OUTCOMES BEYOND PERFORMANCE

PUBLIC ENGAGEMENT REPORT

Boiling points – What to do when corporate governance erupts

Hermes EOS
Q1 2017

HERMES
INVESTMENT MANAGEMENT

www.hermes-investment.com

This report contains a summary of the stewardship activities undertaken by Hermes EOS on behalf of its clients. It covers significant themes that have informed some of our intensive engagements with companies in Q1 2017.

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

What is Hermes EOS?

Hermes EOS helps long-term institutional investors around the world to meet their fiduciary responsibilities and become active owners of public companies. Our team of engagement and voting specialists monitors the investments of our clients in companies and intervenes where necessary with the aim of improving their performance and sustainability. Our activities are based on the premise that companies with informed and involved shareholders are more likely to achieve superior long-term performance than those without.

Pooling the resources of other like-minded funds creates a strong and representative shareholder voice and makes our company engagements more effective. We currently act on behalf of 42 clients and £264.2/€308.9/$330.4 billion* in assets under advice.

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

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

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

How does Hermes EOS work?

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

The Hermes Responsible Ownership Principles[1] set out our fundamental expectations of companies in which our clients invest. These cover business strategy, communications, financial structure, governance and management of social, ethical and environmental risks. The engagement programme we have agreed with our clients, as well as the Principles and their regional iterations, guide our intervention with companies throughout the world. Our approach is pragmatic, company- and market-specific, taking into account the circumstances of each company.

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

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

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

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

We would be delighted to discuss Hermes EOS with you in greater detail.
For further information please contact:
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* as of 31 March 2017

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

Hermes EOS team

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Engagement Support and Client Service

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Engagement by region

Over the last quarter we engaged with 234 companies on 558 environmental, social, governance and business strategy issues and objectives. Our holistic approach to engagement means that we typically engage with companies on more than one topic simultaneously.

Global

We engaged with **234** companies over the last quarter.

- Environmental **20.4%**
- Social and ethical **21.0%**
- Governance **40.7%**
- Strategy, risk and communication **17.9%**

Australia and New Zealand

We engaged with **one** company over the last quarter.

- Environmental **100.0%**

Developed Asia

We engaged with **42** companies over the last quarter.

- Environmental **13.8%**
- Social and ethical **25.2%**
- Governance **41.5%**
- Strategy, risk and communication **19.5%**

Emerging and Frontier Markets

We engaged with **38** companies over the last quarter.

- Environmental **27.7%**
- Social and ethical **20.8%**
- Governance **34.7%**
- Strategy, risk and communication **16.8%**

Europe

We engaged with **52** companies over the last quarter.

- Environmental **10.0%**
- Social and ethical **17.1%**
- Governance **50.0%**
- Strategy, risk and communication **22.9%**

North America

We engaged with **61** companies over the last quarter.

- Environmental **28.8%**
- Social and ethical **27.0%**
- Governance **35.1%**
- Strategy, risk and communication **9.0%**

United Kingdom

We engaged with **40** companies over the last quarter.

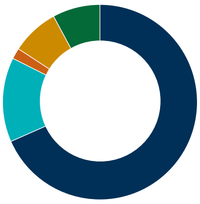
- Environmental **26.8%**
- Social and ethical **13.4%**
- Governance **39.0%**
- Strategy, risk and communication **20.7%**

Engagement by theme

A summary of the 558 issues and objectives on which we engaged with companies over the last quarter is shown below.

Environmental

Environmental topics featured in **20.4%** of our engagements over the last quarter.



- Climate change **68.4%**
- Environmental policy and strategy **14.0%**
- Forestry and land use **1.8%**
- Pollution and waste management **7.9%**
- Water **7.9%**

Social and ethical

Social topics featured in **21.0%** of our engagements over the last quarter.

- Bribery and corruption **12.8%**
- Conduct and culture **18.8%**
- Cyber security **4.3%**
- Diversity **3.4%**
- Human capital management **0.9%**
- Human rights **29.9%**
- Labour rights **17.1%**
- Supply chain management **12.8%**

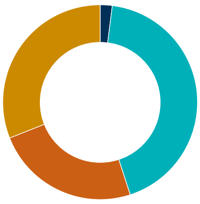
Governance

Governance topics featured in **40.7%** of our engagements over the last quarter.

- Board diversity, skills and experience **26.4%**
- Board independence **18.9%**
- Executive remuneration **28.6%**
- Shareholder protection and rights **16.7%**
- Succession planning **9.3%**

Strategy, risk and communication

Strategy and risk topics featured in **17.9%** of our engagements over the last quarter.



- Audit and accounting **2.0%**
- Business strategy **43.0%**
- Integrated reporting and other disclosure **24.0%**
- Risk management **31.0%**

On the road to sustainability – Transitions in the automotive industry

Our engagement with the automotive industry has intensified after scandals hit several car-manufacturers around the world.

Setting the scene

The car industry has had a few tumultuous years. One of the biggest corporate scandals to emerge was the installation of defeat devices by German car manufacturer Volkswagen in millions of its vehicles, which detected when they were subject to emissions tests. According to the US Environmental Protection Agency, the cars would switch on emissions-control devices for tests but on the road emit much higher levels of nitrogen oxide. In Japan meanwhile, Mitsubishi Motors and Suzuki Motor were found to be undertaking improper fuel efficiency tests on the cars they sell in their home market, while Nissan has been found guilty by a Korean court of using diesel emissions cheat devices in vehicles it sold in South Korea.

Governance roots

We have engaged with the car manufacturers on the root causes of their emissions or fuel efficiency controversies. We believe that failures in their governance and a flawed culture, in which a concentrated ownership structure may have played a role, are likely to have contributed to the unfolding of these scandals.

We have therefore pushed for more independent oversight, as well as the relevant experience and expertise, at the board level of the companies concerned and for a culture that empowers employees to speak up to ensure that the trust of customers and the societies in which the businesses operate and distribute their vehicles will not be compromised again.

Following our engagement on the issue at Nissan, for example, we welcomed the news that the company's joint chair and CEO is stepping down as CEO, citing his additional responsibilities as chair of Mitsubishi Motors, which the carmaker partially acquired at the end of 2016. He will remain chair of Nissan and is also the chair and CEO of Renault, which owns 44% of Nissan Motor.

Low-carbon economy

However, the focus on emissions in the automotive sector is not purely related to past controversies.

Transportation makes up nearly a quarter of energy-related emissions globally, of which passenger cars and trucks represent over half, according to the International Energy Agency (IEA). To limit global warming to 2°C or below, in line with the 2015 Paris Agreement on climate change, the automotive industry thus has a crucial role to play in cutting emissions as it is exposed to climate change through the emissions of its products, manufacturing facilities and global supply chains. This is particularly important as the sector is facing a large number of reduction targets on CO2 and other pollutants. The EU, for example, has set a CO2 emissions target of 95 grammes per kilometre by 2021, a reduction of over 25% on the 2015 target of 130 grammes per kilometre. To date, several carmakers are on course to miss the 2021 CO2 emissions targets,[2] according to PA Consulting.

In addition, the International Council on Clean Transportation has reported an increasing gap[3] between real-world emissions from cars and officially reported levels, a gap which has widened from 8% in 2001 to 38% in 2014.

The move towards a low-carbon economy, fluctuations in demand and technological achievements put pressures on the automotive industry to undergo a significant transformation in the short to medium term. Business models that are resilient to stricter environmental regulations are also required. Changing mobility patterns, such as car-pooling and car hires, further disrupt existing strategies. As part of our engagement, we have therefore challenged car manufacturers about their business models.

At one car manufacturer, for example, we expressed concerns that it appears to lag its peers in terms of CO2 emissions per vehicle. Understanding that this might be because of the increased sales of sport utility vehicles in the US and China, we questioned its strategy for meeting emission targets in the EU, Japan and the US. The company told us that its targets are based on the 2015 Paris Agreement's 2°C scenario, which means that it needs to derive half of its sales from hybrid and plug-in hybrid vehicles and 15% from fuel cell and battery electric vehicles by 2030. While the company admits that this is a difficult target to meet, it is already working with other businesses on the development of batteries and motors.

Electrification

Automobile companies are slowly realising that the future of transportation will be based on sustainable low-carbon technologies, such as sustainable drivetrain technologies and electric vehicles, potentially combined with increased automation, for example in the shape of self-driving cars.

Widespread electrification of the global vehicle fleet is necessary to meet the climate goals set out in the Paris Agreement. Approximately 1.5 million electric vehicles currently exist globally and the IEA estimates that we will need 100 million of these by 2030 to meet the Paris commitments. The widespread adoption of so-called advanced vehicles is likely to depend initially on the incentives provided by governments to switch from combustion engine-propelled vehicles to electric cars.

There is no denying that we have entered a transition period, away from traditional petrol and diesel fuel cars to more sustainable vehicles. At current growth rates, electric vehicles will supply all global incremental demand for cars within five years,[4] according to TSL Research Group. This is underpinned by the ongoing decline in battery costs,[5] which means that in some markets cost parity with internal combustion engines will be reached by 2020. In addition, battery storage capacities are expected to improve to increase the distances cars can cover.

We believe that companies that are reluctant to adapt to a more sustainable future of driving, whether it will be hybrid or fully electric cars, will not survive or merge with other automotive companies. A lot of collaboration is already underway, particularly in Japan and Germany, for example between Suzuki Motor and Toyota Motor, and between BMW and Toyota, as well as between BMW and Daimler. However, as sales of electrified models have failed to take off in a meaningful way, automobile companies must take care in managing the transition and ensure they are producing models for which there is a demand.

In 2016, BMW, Daimler, Ford, General Motors and Volkswagen all announced strategies with an increased focus on electric vehicles, Volkswagen set out its goal of producing one million plug-in electric vehicles by 2025, while Daimler stated its intention to launch 10 fully electrified vehicles by 2025. BMW meanwhile announced that it wants to generate 15-25% of its revenues from electric and plug-in-hybrid vehicles by 2025.

For vehicle manufacturers to stay ahead of the curve, it is important to acknowledge the move towards a low-carbon economy, including upcoming tighter environmental regulation. Their product pipelines need to reflect this move by re-focusing on sustainable technologies beyond the production of diesel and petrol-powered cars and other forms of mobility services.

We have discussed with Daimler the development of a sound roadmap for sustainable vehicle models and with Hyundai the expansion of its sustainable vehicles portfolio. At BMW, we gained reassurance that the company is making good progress towards developing and equipping its fleet with sustainable zero-carbon drivetrain technologies.

As such, although petrol and diesel-powered cars will continue to exist for the foreseeable future, we will push for a growing percentage of the overall sales of car manufacturers to come from electric vehicles, or request explanations as to how their business models will be sustainable without.

Roadblocks

However, several obstacles lie on the way to more sustainable vehicles. A key challenge for the sector is the further reduction of battery costs to allow the phasing out of subsidies and improve the capacities of advanced vehicles. A lack of charging points is another.

For automotive companies, innovation in alternative driving technologies is therefore key. This can include capital expenditures on research and the development of new technologies, more fuel efficient engines, better-performing batteries and the use of lighter materials. Closer cooperation with suppliers might be necessary to accomplish this goal, but vehicle manufacturers must be aware of potentially increased competition for significant production factors that are likely to influence the efficiency of cars. This includes self-driving technologies.

Investor expectations

As a shareholder representative, we need to ensure that each investee company is prepared for the challenges of climate change and that robust policy action is taken to address the transition to a low-carbon world.

The Investor Expectations of Automotive Companies[6] guidance by the Institutional Investors Group on Climate Change, of which we were the lead author, was welcomed by the European Commission at a roundtable discussion of the GEAR 2030 High Level Group on Automotive Industry in Brussels. In it, we outline five expectations investors have of automotive companies, relating to governance, strategy implementation, emissions management, public policy, as well as transparency and disclosure.

Investors expect car manufacturers to have in place appropriate governance structures to ensure that board and management responsibilities in relation to climate change risks and opportunities are clearly defined. They also want automotive companies to develop a long-term strategy which makes the business resilient to climate change and incorporates key industry trends, such as sustainable vehicles technology and digitalisation. Investors expect that a robust greenhouse gas emission reduction plan is in place for the fleet and assembly operations that are sufficient to close the gap between real world and laboratory testing conditions. They also want to see automotive companies engage with public policy-makers to accelerate the transition to a low-carbon economy in line with a 2°C scenario. Furthermore, investors expect automotive companies to disclose in their annual reports and financial filings their position on climate change and emissions regulations, as well as their own fleet and manufacturing emissions.

Next steps

The Volkswagen scandal was, in our view, a contributing factor to the transition that is now happening at a greater pace in the automotive industry and has led to a growing awareness of emissions and sustainable drivetrain technologies.

In our engagement, we will continue to press car manufacturers to develop a sound roadmap for sustainable vehicle models. We also want them to set out a strategy designed to reduce fleet emissions over the next 20 years and publicly back policies that support emissions reduction over time. Furthermore, they need to comply with local air pollution legislation and be supportive of constructive public policies for more robust testing regimes that are reflective of real-life driving conditions. At the moment, our focus is on passenger cars, with heavy duty vehicles such a trucks and busses set to follow further down the road.

In terms of public policy, we will continue to collaborate with the Institutional Investors Group on Climate Change and continue to engage with the European Commission on climate change regulation, emission testing regimes and the future of the automotive industry.

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[2] http://www.paconsulting.com/insights/the-co2-emissions-challenge/
[3] http://www.theicct.org/laboratory-road-2015-update
[4] http://www.trustedsources.co.uk/new-energy/electric-vehicles/the-end-of-the-ice-age
[5] Berenberg Thematics, Battery adoption at the tipping point
[6] http://www.iigcc.org/publications/publication/investor-expectations-of-automotive-companies-2016

Social

Out of the shadows – Tackling bribery and corruption

Addressing bribery and corruption at companies is part of our engagement on social and ethical matters.

Setting the scene

South Korea's embroilment in a corruption scandal, which reached the highest level of its government and businesses, has severely tarnished the reputation of the country's flagship companies. In Brazil, meanwhile, the corruption scandal affecting state-owned energy company Petroleo Brasileiro and politicians – which again involved the country's government – had a similar impact. Also in Brazil, food company JBS is under investigation for allegedly bribing food inspectors to release shipments of beef deemed inappropriate for human consumption. These are just some of the more recent in a long line of high-profile cases which confirm that the threat of bribery and corruption is seemingly omnipresent and difficult to address.

Impacts

The fight against corruption – the abuse of entrusted power for private gain – and bribery – the offering, promising, giving, accepting or soliciting of an advantage as an inducement for an illegal or unethical action – is an important part of our engagement programme. These criminal activities encompass all sectors and countries but prevail in some economies more than others, often taking place at companies that have ties to a country's government.

Bribes cost the global economy annually between $1.5-2 trillion, around 2% of the world's entire gross domestic product, according to the International Monetary Fund.[7] The cost of overall corruption is said to be much higher, as bribes are only one of many forms of corruption.

Corruption distorts market mechanisms, like fair competition, and hinders normal economic development by deterring domestic and foreign investments and stifling growth, innovation and future business opportunities. In addition, corruption can also be used to cover up fundamental breaches of human rights, such as poor health and safety standards or working practices.

Corruption is a key concern for investors as it threatens the long-term sustainability of companies by increasing their reputational, legal and operational risks and costs, forming part of the long-tail risk and potentially destroying shareholder value. It hurts investments by increasing costs, affecting margins and by diverting resources that could be allocated elsewhere.

Because of the negative impacts of these crimes on local communities, and sometimes entire economies, as well as returns to shareholders, we advocate a zero tolerance approach. This is in line with Principle 10 of the UN Global Compact, which states that businesses should work against corruption in all its forms, including extortion and bribery.

Systems and controls

Corruption and bribery should regularly feature as an item on board agendas, particularly as enforcement bodies have stepped up their efforts to curb malpractices. The UK's Serious Fraud Office, for example, is beginning to establish a successful track record of enforcement in relation to corruption.

Companies that are the most exposed to corruption often operate in high-risk sectors, such as extractives, pharmaceutical, banking and defense, or in countries perceived to be at high risk from corruption. However, it is important to note that bribery and corruption can occur anywhere, even in the unlikeliest places and companies.

In our engagement on bribery and corruption with companies, we commend good behaviour and encourage best practice. Based on our experience, exemplary behaviour with regard to anti-corruption and bribery measures often occurs at companies that have had problems in these areas in the past but have since learned their lessons and implemented effective controls, including work on embedding ethical values and training to improve conduct. On the other hand, companies that have managed to avoid any related investigations to date can at

Source: These are extracts of some of the ethics training material of Rolls-Royce, which the company shared with us.

times push bribery and corruption further down their list of priorities and underestimate the efforts needed to keep their business clean.

We encourage the implementation of legislation to the standards prescribed, for example, by the US Foreign Corrupt Practices Act and the 2010 UK Bribery Act. However, while codes of conduct and policies are essential tools for companies to have in place to set out their expectations, they are also insufficient. The application of the codes is what really matters and thus we want to hear from companies about their ethical values and how they seek to ensure that their staff, representatives and suppliers adhere to them. To that extent, we believe a tone from the top is critical.

In addition, we expect to see regular anti-bribery and corruption training for employees across all of a company's operations, from managers and supervisors to contractors.

Furthermore, companies ought to have in place robust whistleblower mechanisms and ensure no recriminatory action against whistleblowers that act in good faith. Importantly, companies should also provide adequate disclosure of their anti-bribery and corruption systems and controls, including reporting that demonstrates their working to ensure ethical conduct.

However, ethical, corruption-free conduct is difficult to establish and promulgate, which is why we encourage companies to take an honest view on how good their culture is and move beyond a legalistic approach. We advocate a holistic look at the issues, involving a human resource, as well as a legal, compliance approach. Effective corporate management of bribery and corruption, but above all setting and nurturing the highest ethical standards in every part of the organisation, demonstrates strong governance and internal controls.

Company engagements

To be able for us to complete an engagement on bribery and corruption, we want to see a genuine board commitment to best practice anti-bribery and corruption standards. The board should communicate the company's aspiration to be a leader in standards of ethical business conduct and be open and transparent, with relevant policies and procedures publicly and easily available, in particular a comprehensive global code of ethical business conduct.

We also need to see a thorough programme in place to identify exposures, including country, business unit-specific, transaction, third party and business opportunity related risks. All business decisions should include an explicit assessment of ethical risk with a board approval and review process in place for high-risk activities.

Additionally, we expect to see detailed risk evaluation, documentation, communication and execution of the programme, including role and situation-specific training, with a thorough review of internal audit reporting to the independent risk, audit or conduct committee, and regular formal reviews.

Due diligence must be undertaken on a risk-based approach over all third parties in all majority joint ventures, as well as material suppliers and contractors, who should be required to adopt the company's standards on ethics. Whistleblower protections and facilities ought to be extended to suppliers and other stakeholders.

We have worked closely with many companies with high-profile corruption allegations against them – such as European defence and engineering, North American engineering and retail, and emerging market companies, as well as banks globally – and pushed them to adopt the best practices of businesses that have faced similar allegations. We strongly encourage those that to date have not been involved in corruption allegations to benchmark themselves against best practice.

Best practice

In our view, one of the current best practice examples is UK engineering company Rolls-Royce. The company managed to negotiate a deferred prosecution agreement with the US and UK authorities when bribery and corruption allegations emerged. The agreement specifically mentioned its reconstituted board as leading a thorough remedial campaign. We also commended the company's willingness to share its anti-bribery and corruption training materials, including permitting us to publish extracts to share its best practice more widely. We were therefore able to conclude our engagement, which has involved meeting a variety of the company's senior managers and directors, including the chair, to understand its actions better and encourage a best-in-class ethics, anti-bribery and corruption programme.

Policy engagements

At a policy and best practice level, we were a leader of the anti-corruption engagement work of the Principles for Responsible Investment and have spoken on a number of public platforms on this topic, including the UN Global Compact's anti-corruption conference. We continue to take part in conferences to see how best practice is evolving and to make clear to participating companies that long-term investors are their allies in pushing for the highest standards.

We also participate in a variety of best practice organisations and have connections to non-governmental organisations that fight corruption, such as Global Witness, Transparency International, the UK's All-Party Parliamentary Group on Anti-Corruption and the Institute of Business Ethics, to collaborate on our engagement with companies, as well as encourage best practice legislation on corruption and fend off any potential weakening of existing laws or their enforcement globally.

In our dialogue with regulators, we have been encouraging the introduction of anti-bribery legislation similar to the US Foreign Corrupt Practices and UK Bribery Act and its consistent reinforcement.

Outlook

Positively, best practice continues to evolve, also in part due to advances in technology and big data that can help companies trace and track bribes and corrupt activities more easily.

As part of our engagement, we will continue to assess and monitor the processes companies have in place to ensure anti-corruption policies and programmes are rolled out across all sites and operations.

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[7] http://www.imf.org/external/pubs/ft/sdn/2016/sdn1605.pdf

Boiling points – What to do when corporate governance erupts

We have been engaging intensively with companies that have been involved in headline-grabbing controversies.

Setting the scene

Corporate governance has always been a prominent part of our engagement with companies, as well as on a public policy level. It often is the basis of our dialogue with companies as we believe good corporate governance can pre-empt environmental, social and strategic issues or make it easier to address them and effect change. Poor corporate governance structures on the other hand can lead to environmental and social problems that can have a significant impact on the reputation of companies and may affect their value. In 2016, corporate governance themes made up over 43% of our overall engagements.

Arrests and charges relating to bribery and corruption, revelations of poor working practices, an unexpected sacking of the chair and an emissions scandal – Samsung Electronics, Sports Direct, the Tata Group and Volkswagen have all been in the press for the wrong reasons.

We have been engaging with three out of the four companies for a number of years and intensified our engagement with Tata Sons, the holding company of Tata Motors, Tata Steel and Tata Consultancy Services (TCS) since the ousting of its chair.

Volkswagen

Our engagement on what we perceive to be a poor board composition at the world's largest car manufacturer Volkswagen dates back to the company's 2006 and 2007 AGMs. While the company complies with the German Corporate Governance Code, in our view, its supervisory board lacks an appropriate number of independent directors with the relevant experience and skills, as most of them are directly affiliated with the Porsche-Piëch families and other major shareholders. Together with an apparently flawed culture, we believe this structure may have contributed to the unfolding of the company's emissions scandal in 2015, which has not only led to significant fines and settlements but also caused severe damage to the car manufacturer's reputation.

The company's highly concentrated ownership structure – in total, approximately 90% of the company's voting shares are held by the Porsche-Piëch families, Qatar Investment Authority and the State of Lower Saxony – makes engagement more challenging. As our limited number of voting rights has restricted the influence we want to have, we have used a range of different engagement techniques and started to collaborate with other shareholders, particularly in the wake of the emissions scandal.

In 2016, for example, we initiated and backed shareholder resolutions at the company seeking the appointment of a special, independent auditor to investigate the underlying causes of the emissions scandal. Our resolution was rejected by the controlling shareholders but subsequently filed at the regional court. We also spoke on behalf of a group of investors at the company's AGM, criticising its supervisory board composition and the remuneration policy, which, in our view, does not properly incentivise managers to generate long-term, sustainable value for shareholders and other stakeholders.

We are pleased that our persistent, private and public and collaborative engagements have borne some fruit. Over the last year, Volkswagen and in particular the chair of its supervisory board have become more open towards a dialogue with investors and the company has embarked on a new strategic direction. We have met its chair three times since the scandal broke. He informed us that the company will reform its executive remuneration policy with input from major institutional shareholders, which we have strongly pushed for. Electrification and digitalisation of vehicles are now also an integral part of the company's strategy.

One setback has been the resignation of the head of compliance and legal affairs after just one year, who was brought in after the emissions scandal specifically to address the company's culture. We plan to attend Volkswagen's 2017 AGM to reiterate our concerns about its governance practices.

Sports Direct

Another company we have engaged with intensively since 2007 is UK retailer Sports Direct. Our focus has been on the ability of the board to exercise independent oversight of management and adequately represent the interests of the company's minority shareholders. While its board may appear diverse, comprising retail experience and independence, in reality the influence of its founder and now also CEO, who holds a 55% share in the company, is evident.

In 2015, an undercover report revealed poor practices, including in terms of working conditions, pay and contract terms, at one of its warehouses, which added to our concerns. We have also addressed executive remuneration, the company's expansion strategy into Europe and its lack of investor communications.

As part of our engagement, we had meetings with the chair, senior independent director, chair of the remuneration committee and former CEO and CFO of the company. We wrote letters to its board to push for reviews of labour practices and governance and better communications with its shareholders. We have also collaborated with other shareholders, including through the UK's Investor Forum. Furthermore, we opposed the re-election of the chair, two non-executive and two executive directors. We supported a shareholder proposal put forward by a labour union calling for the board to commission an independent review of the company's human capital management strategy. In total, 53% of minority shareholders voted against its chair in 2016. This was reconfirmed by an opposition of 54% of the group's minority shareholders at a subsequent EGM. However, the chair remains in position after backing from the founder.

At the AGM, the board was conciliatory and contrite in the remarks it made and in answering questions, in particular on the issue of working conditions. Led by the founder, the board also held a warehouse tour and open day question and answer session for all interested parties. Furthermore, we welcomed the candour of the company's working conditions report, which was released the day before the AGM, and the board's acceptance of responsibility and specific solutions contained therein. The announcement of an independent governance review – although conducted by the company's law firm – and the stepping down of its interim CFO, as called for by the Investor Forum, has been positive. In March 2017, the company also announced the appointment of a worker representative to its board.

It is unclear how the engagement will progress from here. As a representative of minority investors, we will continue to seek to constructively promote changes to the company's governance which benefit the founder and minority investors alike.

Samsung Electronics

In South Korea meanwhile, the vice chair and acting leader of Samsung Electronics has been arrested and charged with bribery offences in connection with the presidential corruption scandal engulfing the country. This follows a tough year for the company in which its Galaxy Note 7 handset was recalled after faults in its batteries caused some devices to catch fire.

The governance structure of the company is that of a chaebol, a large, family-controlled business conglomerate with substantial cross-shareholdings. Chaebols were instrumental to the country's rapid industrialisation and economic growth after the Korean War. They typically have a complicated ownership structure, meaning they own stock in other affiliated companies through a complex, multi-layer and interlocking relationship. In our view, the company's board lacks the relevant international experience.

After initial resistance to our request to have dialogue with its board members, we were eventually able to participate in a meaningful shareholder engagement meeting at the board level, with its CEO, as well as two independent directors. We also sent a private letter to the CEO, seeking a change in the company's board composition, and collaborated with other shareholders on the appropriate restructuring and reform. We were pleased that in the fourth quarter of 2016, the company committed to appointing new board members, in line with our expectations, the establishment of a governance committee composed entirely of independent directors, greater capital efficiency and to undertaking a review of its structure, which is already underway.

We also welcomed the replacement of the corporate social responsibility (CSR) committee with the governance committee, which feeds into the board. This follows our recommendation that CSR should be integrated within the company's business model. Despite these pockets of progress, however, overall its governance still needs further improvements.

With regard to the safety of its products, we believe the company has made good progress in changing its manufacturing process. We have yet to engage in thorough dialogue with the company about its anti-bribery and corruption efforts but expect it to take adequate steps as its success is linked to that of the South Korean economy.

Tata

Indian Tata Group was catapulted into the limelight after it sacked its chair without sufficient explanation – who promptly responded with a public letter in which he outlined issues within the group. An independent director backing him was also removed.

The chair of the family-controlled entity held multiple directorships at the group's listed companies, which raised concerns about the protection of minority shareholders. While we believe his successor has group experience and can steady the company, the individual has strong ties to the controlling family, and we are also concerned about his workload as chair of a number of Tata listed companies. His successor had also been abruptly removed as the CEO of TCS with little prior disclosure of a succession plan. We strongly recommend the appointment of a lead independent director given the board's preference to continue with a non-independent chair.

Through our engagement, we found out that the main discrepancy in views between the ousted chair and other board members appeared to be about the extent of influence of Tata Sons and the strategic direction of the company. As outlined in our letter to the board of Tata Sons, we have pushed for several individual and independent chairs to sit on the largest of Tata's companies to serve shareholder interests better and keep the influence of chairs and nominees of family or founder-controlled shareholders to a minimum. We have also called for better shareholder access to the board, including for minority shareholders, to discuss governance and other concerns, as well as the elimination of historical cross-shareholdings across the Tata companies, acknowledging that some of these holdings have already been reduced. Last, we have advocated for greater board independence, recommending that the nomination and remuneration committees only comprise independent directors, and for the phasing out of cross-directorships of independent directors across the Tata Group companies.

While initially responsive to our engagement efforts, since the letter with our recommendations, we have not heard from Tata Sons. We have sent follow-up correspondence to TCS and Tata Motors for a company-specific discussion as a shareholder representative of these.

Conclusion

The cases outlined above demonstrate how crucial appropriate governance is at a company, because a poor structure can be a contributing factor to environmental and social issues.

While a concentrated ownership structure or family influence does not necessarily mean that a company is not well run, in these circumstances the business needs to ensure that adequate checks and balances are in place to avoid conflicts of interest, concentrations of power and a lack of independent oversight. It also needs to guarantee the protection of minority shareholder rights, which includes granting them access to board members to discuss any concerns. Although major shareholders can expect to have some representation, company boards should comprise of a majority of independent members with the relevant experience and skills. Furthermore, the phasing out of cross-shareholdings and directorships, as well as good communications with shareholders, helps to improve the accountability of companies with concentrated ownership structures.

In difficult cases, where our influence is limited due to the company's ownership structure, we will continue to collaborate with other independent, long-term shareholders to increase leverage and use a wide range of private and public engagement techniques.

Despite our sometimes small economic stakes in companies it is important to continue our engagement in these high-profile cases to set a precedent in a market. In addition, institutional investors in particular can play a role where the parties involved in the governance of an organisation are in conflict.

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The great catch-up – Stewardship developments in the US

Our stewardship efforts in the US have borne some fruit and, we believe, have contributed to the environment in which a flurry of governance and stewardship guidelines have been launched.

Setting the scene

Corporate governance practices and the recognition of the relevance of environmental and social factors by US companies have been different from that of their European counterparts. This was for a long time also reflected in the absence of a corporate governance code and stewardship guidance in the country. However, earlier this year, the Framework for US Stewardship and Governance was launched, the country's version of a stewardship and governance code. It will come into effect on 1 January 2018 to give companies time to incorporate the standards in advance of next year's voting season. This follows the introduction of the Commonsense Principles of Corporate Governance in 2016.

Stewardship Principles for Institutional Investors

A: Institutional investors are accountable to those whose money they invest.

B: Institutional investors should demonstrate how they evaluate corporate governance factors with respect to the companies in which they invest.

C: Institutional investors should disclose, in general terms, how they manage potential conflicts of interest that may arise in their proxy voting and engagement activities.

D: Institutional investors are responsible for proxy voting decisions and should monitor the relevant activities and policies of third parties that advise them on those decisions.

E: Institutional investors should address and attempt to resolve differences with companies in a constructive and pragmatic manner.

