

Q2 | Public Engagement Report 2013



How investors can and should respond to the political inactivity, or indeed political obstruction, around addressing climate change issues

See page 4

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 Q2 2013.

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

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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 \$195bn. in assets under stewardship.

Hermes has the largest stewardship resource of any fund manager in the world. Our 34 person team includes former CEOs and other board members of public companies, as well as senior strategists, corporate governance experts, investment bankers, fund managers, lawyers and accountants.

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

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

How does EOS work?

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

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

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

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

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

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

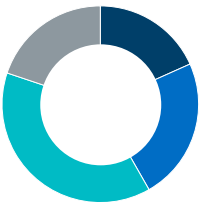
We would be delighted to discuss EOS with you in greater detail. For further information please contact: Colin Melvin on +44(0)207 680 2251.

Engagement by region

Over the last quarter we engaged with 165 companies on a range of 388 social, environmental, business strategy and governance issues. EOS' holistic approach to engagement means that we will typically engage with companies on more than one issue simultaneously. The engagements included in these figures are in addition to our discussions with companies around voting matters.

Global

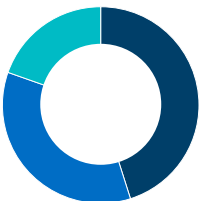
We engaged with 165 companies over the last quarter.



- Environmental 18.30%
- Social and ethical 23.45%
- Governance 38.40%
- Strategy and risk 19.85%

Australia and New Zealand

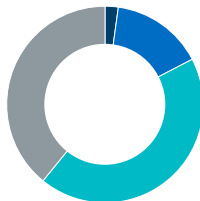
We engaged with 15 companies over the last quarter.



- Environmental 45.10%
- Social and ethical 35.29%
- Governance 19.61%

Developed Asia

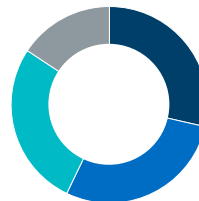
We engaged with 20 companies over the last quarter.



- Environmental 2.17%
- Social and ethical 15.22%
- Governance 43.48%
- Strategy and risk 39.13%

Emerging and Frontier Markets

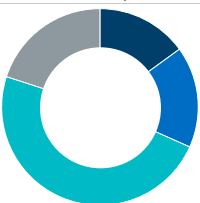
We engaged with 29 companies over the last quarter.



- Environmental 28.57%
- Social and ethical 28.57%
- Governance 27.14%
- Strategy and risk 15.71%

Europe

We engaged with 33 companies over the last quarter.



- Environmental 15.00%
- Social and ethical 16.67%
- Governance 48.33%
- Strategy and risk 20.00%

North America

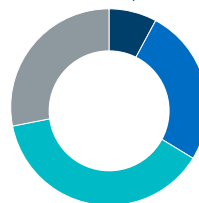
We engaged with 37 companies over the last quarter.



- Environmental 15.28%
- Social and ethical 18.06%
- Governance 51.39%
- Strategy and risk 15.28%

UK

We engaged with 31 companies over the last quarter.



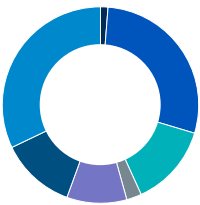
- Environmental 7.87%
- Social and ethical 25.84%
- Governance 38.20%
- Strategy and risk 28.09%

Engagement by issue

A summary of the 388 issues on which we engaged with companies over the last quarter is shown below.

Environmental

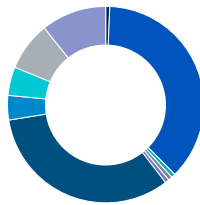
Environmental issues featured in 18.30% of our engagements over the last quarter.



- Biodiversity 1.23%
- Climate change/carbon intensity 28.40%
- Health and safety 13.58%
- Oil sands 2.47%
- Waste 9.88%
- Water stress 12.35%
- Other environmental 32.10%

Governance

Governance issues featured in 38.40% of our engagements over the last quarter.



- Accounting or auditing issues 0.67%
- Board structure 36.91%
- Committee structure 0.67%
- Poison pill 0.67%
- Related-party transactions 0.67%
- Remuneration 32.89%
- Separation of chair/CEO 4.03%
- Shareholder communications 4.70%
- Succession planning 8.05%
- Other governance 10.74%

Social and ethical

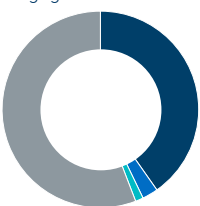
Social issues featured in 23.45% of our engagements over the last quarter.



- Access to medicine 2.47%
- Bribery and corruption 14.81%
- Community relations 17.28%
- Corporate culture 7.41%
- Employee relations 13.58%
- Licence to operate 9.88%
- Operations in troubled regions 7.41%
- Political risk management 4.94%
- Supply chain (inc child/other labour issues) 8.64%
- Other social and ethical 13.58%

Strategy and risk

Strategy and risk issues featured in 19.85% of our engagements over the last quarter.



- Business strategy 40.26%
- Reputational risk 2.60%
- Returns to shareholders 1.30%
- Risk management 55.84%

Focus on key issues

Remuneration featured in 32.89% of our engagements over the last quarter.

Risk management featured in 55.84% of our engagements over the last quarter.

