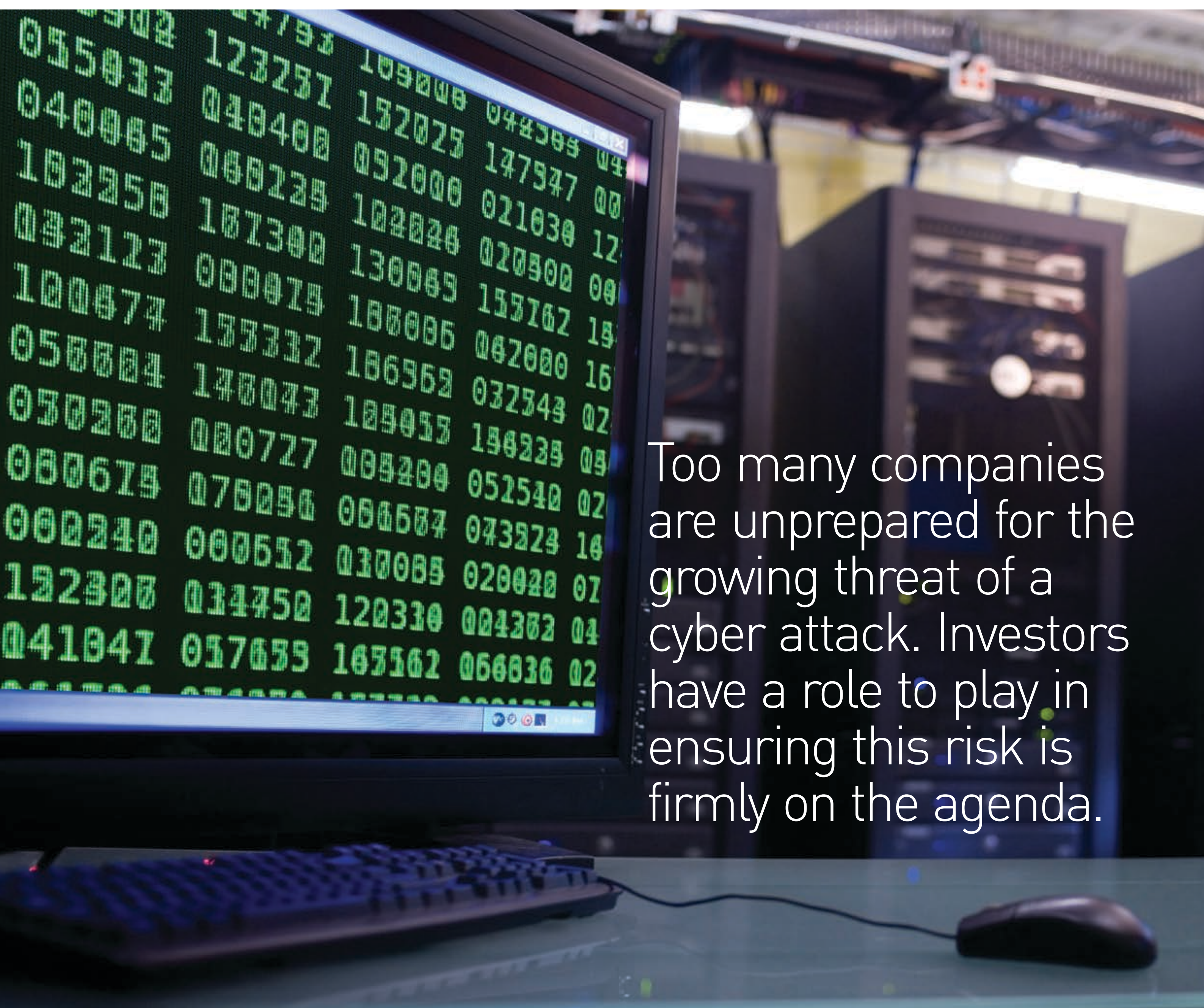
HERMES® | Equity Ownership Services

Q3 Public Engagement Report 2013



Too many companies are unprepared for the growing threat of a cyber attack. Investors have a role to play in ensuring this risk is firmly on the agenda.

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 Q3 2013.

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

1 Preface
What is EOS?
How does EOS work?

2 Engagement by region
Engagement statistics by region

3 Engagement by issue
Engagement statistics by issue

4 Environmental
The challenge of measuring water risk

6 Social
Community relations in emerging markets

8 Governance
Managing cyber risk

10 Strategy
Stranded as the mercury rises

12 Business strategy
Engagement on strategy

14 Public policy
Public policy and best practice

17 Overview
Regional voting statistics

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 $206bn. in assets under stewardship.

Hermes has the largest stewardship resource of any fund manager in the world. Our 30 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 Principles for Responsible Investment (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. 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 are likely to 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 core 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 March 2013

Engagement by region

Over the last quarter we engaged with 123 companies on a range of 319 social, environmental, business strategy and governance issues. Our 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.

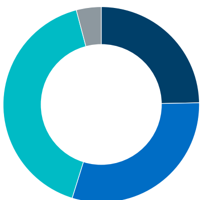
Global

We engaged with 123 companies over the last quarter.

- Environmental **14.7%**
- Social and ethical **25.1%**
- Governance **40.4%**
- Strategy and risk **19.7%**

Australia and New Zealand

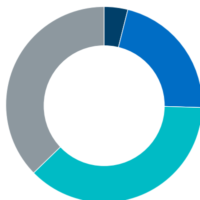
We engaged with 25 companies over the last quarter.



- Environmental **24.7%**
- Social and ethical **30.1%**
- Governance **41.1%**
- Strategy and risk **4.1%**

Developed Asia

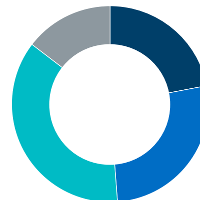
We engaged with 18 companies over the last quarter.



- Environmental **3.9%**
- Social and ethical **21.6%**
- Governance **37.3%**
- Strategy and risk **37.3%**

Emerging and Frontier Markets

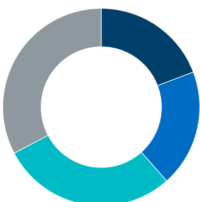
We engaged with 17 companies over the last quarter.



- Environmental **22.0%**
- Social and ethical **26.8%**
- Governance **36.6%**
- Strategy and risk **14.6%**

Europe

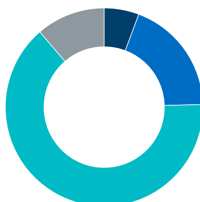
We engaged with 25 companies over the last quarter.



- Environmental **19.2%**
- Social and ethical **19.2%**
- Governance **28.8%**
- Strategy and risk **32.7%**

North America

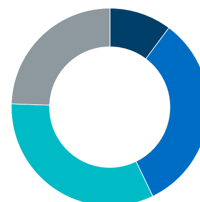
We engaged with 20 companies over the last quarter.



- Environmental **5.7%**
- Social and ethical **18.9%**
- Governance **64.2%**
- Strategy and risk **11.3%**

UK

We engaged with 18 companies over the last quarter.



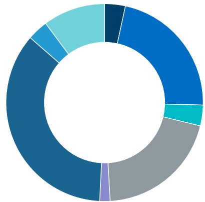
- Environmental **10.2%**
- Social and ethical **32.7%**
- Governance **32.7%**
- Strategy and risk **24.5%**

Engagement by issue

A summary of the 319 issues on which we engaged with companies over the last quarter is shown below.

Environmental

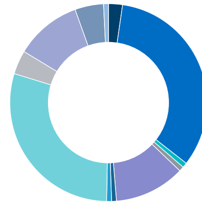
Environmental issues featured in 14.7% of our engagements over the last quarter.



- Biodiversity **3.4%**
- Climate change/carbon intensity **22.0%**
- Forestry **3.4%**
- Health and safety **20.3%**
- Oil sands **1.7%**
- Other environmental **35.6%**
- Waste **3.4%**
- Water stress **10.2%**

Governance

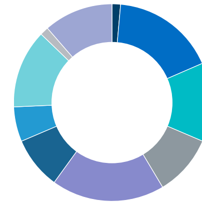
Governance issues featured in 40.4% of our engagements over the last quarter.



- Accounting or auditing issues **2.3%**
- Board structure **33.3%**
- Committee structure **0.8%**
- Conflicts of interest **0.8%**
- Other governance **11.6%**
- Poison pill **0.8%**
- Related-party transactions **0.8%**
- Remuneration **29.5%**
- Separation of chair/CEO **3.9%**
- Shareholder communications **10.9%**
- Succession planning **4.7%**
- Voting rights – not 1 share 1 vote **0.8%**

Social and ethical

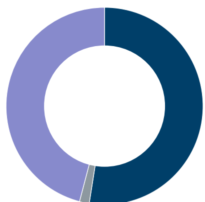
Social issues featured in 25.1% of our engagements over the last quarter.



- Access to medicine **1.4%**
- Bribery and corruption **17.1%**
- Community relations **12.9%**
- Corporate culture **10.0%**
- Employee relations **18.6%**
- Licence to operate **8.6%**
- Operations in troubled regions **5.7%**
- Other social and ethical **12.9%**
- Political risk management **1.4%**
- Supply chain (inc child/other labour issues) **11.4%**

Strategy and risk

Strategy and risk issues featured in 19.7% of our engagements over the last quarter.



- Business strategy **52.5%**
- Returns to shareholders **1.6%**
- Risk management **45.9%**

The challenge of measuring water risk

Enhancing disclosure of water risk is critical to its management

Basic awareness of water risk exists throughout affected sectors. However, lack of sufficiently granular data makes it difficult to pursue meaningful engagement with companies. Investor efforts need to concentrate on better disclosure and insisting on more robust and detailed information.

Overview

Water risk is on the rise globally, partly as a result of climate change. The phrase itself catches exposure of a range of different types, such as water scarcity (including droughts), pollution and flooding. While affected companies in many cases have a measure of disclosure in place, they often publish only aggregate data, which makes it hard for investors to estimate specific risks. The Principles for Responsible Investment (PRI) steering group on water, in which we participate, is trying to address this and to establish an appropriate angle for further engagement with companies.

What is water risk?

With the decline of a number of key water resources worldwide, water risk has emerged as a prominent topic in responsible investment. Often a lack of water resources exists where water is needed most: for example mining in arid territories. While the potential for operational impacts and disruption as a result of water risk is obvious, a best practice standard for its management at company level does not, as yet, exist. Compared to carbon emissions (CO2), water risk is both more varied and more localised. Under the catch-all notion of water risk are gathered risks resulting from water scarcity, pollution, and flooding.

The way water risk manifests itself is naturally very different from region to region and even from water basin to water basin. Each water source will have its own specific risk profile, and will require local management. Globalised solutions, after the model of the ones pursued for carbon such as cap-and-trade schemes, are therefore not workable for water risk.

The localised nature of the risk poses a further central challenge: its measurement.

The data challenge

While CO2 is comparatively easy to measure directly or estimate adequately, it is a lot more difficult to achieve an accurate estimation for water risk. In order to evaluate the exposure of a given company, investors would need very granular data about its operational sites and supply chain.

As a part of our work with the PRI steering group on water, research providers have presented us with most existing methodologies to map water risk. However, access to data is a problem for research providers as well. In some cases, they address this by filling the gaps with modelled data or narrowing the scope of their measurement tool outright. As a result, most of the available data is at a comparatively high level and, while broad comparisons between regions and industry sectors are possible, more sophisticated benchmarking and peer comparisons are at present still out of reach.

Among the existing mapping tools, the Water Research Institute (WRI) is capable of providing comparatively accurate maps of water scarcity at basin level. However, investors are then left with the challenge of trying to locate and map company facilities onto the basin data.

Furthermore, most of the existing mapping tools concentrate on water scarcity; there seems to be little capacity for taking other risks such as pollution and flooding into account. Another difficulty is that much of the existing data on water is proprietary company data, which is not always available to investors.

Relevance of water risk to investors

The direct financial impact of water risk exposure is usually limited as water is an undervalued resource worldwide; that is, in most countries there is currently a very low or no price on water, regardless of its actual availability. However, we expect that as issues of water scarcity increase, its cost is likely to become material. In addition, it can be useful to investors to consider exposure to water risk as a way of gauging the probability of operational disruptions at key sites. Furthermore, questions of social licence to operate can also arise out of exposure to water risk, especially in regions prone to water scarcity.

How companies handle water risk

The sectors most prone to water risk, according to the United Nations Food and Agriculture Organisation estimates, are extractives, food and beverage, and agriculture (the latter accounting for 70% of all water used in industry). Market leaders in developed markets are usually aware of the risk and companies such as Coca-Cola and Pepsi have developed data gathering methodologies and water risk policies. Other companies, such as fashion retailer Hennes & Mauritz, are in the process of developing partnerships with NGOs in order to manage their impact. Industry initiatives, such as Better Cotton, also aim at introducing better water management practices. Nestlé is one example of a company that is particularly active in the development of proprietary measuring tools and engages in water policy advocacy as well. Nestlé is also attempting to address water management practices at supplier level. While basic awareness of the materiality of water risk is present in almost all affected sectors, most initiatives are still at a policy level.

Challenges to effective investor engagement

Besides access to useful data, the other difficulty we have encountered during our participation in the PRI steering group on water is establishing the right addressee for engagement. While investors often have more leverage with companies than with regulators, many of the issues relating to water are policy or regulatory issues. Another problem is that water scarcity risks or groundwater contamination often arise at supplier level. As a rule, not many companies have the necessary influence or oversight over their supply chain in order to deliver meaningful change.

Due to these factors, many companies are merely reacting to the risk and managing their exposure to some degree. They are often unable to address the broader issues at stake, for example lack of appropriate infrastructure or inadequate legislation. Furthermore, some of the companies who are the largest water users in a given region, are private and thus not a suitable target for investor engagement. This applies mainly to large agricultural producers.

A further difficulty is the lack of standards and best practice when it comes to appropriate water stewardship. At present, most of the relevant standards come from environmental regulation and depend on its strength in the relevant region of operation. More detailed guidance often does not exist due to the fact that water is comparatively low on the agendas of most governments. This means that investors will need to enhance their own understanding of the issues to a significant degree if they are to foster appropriate standards of disclosure and water management. While there are examples of companies who proactively develop their own understanding and management of the issue, investors can play an important role in defining and encouraging the adoption of best practice.

First, investors can make a meaningful contribution to public policy on the topic. One of the leading efforts is the Carbon Disclosure Project's program on water (CDP Water), which aims to enhance disclosure and improve the available information on water use at company level. Disclosure aside, there are also a number of high profile efforts that aspire to contribute to the development of best practice. Public-private initiatives include the UN Global Compact's CEO Water Mandate, which aims to create and develop water sustainability practices, and the World Economic Forum Water Resources Group, which provides a platform for interaction between government water officials and other stakeholders.

Second, and complementary to public policy and broad best practice work, is the corporate engagement which investors can undertake on water risk. The three components of managing water risk appropriately in our view consist of:

- appropriate disclosure
- efficient management of water consumption, and
- engagement with local communities and regulators.

At present, investor engagement is to a large extent focusing on data gathering and disclosure. Once a solid basis for further analysis is established, the next step would be to identify leaders and laggards within each industry and to establish a standard for best practice from there. At a minimum, a company should be required to gather data about its water use and to be aware about its levels of exposure to water risks. As a next step, companies ought to have effective policies in place to deal with these risks and, ideally, be able to engage in an appropriate manner with the communities in which they operate.

Michaela Zhirova
Associate – Europe

Community relations in emerging markets

Ensuring sound relationships with local communities and indigenous people throughout a project's lifecycle and beyond

Companies failing to adequately manage community relations are likely to face significant operational risks and reputational damage. This can cause major delays to projects and have a significant financial impact.

Overview

For companies whose operations require the acquisition and exploration of large areas of land, establishing and maintaining good relationships with local communities, including indigenous peoples, is of critical importance. EOS has been actively engaging with companies and regulators around the world on this issue, particularly investment projects in emerging markets. Affected companies include those involved in mining, utilities, industrial farming and plantations.

Why community relations matter

Companies – typically but not exclusively extractive companies and plantation operators – often face opposition to their activities from local communities. The latter may not wish to relinquish their rights to land and are concerned about the impact of the development on the local environment and their livelihood. This often happens after companies have obtained official licenses from relevant authorities (whose interests may not necessarily be aligned with those of the local population) and arrangements for compensation have been made. This in turn can cause major delays to the projects and have a significant financial impact on the companies involved. Such disputes at times also result in violent clashes between the two parties. There have been instances where companies reportedly responded to local opposition by deploying a security force, whose behaviour led to accusations of human rights violations by both local communities and NGOs.

We have engaged with various companies including those in the mining sector, palm oil producers, steel manufacture and utility companies who have been involved in disputes and conflict with local communities in India, Indonesia, Malaysia, Brazil, Ecuador, Peru and Liberia. They have been accused by NGOs of grabbing land and forcibly removing local residents who opposed the acquisition and development of the land. The real or perceived impact that a company's operations can have on the environment is often at the core of the dispute. We have engaged with several mining companies in Latin America on how river or soil pollution related to their projects directly affects the livelihood of local communities, in turn leading to protests and operational delays.

A complex set of risks

The issues around land tenure in these countries can be complex due to weak legislation and the lack of an effective system to track land ownership, while local authorities may be politically influenced or lack sufficient capacity to handle these issues effectively. In order to mitigate the risk of being involved in such disputes, we have urged companies to observe the principle of free, prior and informed consent and to closely engage with relevant stakeholders. In cases where companies were allegedly implicated in violent acts through the use of security forces, we not only condemned the use of inappropriate force, but also encouraged the companies to adopt and adhere to the Voluntary Principles on Security and Human Rights, to mitigate the

risks of being implicated in the activities of security forces. While the principles are primarily designed for companies in extractive sectors, we believe that they also apply to companies in other sectors that face similar risks.

The management of such risks needs to be effectively integrated into core business strategies and operations at every stage in a project lifecycle, as prolonged disputes will delay projects and have direct financial implications, as well as causing reputational damage. Companies also have a wider role to play in the communities in which they operate in terms of economic and social development and capacity building. Initiatives to promote local employment and local business development such as education and health projects can help to enhance companies' image locally and internationally and generate local support for projects. It is therefore crucially important that a community relations strategy is established for the entire life of a project, engaging local communities and assessing the relevant risks in the planning phase and maintaining good relations and mitigating any negative impact on the communities during the operational phase. Lastly, companies need to agree an exit strategy with local communities once a project is terminated to manage expectations of ongoing support.

One of the palm oil producers we have engaged with assured us that its chair/CEO had been closely involved in the management of community relations while visiting plantations. EOS has undertaken site visits of palm oil plantations in Indonesia, oil fields in Russia and Nigeria, mines and dams in Brazil as well as industrial projects in India, to assess first-hand how community relations were managed by companies. Indeed one of the objectives of our engagements is to ensure board level commitment to and involvement in maintaining sound community relations and the disclosure thereof.

How can companies benefit from sound community relations?

There are a number of benefits to companies and their performance from sound community relations. Close links with the local population generates support for projects leading to a reduction in delays due to strikes, lawsuits, sabotage or demonstrations. Taking into account the views of affected populations can also improve project design and facilitate operations over the long-run. Clear definition and protection of land rights facilitates the planning and implementation of private sector projects and reduces the risk of conflicts over land and resources. Finally, companies are likely to benefit from an enhanced public image both locally and internationally.

Key engagement objectives

Our engagement objectives relating to community relations, based on internationally recognised standards such as the United Nations Voluntary Principles on Business and Human Rights and the ILO convention 169, are as follows:

- Adopt and implement a community relations policy and strategy, committing the business to respect and support local communities, including indigenous peoples, with board oversight
- Conduct due diligence and impact assessments to identify actual or potential impacts
- Consult with local communities in relation to matters that may affect them
- Obtain (and maintain) free, prior and informed consent (ILO Convention 169 related to indigenous peoples) where appropriate
- Establish or cooperate with an effective and culturally appropriate grievance mechanism
- Establish or cooperate with legitimate processes to remediate any adverse impacts
- Monitor and report on business performance in relation to community relations

Bruno Bastit
Assistant Manager
Sachi Suzuki
Assistant Manager

Governance

Managing cyber risk

Encouraging companies and their boards to be prepared for the growing risk of cyber attacks

Hermes EOS engages with companies across different industries on the level of cyber threat they face and the processes and tools they have in place to manage this increasing risk.

Overview

Cyber security is a rapidly evolving issue and we fear many companies and their boards are ill-equipped to deal with the threats posed. Information technology systems are increasingly subject to sophisticated attacks that can damage the value of a business in many ways. Managing this risk is particularly challenging due to its constant evolution through technology, anonymity and international scope. Already the cost of cyber breaches against British businesses has tripled since 2012, amounting to billions annually according to a survey by the UK Government. Cyber crime and cyber spying is costing the US economy $100bn a year and the global economy perhaps $300bn annually according to the Financial Times. Globally, regulators are beginning to take steps to challenge companies on their preparedness.

The evolving nature of cyber risk

In a world where information systems and the internet are integral to most companies' systems, cyber risk is one of the most complex and rapidly evolving issues they need to protect themselves against. Gone are the days where cyber attacks were limited to the plots of Hollywood blockbusters; today they are commonplace, defined broadly as a 'breach of any interconnected network(s) or the space within which electronic communications take place'.

The types of attackers are evolving: motives range from fraud and extortion, through competitors or governments interested in gaining economic advantage for their national companies or to further their own national interests, to individual computer hackers who launch attacks for political or ideological motives. Their approach to penetrating systems has developed too, with the use of social engineering, where people are tricked into opening malicious links in emails from friends or colleagues in a bid to hack a system. There are also many well known cases where hackers, masquerading as service providers, have persuaded IT support staff by telephone to reset passwords and hand out computer information, thus easily enabling an attack.

Welcome to the real world

Although most attacks don't make headlines, those that do have recently included Barclays, which was victim of a £1.3m heist after hijackers gained access to the bank's systems through a north London branch in September 2013. In 2012, London listed BUMI Plc saw its chairman's computer hacked and sensitive information stolen, which was later released to the public. Worryingly too, Saudi Aramco, the world's largest oil company, had to isolate its production systems from infected PC workstations inside the company. Following thousands of attacks through a worm, during which data was deleted from hard drives, the business' activities were severely disrupted. Unsurprisingly regulators are taking action, with the Securities Exchange Commission encouraging all publicly traded companies to disclose cyber incidents, and the UK Treasury and Bank of England planning to benchmark banks on the security of their IT systems.

Cyber attacks impact companies of all sizes and industries. Symantec, a maker of security software, has reported that 31% of attacks in 2012 were focused on companies with between one and 250 employees, and that although companies in the financial industry suffered 19% of all attacks, manufacturing companies were impacted the most, with 24% of cyber attacks. Supply chains were identified as of specific interest to hackers too.

The investment risk

Alongside other material business risks, the ramifications of cyber crime for investors can be just as serious. A recent Reuters article stated that "publicly traded companies who disclose a security breach can expect to see a 5% drop in their share price within two weeks of their announcement. In 2011, Sony witnessed its stock price drop by over 8% following a string of cyber attacks. It is therefore important that investors educate themselves on the scale of the risk to the companies in which they invest, better understand company responses and challenge them where they see the risk not being properly addressed.

Boards taking control

Given the severity of the consequences for many companies, cyber risk should be high on the board's risk agenda. With ramifications such as fraud, intellectual property and data theft, and reputational embarrassment, its ownership cannot be simply left with IT departments. Approaches to this issue differ significantly across companies, but our understanding is that cyber risk is not sufficiently discussed in the board room.

This needs to change. Boards, and in particular their audit and risk committees, need to seize control and oversee the identification of the type of cyber risk the company faces, and develop plans and procure the tools to address the risks faced. The following questions can help companies set priorities: What information is of value to our organisation? Who might be interested in obtaining it? How are we protecting ourselves? What is our contingency plan should we experience an attack and who is responsible for owning the risk? We also suspect that in many cases these conversations will lead to training and possibly the development of new skills, examination of audit, information governance, and risk exposure testing. Additionally, the scope of a cyber security assessment should extend to third party security systems, as service providers such as lawyers, auditors and accountants often have lower security levels than larger corporate organisations, and are increasingly suffering attacks.

It is critical that boards take ownership, understand the risks, ask the right questions of executive teams, audit committees, internal and external auditors, and are able to speak coherently about the challenges of managing this area appropriately with customers, investors and other relevant stakeholders.

Hermes EOS approach

EOS has spoken to a leading UK-based information solutions company to discuss the type of attacks being waged as well as the best practice company responses and board procedures to address the risk. We have also initiated engagements at board level in our clients' major holdings, addressing the specific risks being faced and the board oversight, management processes and resources companies have put in place. We expect cyber risk to be a significant engagement issue for the foreseeable future.

Victoria Barron

Assistant Manager – UK

Stranded as the mercury rises

Stuck with unburnable carbon

Engagement with the oil and gas industry on climate change is urgently needed to help avoid catastrophic climate change.

Overview

The publication of the latest report from the United Nations Intergovernmental Panel on Climate Change (IPCC) in September 2013 provided a stark reminder of the threat posed to the planet by greenhouse-gas emissions. According to the study, which is the most comprehensive of its kind, our chance to remain within 2°C of current global temperatures will be gone if we continue to burn fossil fuels at the current rate for the next 30 years. If temperatures rise by this amount there will be catastrophic climate change.

What is 'unburnable' carbon?

Coal usage in the US is in a downward spiral as a result of cheap gas from the nation's shale boom and increasing regulatory intervention. In the past couple of years, the US has experienced the sharpest reduction of greenhouse-gas emissions among leading economies largely because shale deposits are supplanting coal to generate gas-fired electricity. Despite this shift, how should asset owners engage major oil and gas companies about the effects of their products on climate change?

Above all asset owners must ask them to consider how their deposits may become economically obsolete or 'stranded'. According to the International Energy Agency's 'World Energy Outlook 2012', achieving a 50% chance of limiting global warming to 2°C means that only one third of the world's proven oil and gas reserves can be commercialised. The 'Oil and Carbon Revisited' research paper by HSBC in 2013 concluded that 40-60% of the market capitalisation of major European oil and gas companies is at risk because of the 'unburnable' carbon in their reserves if climate change is to be avoided.

Asset owners now have the best opportunity to engage oil and gas companies about the carbon embedded in their businesses. The latest IPCC report bangs another nail into the coffin of climate change deniers and oil majors are publicly acknowledging that climate change is happening. Importantly, the experience of shale gas in the US has demonstrated that switching from coal and oil to gas can significantly reduce carbon emissions in the short-term, giving credence to the industry's argument that it can play an important role in the transition to a low-carbon future. This provides us with an opportunity to have a constructive engagement with the industry to ensure that its rhetoric is matched by action.

Asset owners should ask how oil and gas companies use a carbon price to plan for the impact of future regulation, and how projected oil or gas prices are used in project planning. Also, they should test the oil and gas majors on how they are managing their portfolios for regulation and their likely inability to exploit all of their reserves – in particular those that contain more carbon or are more carbon intensive to exploit. Investors must ask: should the majors be moving away from heavy oil and towards gas?

Companies need to assess climate risk

In the context of worryingly lower returns on capital in the industry, do carbon risks mean that companies should not invest in new, high-risk developments such as those in the Arctic? Investors may be at an informational disadvantage but we expect the oil majors to provide clear, reasoned analyses of how they assess climate change risk in their decisions and provide evidence that it is taken properly into account before proceeding to final investment decisions. Increasingly, using a notional price of carbon is not sufficient: the company needs also to understand and explain why the exploitation of additional reserves is not an unacceptable risk. These reserves may consume capital and, as a result of future regulation or other pricing factors, they might never be commercialised. It is important that the process used to make final investment decisions is made transparent so that outsiders can assess the extent to which such risks are taken into account. If the most capital-intensive projects are too risky, should

company boards consider whether they need to change their business models? In a world where demand and regulation is uncertain and extraction of all known fossil fuel reserves will be likely to lead to uncontrolled climate change, boards of oil and gas companies must be ready to explain why retrenchment, shrinking the balance sheet and making greater returns to shareholders is not a better strategy than continued, risky expansion.

It is legitimate for asset owners to pursue the following lines of questioning: what are oil and gas majors' views on adjacent technologies and products? Should companies be developing carbon capture and storage capabilities? Are bio-fuels appropriate products for these businesses to develop? To what extent should the majors be considering other renewable technologies? How do they encourage a switch from oil to gas among vehicle fleets and private consumers? Within their own operations, how do companies encourage energy efficiency?

While engaging on the necessary reduction in greenhouse-gases, asset owners should not ignore oil and gas companies' plans to adapt to climate change. The industry works in some of the most inhospitable places on earth, and as climate change becomes more pronounced, the weather will become more unpredictable, savage and likely to wreak harm to the industry's installations. The oil majors should be tested on the ability of their operations to withstand such additional pressures – one only has to note that the Deepwater Horizon oil rig was located not only in the heart of the US offshore oil industry but also in the US' hurricane zone. The increasing risk of a similar catastrophic spill resulting from more frequent and extreme weather events must be managed and seen to be managed. Hurricane Sandy's devastation of parts of New York City demonstrates the increased unpredictability of the weather in the era we are now in.

Trade associations are an important factor in the ongoing dialogue with the industry, not only with shareholders but with governments and other stakeholders. They should hear asset owners' concerns about climate change and the lower returns that they are suffering. In this context, dialogue with fund managers on the increased riskiness of the industry – with the possibility of even lower returns – should provide another avenue for engagement even with those fund managers that are still not factoring climate change into their investment decision making process.

Key questions for investors to ask

Hermes EOS continues to engage with most of the oil and gas majors on climate change and other issues that affect the industry's long-term value. Earlier this year we wrote to one of the US majors and called for, inter alia, better disclosure about how the company managed climate change risk. In our letter to the company and subsequent conversation, we noted it was encouraging that it acknowledged climate change as an important issue to manage but expressed our concern that its thinking, as reflected by its disclosure, needed to extend to the risk of owning stranded assets. We obtained a fulsome response from the company. We also led and supported engagements in the Carbon Action campaign to encourage large greenhouse-gas emitters to set quantitative reduction targets if they haven't already done so. These companies often pushed back, but we were often able to hold constructive conversations with them to encourage better disclosure on managing climate change risk. It also helped us to learn which boards are better prepared for climate change regulation and potentially significant changes to their business models. We have now identified and challenged some companies that are still prepared to arbitrage climate change risk by using lower carbon prices in their investment decisions in countries which in the short term, are less likely to impose a serious carbon charge on hydrocarbon extraction.

In our extensive engagement with leading oil and gas companies on disaster response and health and safety management, we have increasingly pushed at opening doors. Companies realise that they had to respond to our concerns – which are mirrored by those of the regulators, their own staff and other stakeholders. The industry faces far greater challenges in relation to climate change. Long-term investors cannot wait until a climate change equivalent of the Deepwater Horizon spill provokes boards to act. We have to encourage the industry – and policymakers – to respond now to the impending climate catastrophe. We will continue our engagements with vigour as the future value of our clients' portfolios, not just their investments in the oil and gas sector, is dependent on the industry playing a crucial role in reducing the carbon emitted into the atmosphere to 20% of current levels.

Tim Goodman

Associate Director – Head of North American Engagement

Strategy

Engagement on strategy

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

Overview

EOS adopts an holistic approach to engagement combining 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 met with a large conglomerate shortly after it responded to an activist shareholder proposal to list a portion of its entertainment business. While we did not support this proposal, we argued that it, and the market reactions to related developments, sent a strong signal that shareholders had serious concerns about the business and felt a need for some change. Acknowledging the company's point that maintaining the entertainment operation may offer valuable synergies with the electronics business, we emphasised that it needs a clearer and more solid strategy for revitalising the electronics unit and urged it to provide more specific targets for each business segment. We again questioned the relevance of its financial business, which does not have any apparent benefit for other businesses within the conglomerate. The company seemed to receive our suggestions positively. On governance, we again welcomed the appointment of the new independent chair, following our engagement about the suitability of the previous chair, who was the former CEO. Although the current board seem to have diverse skill-sets, we suggested it consider appointing a director with strong credentials in content businesses which it views as key to its operations. We again urged the company to enhance disclosure on executive remuneration.

We met with the CFO of a multinational energy corporation and separately with the independent director. We welcomed the clear improvements in shareholder communications we have noticed over the last few months. The current board dynamic was tested and we discussed what contributions had been made since the assembly by the independent director as well as independent members. We talked about the main challenges in influencing board members who are mostly government officials and probed current board dynamics with both the CFO and the director. We also met with representatives from the exploration, health and safety, environment and social teams to discuss sustainability issues. We were impressed by the company's willingness to talk about these issues and were pleased to hear that a lot of work has been done since to streamline and simplify the oversight process since we last talked. We continued to urge for

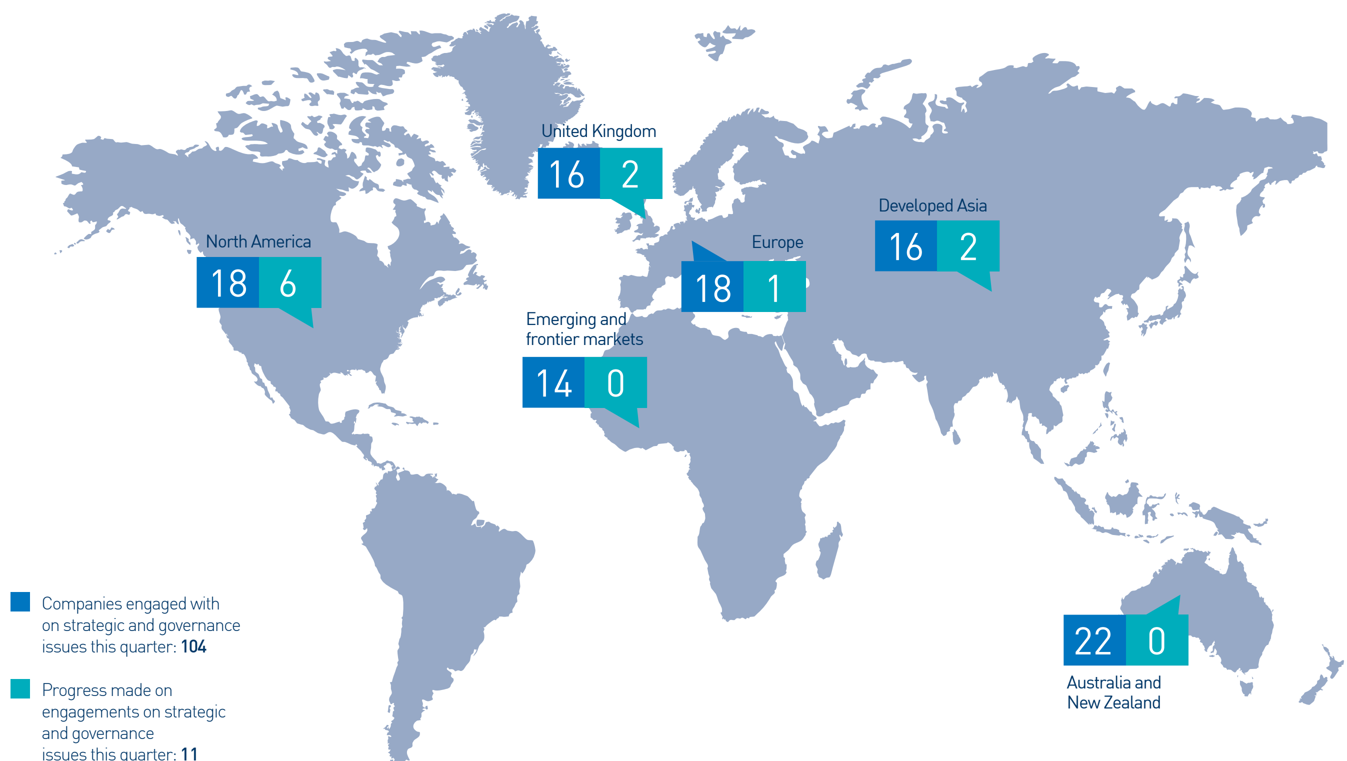
stretching reduction objectives and targets to be set for carbon as well as for the disclosure of an historical overview of spills, gas flaring and health and safety indicators. We welcomed assurances that such targets do exist and urged the company to disclose them in its next round of reporting. Best practice examples will be provided and we will keep working together closely on these issues.

We met with the head of corporate governance and other senior executives at a large telecommunications provider to discuss governance matters. We discussed the appointment of a long-standing board member (who is also chair of three board committees) as a lead independent director, noting that, while we regard the creation of such a position as a positive step, we would have preferred to see a genuinely independent and strong outside candidate in the role. We questioned whether the current arrangement is capable of ensuring an effective counterbalance to the powerful chair/CEO, and discussed the overall levels of independence and the types of skills present on the board, and how they fit with the company's long-term strategy. Discussions were also held on remuneration, and we provided examples of best practice.

We had a detailed discussion with a multinational oil and gas corporation covering a range of governance matters. After noting the 45% vote in favour of implementing majority voting we encouraged the board to implement this standard into the bylaws in order to build investor confidence. In relation to the substantial vote in favour of an independent chair policy, we reiterated some of our suggestions to increase the powers of the presiding director. We also noted that there is an increasing trend towards independent chairs at US companies and that a CEO who steps down from chair to enable an independent chair to be appointed would be viewed as a leader in US corporate reform. We emphasised that calls for greater transparency were not going to disappear, so the company could position itself more positively by embracing some reform. The company was encouraged to consider a greenhouse gas target per barrel of oil equivalent or per dollar of revenue. Regarding board structure, we gained some reassurance about succession planning.

Along with other investors which are part of the EOS-led engagement group, we met with the chair of a global metals and mining company. We emphasised the need for regular shareholder dialogue with the chair (consistent with the company's peers) and tested whether the corporate culture embedded sustainability into the business. It was interesting to note the emphasis on the sustainability credentials of the two most recently appointed non-executive directors; we requested that the company articulate this information in its public reporting, which it agreed to do. We flagged the perception amongst some stakeholders that the sustainability successes at the company were due to an individual amongst the senior management, and questioned to what extent the chair could correct such thinking. We also had a positive and interactive meeting with the company's new chief sustainability officer. The CSO shares many of his predecessor's sentiments, demonstrating a particular expertise in community relations which is helpful as this is the area in which the company continues to be under scrutiny. It was acknowledged that the company has historically been poor at addressing and replying to campaigns, articles and shareholder concerns, to the detriment of its reputation. The CSO therefore agreed that setting up a reputation risk committee would be beneficial to improve communication channels.

Engagements on strategy



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.

Overview

We actively participate in debates on public policy matters to protect and enhance value for our 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

EU consultation on post-2030 energy policy

We responded to an EU consultation on energy policy post-2030. We pointed out the importance of appropriate incentives for long-term investment as an instrument for future energy policy. We underlined that we are keen to avoid further market fragmentation caused by unilateral national measures. In that regard, we called for the emissions trading scheme to be appropriately modified and strengthened so that it can fulfil its purpose as a significant driver of decarbonisation. Specifically, we recommended the removal of the structural surplus of permits and the adoption of supply-regulating additional measures. We also urged that any measures adopted have time horizons consistent with those for infrastructure investment. We made clear that regulatory certainty, along with a strong price signal from the emissions trading scheme, is a key requirement for an effective energy policy.

Roundtable with Japanese companies

We provided the main speaker at a roundtable event with 18 company representatives to exchange views about current corporate governance practices in Japan. Reviewing the last AGM season, we welcomed the surge in the number of companies to have appointed independent non-executive directors. We had some in-depth discussions about the definition of independence and emphasised the importance of making transparent the nomination process in order to provide assurance to shareholders. We encouraged companies to improve access to board members, particularly providing opportunities for investors to meet with independent non-executive directors, noting that this is standard practice in other markets. Companies sought our views about poison pills, which have been widely adopted in Japan.

Preparation of engagement on water risk via PRI

We participated in a number of conference calls with a group of investors in preparation for collaborative engagements on water risk using the PRI clearinghouse mechanisms. We contacted providers of a variety of mapping tools to get an idea of the methods to measure water risks. In particular, we spoke with the World Resources Institute (WRI), PwC, WWF and Trucost to compare their methodologies and data sources. A lack of reliable data is recognised throughout the regions and while PwC and Trucost fill the gaps with modelled data, WRI has a tool that works with water data on a river basin level. While WRI's Aqueduct tool offers some of the most granular mapping available, it does not as yet support superimposing operational sites onto exposed locations. WWF uses company data and their tool, while less sophisticated than some commercial solutions, can be tailored to specific sectors and companies.

As part of our preliminary discussions we also contacted a number of companies to discuss the tools they use to manage their exposures to water risk. We discussed in detail one company's efforts to manage its two biggest impacts, raw materials production and wet processing. We discussed potential engagement approaches with a range of ESG

analysts. The main challenges that emerged from these discussions are locating issues with sufficient precision and determining correctly the materiality of risks for different sectors. Most analysts agree that the available data is patchy and awareness of the need to report on this aspect of supply chain risk may be lacking at most companies. Although different addressees for engagement, such as regulators, farmers and water traders, were discussed, we welcomed agreement that we should engage directly with companies.

Other work in this quarter included

Promoting best practice

- We sent a letter to the Bipartisan Policy Center that is working with a number of North American retailers and apparel brands on developing a response to the recent tragedies in Bangladesh. We set out our expectation that the agreement should encourage collaboration with the signatories of the Accord on Fire and Building Safety in Bangladesh and be powerful enough to solve the systemic problems of the garment industry in that country.
- We took part in the latest roundtable of the Enhanced Disclosure Task Force, hosted in Basel by the Financial Stability Board. We were among a handful of investors to take a leading role in pressing for better practice among banks in putting the EDTF recommendations (which we helped develop) appropriately into practice. Alongside other investor members of the EDTF we had mounted a review of the delivery of adherence to the key recommendations by leading banks and made clear the extent of the difference between our views of what they had done and the banks' own self-assessment; we also shared our own individual analysis of delivery against one of the other recommendations.

Public policy

- We submitted requested comments to the Canadian Securities Regulators (CSA) and the Autorité des Marchés Financiers (AMF), the Quebec securities regulator, on regulation of shareholder rights plans and defensive tactics and various related amendments to securities laws. The regulators are seeking new rules for rights plans because bidders who seek control but are held back by rights plans inevitably go to the CSA to seek regulatory relief to allow their bid to proceed. The two regulators put forward different solutions. We recommended that the regulator set out minimum provisions for rights plans, which mirror those of the newer generation of Canadian rights plans. We supported the frequent shareholder re-approval of rights plans required under the CSA draft policy. Finally, we put forward the position that if the regulators continue to allow the adoption of tactical rights plans in the face of a hostile bid, any vote to remove such plans at a special meeting called for that purpose should exclude votes cast by management and directors.
- We met with the under-secretary of state for foreign affairs to discuss the ongoing demonstrations in Brazil and to share our concerns about the growing influence and control of the state in business activities. Over the last few months, Brazil has seen the largest demonstrations for more than 20 years. We questioned what changes one could expect to deal with the situation and manage the Brazilian government's tarnished image with foreign investors.
- We responded to a further request for input from the UK's Competition Commission as part of its work to enhance competition in the audit market. Specifically, the Commission asked whether investors support its proposal to reduce the period in which an audit tender must occur from the 10 years now in place under Financial Reporting Council requirements to five years. We indicated our favouring of the longer time horizon. We also noted that we welcomed the other decisions taken by the Competition Commission, which have closely reflected our broader input to the process.
- We met with the commissioner to discuss our recent letter to the securities commission's chair with our recommendations regarding the nomination and election of directors. The commission is working on a revision of its article 481 regarding directors' election, nomination process as well related party transactions, and had asked for our views on the matter. We offered to help gather other international investors' views and to coordinate a group response once the consultation goes live around the end of the year.
- We met with the president and COO of the main market division of Korea's stock exchange raising concerns that the Code of Best Practices for Corporate Governance has not been updated in the last 10 years but welcomed news that a revision is underway and expected by early 2014. We welcomed amendments to the Fair Trade Act to lower materiality thresholds for disclosure of related party transactions. Plans were discussed to make sustainability reporting compulsory for listed companies. Lastly, we pointed out that Corporate Governance Services, an exchange organisation in charge of administering the Code, consists mostly of academics and suggested that it should include some business representatives in order to provide practical advice.
- We wrote to NASDAQ urging it to propose a rule for adoption by the Securities and Exchange Commission requiring listed companies to use a majority voting standard in uncontested director elections. We highlighted the existence of this fundamental shareholder right in nearly all major markets, as a mechanism to reflect the democratic will of shareholders. We expressed our preference for true majority voting.
- We took part in a roundtable discussion on the impacts and implications of the new EU bank pay requirements known as CRD IV with a key remuneration consultant that advises a significant number of leading European banks. These new EU rules will limit incentive pay for the bulk of risk-taking and senior staff to one times fixed pay, or two-times with shareholder approval. We took the opportunity to press hard for a model which sees that a significant portion, if not all, of the inevitable increase in fixed pay is made up of shares which must be held for a significant period of time. This model should at least ensure that the link to performance and the need to preserve the bank is maintained at the forefront of employees' minds.

Working with other shareholders

- We met with a managing director of Central Huijin Investment in Beijing. Central Huijin is a state-owned investment company and is a wholly-owned subsidiary of China Investment Corporation (CIC). The discussions focused on roles of institutional investors in corporate governance and risk management. We discussed the priority areas where Central Huijin actively engages with investee companies. We shared views and experience in engaging with major global banks in other markets on corporate governance concerns, and tested what Central Huijin had done differently in its approach to governance, internal control and risk management at major Chinese banks especially after the financial crisis.

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.

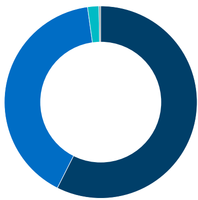
In most cases of a vote against at a company in which our clients have a significant holding we follow up with a letter explaining our concerns. We maintain a database of voting and contact with companies and if we believe further intervention is merited, we include the company in our main engagement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

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

Overview

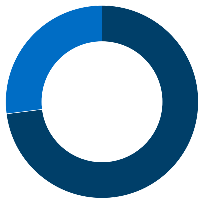
Over the last quarter we voted at 1,187 meetings (9,604 resolutions). At 479 of those meetings we opposed one or more resolutions. We voted with management by exception at three meetings and we abstained at 22 meetings. We supported management on all resolutions at the remaining 683 meetings.

Global
We voted at 1,187 meetings (9,604 resolutions) over the quarter.



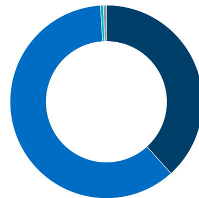
- Total meetings voted in favour **57.5%**
- Meetings where voted against (or voted against AND abstained) **40.4%**
- Meetings where abstained **1.9%**
- Meetings where voted with management by exception **0.3%**

Australia and New Zealand
We voted at 37 meetings (168 resolutions) over the quarter.



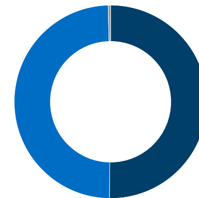
- Total meetings voted in favour **73.0%**
- Meetings where voted against (or voted against AND abstained) **27.0%**

Developed Asia
We voted at 214 meetings (1,480 resolutions) over the quarter.



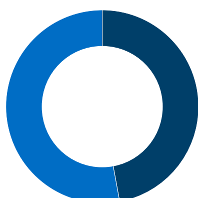
- Total meetings voted in favour **38.3%**
- Meetings where voted against (or voted against AND abstained) **60.7%**
- Meetings where abstained **0.5%**
- Meetings where voted with management by exception **0.5%**

Emerging and Frontier Markets
We voted at 269 meetings (1,863 resolutions) over the quarter.



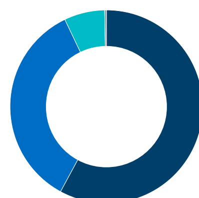
- Total meetings voted in favour **50.2%**
- Meetings where voted against (or voted against AND abstained) **49.4%**
- Meetings where voted with management by exception **0.4%**

Europe
We voted at 136 meetings (997 resolutions) over the quarter.



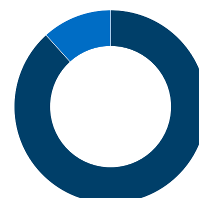
- Total meetings voted in favour **47.1%**
- Meetings where voted against (or voted against AND abstained) **52.9%**

North America
We voted at 309 meetings (2,401 resolutions) over the quarter.



- Total meetings voted in favour **57.9%**
- Meetings where voted against (or voted against AND abstained) **35.0%**
- Meetings where abstained **6.8%**
- Meetings where voted with management by exception **0.3%**

UK
We voted at 222 meetings (2,695 resolutions) over the quarter.



- Total meetings voted in favour **88.3%**
- Meetings where voted against (or voted against AND abstained) **11.7%**

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