F: Institutional investors should work together, where appropriate, to encourage the adoption and implementation of the Corporate Governance and Stewardship principles.

We have welcomed the introduction of what we believe are important developments in the US corporate governance and stewardship landscape and which have the potential to drive improvements in this area. It is a sign that asset owners are beginning to assert themselves and that asset managers have felt under pressure to respond by taking action.

We have for a long time been calling for stewardship codes globally and been involved in their development across the world from Brazil to Singapore. We have therefore contributed to the changing stewardship landscape globally, including in the US. We believe that one of the reasons behind the introduction of the country's stewardship framework is the growing acceptance by many US boards of the value of meaningful engagement at the board level about any issues that could upset the long-term value of the company. A forerunner of the new US initiatives was the Shareholder-Director Exchange, of which we were a founding participant.

Stewardship guidance

We believe that the stewardship framework is on balance positive, even though it does not go as far as we would like in a number of areas.

The Framework for US Stewardship and Governance, to which we, as part of Hermes Investment Management, intend to sign up, aims to set baseline expectations for publicly-listed US companies and their institutional shareholders without being prescriptive. The Investor Stewardship Group (ISG), the collective of large asset owners and managers with over $17 trillion in US equity markets that was behind the development of the framework, encourages institutional investors to be transparent in their proxy voting and engagement guidelines and to align them with the stewardship principles. The principles should not restrict investors from choosing to adopt more explicit and stronger stewardship practices.

However, with our experience in stewardship codes, we feel the US framework is based on the lowest common denominator and should stretch companies and investors further, like the stewardship codes of other countries or the Global Stewardship Principles by the International Corporate Governance Network, without setting too high a bar. One of the main dangers of the stewardship framework is the absence of an enforcement mechanism and a lack of consultation. To ensure a successful implementation of the guidelines and their continuing evolvement, experience suggests that a regulator needs to oversee and enforce their application, as well as review and monitor the principles. The UK, for example, which successfully introduced the blueprint for stewardship codes in 2010 had the Financial Reporting Council (FRC) behind it to ensure widespread implementation, as well as a transparent mechanism for review and enforcement. The FRC has, for example, introduced tiering based on the quality of the disclosure regarding the code's implementation by signatories.

Without appropriate governance of the codes, how can signatories step in to ensure the initiative does not become meaningless over time through a lack of monitoring against its standards and active consultation over its future direction?

We stand ready to participate in the periodic review of the framework based on our extensive involvement with the development of stewardships globally so that it has the best possible chance of gaining traction among investors and companies and increasing the rigour of what are at present undemanding standards.

Corporate governance principles

The emergence of the Commonsense Principles in 2016 and the subsequent Corporate Governance Principles for US Listed Companies[8] are also symptoms of the corporate governance landscape in the US changing for the better, not least because they formally hold company boards accountable for the oversight of assets they entrust in them.

Both sets of principles allow companies to combine the roles of chair and CEO. Nevertheless, they point out that independent leadership of the board is necessary to oversee a company's strategy, assess the performance of management, ensure the effectiveness of the board and board committees and provide a voice separate from management that is accountable directly to shareholders and takes into consideration other stakeholders. We go beyond this, and, as best practice, advocate that the roles be split.

However, at companies where the roles of chair and CEO are combined, we expect to see a lead independent director in place with powers equivalent to those of an independent chair. The lead independent director should be able to challenge the combined chair/CEO and play a significant role in establishing the board and its agenda, as well as in the evaluation of individual directors and the CEO and in the succession planning for the board and CEO. Ultimately, he or she should be accountable for the board, its committees and all of the directors, including the CEO. We also expect the chair/CEO roles to split on retirement of the CEO.

Encouragingly, the separation of chair and CEO continues to grow in the US. We believe that the combined chairs and CEOs of asset managers that have signed the stewardship framework and governance principles should step down as chairs and appoint independent chairs. They could then more easily call for similar steps at their portfolio companies.

However, there have also been negative signs, such as the increasing uptake of dual-class shares in initial public offerings. We believe that dual- or multiple-class share structures allow some shareholders to hold disproportionate voting power in relation to the shares that they own, thus creating an uneven playing field. Any divergence from the one-share one-vote principle can have a disenfranchising effect on minority shareholders and entrench management and poor practice.

Proxy access

In December 2016, proxy access reached its tipping point,[9] with over 50% of S&P 500 companies having adopted proxy access, according to the Harvard Law School Forum on Corporate Governance and Financial Regulation. Proxy access is an important right that gives long-term shareholders a voice in the election of company boards. It enables them to put their nominees for a director's position on the company's proxy, thus avoiding the cost and logistical hurdles of a proxy fight when they are dissatisfied with a board and want to submit their own candidates.

While the increasing adoption of proxy access over the last 24 months has been a welcome first step, the focus now needs to be on encouraging companies to enhance their initial proxy access policies to make them more accessible for use by shareholders. In 2017 to date, we have already seen several shareholder proposals at companies that have recently adopted proxy access seeking an adjustment to the terms of the policies which makes them easier to use. This has included the removal of caps on the number of shareholders who can group together to meet the holdings requirements, as many companies limit it to a group of no more than 20 shareholders to reach the common 3% threshold requirement to nominate a candidate to stand for election as director. This requirement means that often the required 3% cannot be met, even with the 20 biggest asset owners grouped together.

The Trump effect

The stewardship framework and corporate governance principles appear particularly crucial given that US president Trump may seek to dismantle regulations that he believes restrict the freedom of companies, such as the Dodd-Frank Wall Street Reform and Consumer Protection Act, which was introduced in 2010 to avoid a repeat of the financial crisis of the previous years and protect investors.

Following an executive order by the president, US legislature ratified to repeal section 1504 of the Dodd-Frank Act on the disclosure of payments made by extractive companies to foreign governments. The president also signed an executive order to repeal section 1502 of the Dodd-Frank Act, which requires US companies to report on how they manage the risk of conflict minerals in their value chains. The enactment of this rule has helped to improve the management of difficult supply chains and human rights risks, particularly in the Democratic Republic of Congo. Serious abuses of human rights still occur in conflict mineral supply chains and the repeal of the law may result in fewer efforts to resolve them, which is why we signed an investor statement to protest against its repeal.

We do not want to see the safeguards of the Dodd-Frank Act removed and believe that the argument that less regulation is good for companies is overly simplistic. There is a real danger that important protections may be lost, but we are positive that investors will seek to hold companies to account if their governance standards weaken. A lighter touch financial regulation should not automatically lead to less diligence or urgency in risk awareness and management or encourage a focus on short-term returns. However, investors must work hard to reduce the risk of this happening.

In addition, despite the US government's reversal of much of the previous administration's efforts to address climate change, we believe the majority of investors and companies are unlikely to step off the trajectory towards a low-carbon world. Economics, corporate long-term planning and technological advances in renewables mean that coal-based power generation will continue to decline. The apparent failure of the Dakota Access Pipeline project to undertake sufficient due diligence or consultation with the Standing Rock Sioux Tribe and the banks financing the project seemingly to do likewise has shown that companies need to respond sensitively to material shareholder concerns, not just the law.

We therefore continue to engage with US companies with a focus on maintaining appropriate ethical policies, behaviours and cultures to provide private sector leadership.

Outlook

Overall, the developments in stewardship and governance are supportive of our efforts to promote open dialogue between companies and investors in the US. Nevertheless, they require an ongoing commitment to ensure they properly serve the asset owner community and its beneficiaries.

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[8] https://www.isgframework.org/corporate-governance-principles/
[9] https://corpgov.law.harvard.edu/2017/01/16/proxy-access-reaches-the-tipping-point/

Strategy

Engagement on strategy

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

Overview

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

Examples of recent engagements

Board composition

Lead engager: Sachi Suzuki

We were pleased with the significant improvements an Asian company has made to the composition of its board and its overall openness towards the views of investor. The company is proposing to move from its existing two-tier board structure to a unitary one with an audit committee. While we do not welcome such a transition when the motivation is unclear or superficial, the company explained that, by separating the executive and monitoring functions, the move enables the board to focus more on strategy. Encouragingly, this was influenced by the opinions of non-executive directors as part of a board evaluation and learnings from its international business partners, whose decision-making is faster. While we welcomed the appointment of a second woman to the board, we also pushed for internationalisation of the board. The company thinks that this will be difficult, largely because of its remuneration structure and the relatively low levels of pay for directors in its home market. However, it plans to review its executive remuneration structure and increase the portion of variable pay. We suggested that it link the key performance indicators to its new mid-term business plan. Furthermore, we welcomed its intention to continue to sell some of its cross-shareholdings this year. The company faces difficulties in selling the shares of other companies, particularly smaller ones, as their funding from banks would be affected by its sale of their shares.

Board evaluation

Lead engager: Jaime Gornsztejn

We were pleased with the independent external board assessment and the board refreshment undertaken by a European financial institution. We had been engaging with the company on the importance of external board evaluations due to concerns about the effectiveness of its board. As described in its annual report, an external board evaluation was performed and the results presented to the nomination committee. The proposed board refreshment, with four new directors nominated by the committee, filled us with confidence. Their skills, for example, in digital technology and financial services regulation, are aligned with the bank's strategy. The company also described the role of the compliance department, which has been strengthened by the appointments of outsiders and personal investments by senior managers.

Climate change disclosure

Lead engager: Darren Brady

An energy company published its first ever climate change scenario planning and stress-testing report, fulfilling the CEO's commitment to look into the matter as a result of our presentation at its AGM and intensive engagement efforts. We are heartened that the company appears to embrace the notion of increasing its transparency on this subject and are encouraged by its efforts so far. Most importantly, the exercise has led to a healthy, robust dialogue at the company – internally and externally – and demonstrates its commitment to working with investors to expand future versions of the report and undertake regular updates in response to shareholder feedback. Overall, the company's attitude towards enhancing its communications on stress-testing and scenario planning has markedly thawed and it is beginning to more fully embrace the value of these efforts.

Compliance programmes

Lead engager: Jaime Gornsztejn

We were satisfied with the maturity of the compliance programme of an emerging markets company. In a positive meeting with its chief compliance officer, we reviewed the progress of the compliance programme, which had been launched as a response to a corruption issue, but is now being embedded in corporate culture. The chief compliance officer described the due diligence that all suppliers, service providers and appointees to non-executive or senior executive positions must be subject to. We were encouraged that the procedures are now part of the company's articles of association. The chief compliance officer sought to reassure us that the compliance and culture change programmes are also being rolled out at all subsidiaries, with the reported metrics consolidating data from all companies. We raised concerns about compliance risks when the company is a minority partner and not in control of operations. The chief compliance officer illustrated the priority given to compliance using the example of a partnership agreement with another company. We gained comfort from the progress of the compliance programme and encouraged the company to share its expertise and experience with its supply chain to improve integrity among its peers. The chief compliance officer promised to consider this.

Remuneration policy

Lead engager: Natacha Dimitrijevic

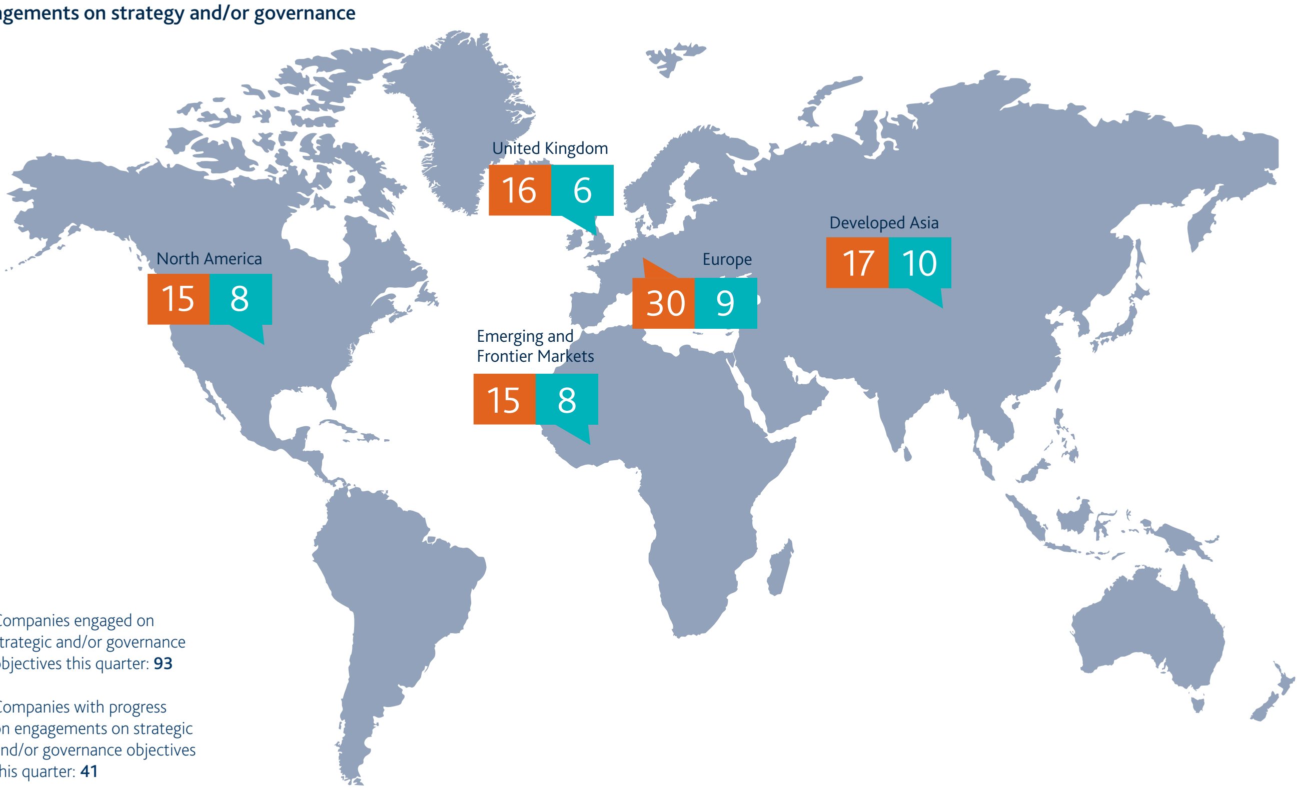
We commended the new remuneration policy of a financial institution, which was presented to us by its head of rewards. A fruitful meeting with the bank in November 2016 had enabled us to feed early into the process with our updated remuneration guidelines. As a result, the new policy meets all of our key expectations. Quantum has been brought back to market median, resulting in a 40% decrease in the CEO's fixed pay and 100% cap on variable pay. The structure is clearly aligned with long-term value creation, with the bonus taken out altogether and the long-term plan, which is entirely based on shares, encompassing seven years for the CEO. It is built on a set of performance conditions fully disclosed and aligned with the strategic plan. However, the shareholding requirement for the CEO is 200% – lower than the 500% recommended in our principles – to be acquired through his own funds. We also welcomed the simplicity of the long-term scheme, which, apart from regulatory conditions, relies on only three indicators. We questioned the risk of the plan becoming void during difficult and volatile market conditions. The bank agreed that a number of external circumstances could interfere with the strategic plan, in which case the board would go back to its shareholders to revisit the incentive scheme. We were pleased to see that our suggestions had been taken into account, as the policy describes precisely how board discretion can be exercised downwards and following the assessment of clearly defined parameters only. We expressed our support for the policy, which is an example of best practice in the industry.