Shareholder communications featured in 4.7% of our engagements over the last quarter.



The Big Stink

Investors are losing out by not creating a commotion over the uncontrolled emission of greenhouse gases

Countries with the least formulated responses to climate change are likely to face significantly worse risks than those with lower exposures and greater preparations.

The case of The Big Stink is just one example of our political leaders' ability to ignore a problem that is readily apparent until it is all but thrust in their faces. In some ways it is heartening to be reminded that it is not only current politicians who can be short-sighted. We are perhaps no more ill-served now than we were in history, for all our tendencies to assume that things are getting worse.

There is an issue larger than the wanton pollution of the Thames which our current crop of politicians is failing to address. One wonders what form of Big Stink is necessary for the world's politicians to address the damage we are wreaking on our planet through the uncontrolled emission of greenhouse gases. Our climate is changing, the planet overall is warming and we have already released enough CO₂, methane and other heat-trapping emissions for this to continue long into the future.

For those of us charged with investing for the long term, the uncertainties that this situation introduces to our investment plans are highly significant and painful ones: the economic system relies on valuations which assume that the current unsustainable activities are sustained. We know that this cannot be the case but we also know that the timing at which the un-sustainability bites is uncertain. We need to invest in the present economic context, make money and preserve

Overview

The problems with London's sewerage systems – or rather, the lack of them – had been readily apparent for years, particularly in the poorer districts of the capital. But it was only in 1858 when the noses of parliamentarians were assailed by filthy smells from the Thames outside the windows of the Palace of Westminster (which came to be known as The Big Stink) that they were moved to address the issue.

The result is one of London's pleasures: perhaps the closest thing to a Parisian tree-lined boulevard the city possesses: the Victoria Embankment, running east from Westminster. The Embankment sits above the rather more practical and invisible – but one is told still more impressive – great sewer bearing away the city's waste for treatment. This ensures that the noses of British politicians no longer suffer pungencies of that particular form.

value for beneficiaries over the near and mid-terms, but with an eye to the disruptions to current valuation models which we know must be coming but cannot know when and to what extent.

The analogy with the historic abuse of the Thames is a good one: we are in effect using the narrow skin of atmosphere around our planet as an open sewer, clogging it up with filth and mess at levels that it simply cannot deal with. While warming appears to have slowed of late, for unknown reasons, and there are some positive straws in the wind about further ways in which emissions can be cut, we continue to conduct a risky experiment with the only breathable atmosphere we have. The news that CO₂ levels in the air have now reached 400 parts per million is deeply disheartening, but we know that this cannot be The Big Stink of climate change: passing a numerically interesting hurdle, while newsworthy, will never be sufficiently lapel-tugging to force itself to the attention of our politicians.

Indeed, if anything, it appears that politicians are increasing in their willingness to ignore the science and ignore the reality of the open sewer of CO₂. The European Parliament recently blocked plans to revive the Emissions Trading Scheme (ETS) by removing, or at least postponing, excessive credits in the system – there had always been too many of these as countries tried to gerrymander the system to favour their national industries, but the excess became a glut in the

economic slump. The result of the parliament's decision is that the ETS remains flat-lining, the carbon price is almost zero, and thus the signal it should provide for investment that takes account of long-term carbon price risk has disappeared. In a sadly similar way, the carbon pricing implemented in another country, Australia, seems set to be dismantled if the forthcoming election falls out as the polls suggest. Governments around the world appear to have concluded that promoting economic growth in the short term must take priority over addressing the pending climate crisis. One glimmer of hope however could be coming from the US, which has indicated new appetite to address climate change. However with the current acrimonious political atmosphere, both nationally and internationally, it is highly uncertain that real progress can be made, especially as President Obama approaches lame duck territory and considering the fact that any international agreements will have to be brokered through the beleaguered United Nations Framework Convention on Climate Change (UNFCCC).

In all cases, the politicians are responding to the extensive lobbying they have heard. Many companies appear to believe that it is in their shareholders' interests for emissions not to face pricing. It is not clear whether they have asked their shareholders' views on this, and few seem to feel it appropriate to disclose the substance and cost of their lobbying activities, whether direct or through representative organisations. Investors should increase their engagement with companies to understand their lobbying activities and challenge them as to whether the expenditures are genuinely in shareholders' long-term interests. But that alone is not enough: in lobbying terms, investors are entirely outgunned and all but invisible in these debates, and the simple fact is that they need to be much more active, specific and deliberate in the way they take this forwards. This will require greater resources, but unless and until investors create their own Big Stink by participating much more actively in crucial public policy debates, it should be no surprise that the system continues to fail to work in their interests.

And it is clear that investors are only losing out by failing to create such a Big Stink. The result of the political failures to act – and the decisions to dismantle the limited actions already taken – is that the scenarios for climate change become significantly more negative in investment terms. Looking back at the Mercer report, *Climate Change Scenarios – Implications for Strategic Asset Allocation*, published in 2011 in collaboration with 12 major institutional investors, two of the posited scenarios now look utterly implausible. These were 'Stern Action', a concerted and vigorous global policy response, and 'Regional Divergence', at least as defined in the report, though a cynic might suggest that all regions seem to have converged on inaction. 'Delayed Action', previously seen as the second most likely scenario, has become the most probable; unfortunately, 'