we include the company in our main engagement programme.



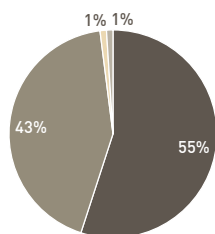
Hermes votes at company meetings all over the world, wherever its clients own shares.

Voting overview

Over the last quarter, we voted at a total of 1,421 meetings around the world, analysing 11,176 resolutions. At 681 of those meetings we opposed one or more resolutions and we abstained at 29 meetings. We voted with management by exception at 38 meetings, while we supported management on all resolutions at 673 meetings.

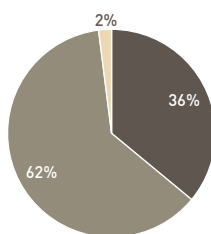
North America

We voted at 302 meetings (2,228 resolutions) over the quarter.



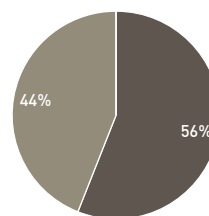
Asia Pacific

We voted at 428 meetings (2,996 resolutions) over the quarter.



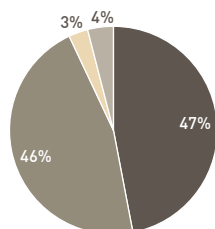
Australia & New Zealand

We voted at 27 meetings (87 resolutions) over the quarter.



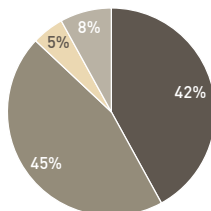
Emerging & Frontier Markets

We voted at 290 meetings (2,108 resolutions) over the quarter.



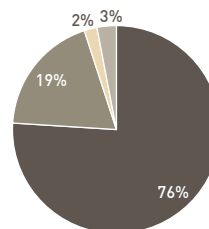
Europe

We voted at 250 meetings (2,477 resolutions) over the quarter.



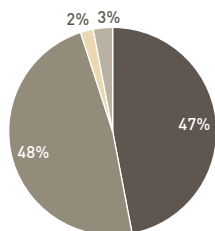
UK

We voted at 124 meetings (1,280 resolutions) over the quarter.



Global

We voted at 1,421 meetings (11,176 resolutions) over the quarter.



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

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