Restructuring

Lead engager: Jaime Gornsztejn

We welcomed the proposed restructuring of an emerging markets company, which was outlined to us in a call with its CEO and CFO. In the third quarter of 2016, we had engaged with a major shareholder in the company's controlling shareholder, encouraging it to take the opportunity of the expiry of the controlling shareholders' agreement in the second quarter of 2017 to improve the company's governance. We were therefore delighted with the decision announced by the CEO that the controlling shareholders will dissolve their agreement, ownership will be dispersed through the conversion of non-voting shares into voting shares and that the company will seek a listing at a stock exchange for companies with high governance standards. The company described the essential and interdependent steps that will lead to the listing in three years, subject to approval at an EGM. We pressed it to go beyond the minimum 20% independence level required by the stock exchange so that at least one third of its board is independent. We also reiterated that its forthcoming refreshment is an opportunity to increase the board's diversity. The company was receptive to our view but highlighted that it is in the early stages of implementing the new dispersed ownership model, which, to ensure a smooth transition, will take up to three years to complete. We will continue to engage with the company on board composition and governance during the transition period.

Engagements on strategy and/or governance



Companies engaged on strategic and/or governance objectives this quarter: **93**

Companies with progress on engagements on strategic and/or governance objectives this quarter: **41**

Public Policy

Public policy and best practice

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

Overview

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

Highlights

Dakota Access Pipeline

Lead engager: Tim Goodman

We co-signed the investor statement on the Dakota Access Pipeline, seeking an equitable resolution of the concerns of the Native American tribe which did not provide its free, prior and informed consent to the construction of one section of the pipeline.

After signing the investor statement, which sought to put pressure on the banks financing the project, we were honoured to be invited to a small, private investor briefing with the chair of the Standing Rock Sioux Tribe regarding the controversial pipeline. In the meeting, we learned about the history of Native Americans and how the tribe views the pipeline as the latest attack on its rights since the colonisation of the country. While the chair was relatively pessimistic about the chances of the pipeline being rerouted, he was much more optimistic about the wider effects of the opposition to the route of the pipeline. We believe that future projects will be more mindful of the risks of failing to obtain free, prior and informed consent of indigenous peoples and of failing to consult and consider the views of communities in a sympathetic manner. We will engage with the companies involved that are part of our engagement programme and use the example of the Dakota Access Pipeline more widely to encourage companies to treat their stakeholder outreach as a vital part of managing their reputational, legal and financial risks.

Diversity of boards

Lead engager: Natacha Dimitrijevic

We supported the recommendations on the ethnic diversity of UK boards made by the Parker review. Nevertheless, in our response to the consultation, we suggested a clearer reference to adherence to the principle of comply-or-explain. We also encouraged less prescriptive recommendations on ways to achieve this. We pressed for the disclosure of a more all-encompassing strategy by companies on diversity to give ethnicity equal consideration alongside gender and other relevant aspects to foster deeper organisational buy-in and drive change that goes beyond being merely a box-ticking exercise.

Electronic Industry Citizenship Coalition

Lead engager: Christine Chow

Our engagement with the Electronic Industry Citizenship Coalition (EICC) has been making progress. Apart from launching new initiatives on the ethical sourcing of raw materials, the EICC announced at a stakeholder outreach meeting that it would go beyond the conflict minerals mandated by the Dodd-Frank Act in the US – tin, tungsten, tantalum and gold – to include cobalt from the Democratic Republic of Congo. The EICC has also started to engage with the OECD and the China Chamber of Commerce of Metals, Minerals and Chemicals Importers on how to align initiatives. We encouraged the coalition and its stakeholders to create a platform for companies to discuss initiatives that address wider industry issues.

We also made a number of recommendations at the EICC board of directors investor roundtable, which were received positively. These included a review of the EICC's code of conduct to clarify its definition of manufacturing and for the coalition to help set standards on reporting, using the frameworks of the Sustainability Accounting Standards Board and the International Integrated Reporting Council.

Transition Pathway Initiative

Lead engager: Bruce Duguid

We supported the launch of the asset owner-led Transition Pathway Initiative to rank companies based on their continuing performance in relation to the management of climate change-related risks. The initiative provides a framework for assessing companies against two dimensions, namely the quality of climate risk management and company performance in reference to that required to limit global warming to below 2°C. Larger companies in more exposed sectors are then scored according to one of five different levels, depending on their performance, using publicly available data. In the initiative's press release, we highlighted the potential of the framework to assist in company engagement as it enables feasible objectives to be set with regard to improving the level at which companies score in the framework. We have already started to pilot this methodology and provided early input into its design. We will continue to support the initiative by advising on its evolution as a member of its technical advisory committee.

Other work in this quarter included

Promoting best practice

- We provided the investor perspective on environmental performance disclosure of companies at the **CDP training seminar in Beijing**, as part of our continuing collaboration with the initiative in China. Our connections with companies have supported the expansion of this training, as the number of attendees at this event has grown from two in 2016 to over 20 company representatives this year. We were pleased to see that companies, especially those from the energy, chemicals, consumer and financial services sectors, have increased their resources to improve the disclosure of their environmental performance and set objectives in line with global best practice.
- We participated in the discussion of the inaugural **CEO Investor Forum** in New York. The forum was hosted by the Strategic Investor Initiative of CEO-coalition CECP and brought together a large number of the CEOs of major US-listed companies, as well as long-term orientated institutional investors. Its purpose is to expand the focus of traditional investor presentations to include topics that demonstrate a strategy capable of creating long-term value and facilitate dialogue between CEOs and investors on related issues.
- We gained insights into the **Circular Economy Principles** and associated applications through a discussion with the programme lead of the CE100 Programme, a leading initiative on waste reduction and resource efficiency. The application of circular economy principles may involve dramatic changes in the design of products, based on resource scarcity issues and the cost of materials.
- We discussed investor views on the merits of **climate change policy**, including the evolving policy of the government of Japan, with the country's Ministry of Economy, Trade & Industry. We explained that long-term investors are generally supportive of stronger policies to tackle climate change, as the long-term benefits outweigh the costs of avoiding potentially catastrophic climate change.
- At a meeting of the **Corporate Governance Forum**, we advocated our approach to corporate governance reform in front of other major asset managers. We explained our intention to take a tougher line on high variable-to-fixed pay ratios, expecting to reject a ratio of 10 times. We also highlighted our increasing support for restricted shares. Furthermore, we noted our intention to oppose chairs of nomination committees at companies whose boards have low levels of diversity. We are likely to vote against FTSE 100 companies which are significantly short of 25% women directors and FTSE 250 companies with no women on the board.
- We participated in an event by the **Corporate Human Rights Benchmark** (CHRB) and were pleased to see our contributions publicly recognised by the chair of the CHRB steering committee. The 2017 Corporate Human Rights Benchmark assessed 98 of the largest publicly traded companies in the agricultural products, apparel and extractives sectors globally on 100 human rights indicators. The results revealed that a vast majority of companies fall into the low-performing bands, with only a handful of companies displaying best practices.
- We sent a letter to Japan's Financial Services Agency (FSA) to raise concerns about the prevailing practice of **cross-shareholdings** in the country. Backed by several large global investors, the letter stated that many companies still believe it to be acceptable to hold shares of other companies to maintain long-term business relationships and listed a number of reasons why the practice is problematic. These include obstruction to fair competition and the effect of cross-shareholdings on governance practices and shareholder rights, which many companies appear to fail to understand. As a first step, we encouraged the FSA to strengthen the disclosure requirements for cross-shareholdings.
- We participated in the **Diversity Project** outreach meeting to understand the different work streams that we are able to contribute to on the subject of diversity. The Project is led by an advisory council composed of C-suite executives with 37 members in the steering committee and 15 different work streams. The project targets pension funds and the investment management industry.
- We gave a presentation at the **Good Governance Forum** to outline three steps that we believe UK company boards can pursue irrespective of any government reforms to rebuild trust with the public. We advocated for companies to consider promoting the employee voice within their governance arrangements, to provide more transparency on their human capital management practices and for board chairs to write annually to the workforce to justify the pay arrangements.
- We held a successful meeting at the US Council of Institutional Investors' (CII) conference on **methane reduction** in the US oil and gas industry. We discussed the efforts by the industry to minimise methane leakage to preserve saleable product and manage its licence to operate.
- We hosted a roundtable on the proliferation and implementation of **stewardship codes and principles in Asia** at which the CEO of Stewardship Asia and the managing director of the International Corporate Governance Network presented. The roundtable addressed whether investor stewardship is appropriate in Asian economies where companies are often controlled by large shareholders and cultures and regulations differ significantly. All participants agreed that accommodating regulation plays a major role in the success of stewardship in practice, for example with regard to investor collaboration.
- We were pleased to have been invited by the Principles for Responsible Investment to become a member of the **Sustainable Stock Exchanges investor advisory group**. Our focus is to set the strategic direction of the working group, and we agreed to undertake a combination of bottom-up and top-down approaches to promote sustainable market practices at stock exchanges.
- We joined the **Workforce Disclosure Initiative** (WDI). The WDI models itself on the CDP initiative and is an opportunity to improve the reporting on social matters by providing a comparable data framework on workforce issues. We gave feedback on the initial phase of the project and agreed to provide official support. We also agreed to join the advisory panel of the WDI.

Public policy

- We participated in an informal survey on potential **amendments to Japan's Companies Act** regarding the requirement to appoint independent directors. The act currently requires companies to provide an explanation if they fail to appoint at least one outside director to their board. The stock exchange believes that this should be tightened so that all companies are required to have at least one outside director. However, in our view, if the appointment is to be made a hard requirement, the number of outside directors is likely to be kept to a minimum, which will not increase the level of board independence across Japan. Instead, we suggested raising the expectation for the level of independence to be a third of the board, while maintaining the comply-or-explain model.
- We took part in a public policy committee discussion on the **shareholder access policy** of the Canadian Coalition for Good Governance. The policy is close to its final form and after discussions with other stakeholders was altered to follow more closely the form of proxy access most commonly found in the US.

Report written and produced by Nina Röhrbein

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

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

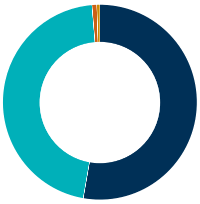
Hermes EOS makes voting recommendations at companies all over the world, wherever its clients own shares.

Overview

Over the last quarter we made voting recommendations at 1,311 meetings (11,853 resolutions). At 602 of those meetings we recommended opposing one or more resolutions. We recommended voting with management by exception at seven meetings and abstaining at 11 meetings. We supported management on all resolutions at the remaining 691 meetings.

Global

We made voting recommendations at **1,311** meetings (**11,853** resolutions) over the last quarter.



- Total meetings in favour **52.7%**
- Meetings against (or against AND abstain) **45.9%**
- Meetings abstained **0.8%**
- Meetings with management by exception **0.5%**

Australia and New Zealand

We made voting recommendations at **eight** meetings (**40** resolutions) over the last quarter.

- Total meetings in favour **50.0%**
- Meetings against (or against AND abstain) **50.0%**

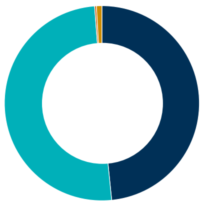
Developed Asia

We made voting recommendations at **421** meetings (**2,967** resolutions) over the last quarter.

- Total meetings in favour **45.6%**
- Meetings against (or against AND abstain) **53.9%**
- Meetings abstained **0.2%**
- Meetings with management by exception **0.2%**

Emerging and Frontier Markets

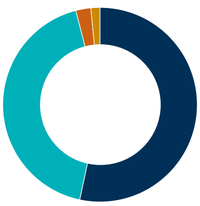
We made voting recommendations at **347** meetings (**2,535** resolutions) over the last quarter.



- Total meetings in favour **48.4%**
- Meetings against (or against AND abstain) **50.4%**
- Meetings abstained **0.3%**
- Meetings with management by exception **0.9%**

Europe

We made voting recommendations at **197** meetings (**3,006** resolutions) over the last quarter.



- Total meetings in favour **53.3%**
- Meetings against (or against AND abstain) **42.6%**
- Meetings abstained **2.5%**
- Meetings with management by exception **1.5%**

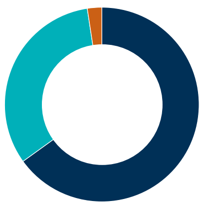
North America

We made voting recommendations at **215** meetings (**1,840** resolutions) over the last quarter.

- Total meetings in favour **66.0%**
- Meetings against (or against AND abstain) **33.5%**
- Meetings abstained **0.5%**

United Kingdom

We made voting recommendations at **123** meetings (**1,465** resolutions) over the last quarter.

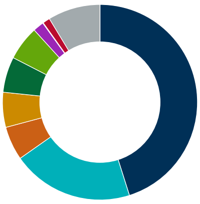


- Total meetings in favour **65.0%**
- Meetings against (or against AND abstain) **32.5%**
- Meetings abstained **2.4%**

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

Global

We recommended voting against or abstaining on **1,304** resolutions over the last quarter.



- Board structure **45.2%**
- Remuneration **20.2%**
- Shareholder resolution **5.6%**
- Capital structure and dividends **5.8%**
- Amend articles **5.9%**
- Audit and accounts **5.7%**
- Governance **1.8%**
- Investment/M&A **0.1%**
- Poison pill/Anti-takeover device **1.2%**
- Other **8.7%**

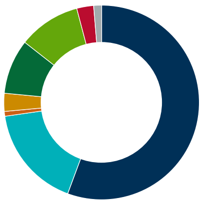
Australia and New Zealand

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

- Board structure **16.7%**
- Remuneration **66.7%**
- Shareholder resolution **16.7%**

Developed Asia

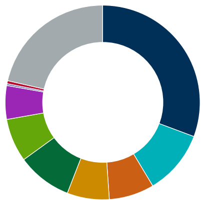
We recommended voting against or abstaining on **397** resolutions over the last quarter.



- Board structure **55.7%**
- Remuneration **17.1%**
- Shareholder resolution **0.8%**
- Capital structure and dividends **3.0%**
- Amend articles **9.1%**
- Audit and accounts **10.3%**
- Poison pill/Anti-takeover device **2.8%**
- Other **1.3%**

Emerging and Frontier Markets

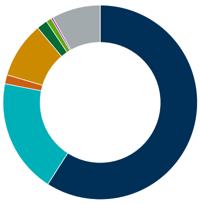
We recommended voting against or abstaining on **374** resolutions over the last quarter.



- Board structure **30.7%**
- Remuneration **10.7%**
- Shareholder resolution **7.5%**
- Capital structure and dividends **7.0%**
- Amend articles **9.1%**
- Audit and accounts **7.2%**
- Governance **5.6%**
- Investment/M&A **0.3%**
- Poison pill/Anti-takeover device **0.5%**
- Other **21.4%**

Europe

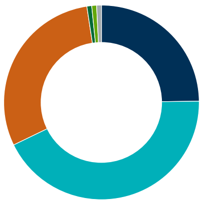
We recommended voting against or abstaining on **332** resolutions over the last quarter.



- Board structure **59.0%**
- Remuneration **19.0%**
- Shareholder resolution **1.5%**
- Capital structure and dividends **9.3%**
- Amend articles **1.8%**
- Audit and accounts **0.9%**
- Governance **0.3%**
- Other **8.1%**

North America

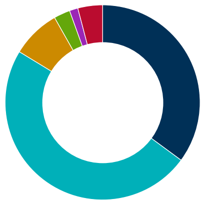
We recommended voting against or abstaining on **121** resolutions over the last quarter.



- Board structure **24.8%**
- Remuneration **43.0%**
- Shareholder resolution **29.8%**
- Amend articles **0.8%**
- Audit and accounts **0.8%**
- Other **0.8%**

United Kingdom

We recommended voting against or abstaining on **74** resolutions over the last quarter.



- Board structure **35.1%**
- Remuneration **48.6%**
- Capital structure and dividends **8.1%**
- Audit and accounts **2.7%**
- Governance **1.4%**
- Poison pill/Anti-takeover device **4.1%**

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

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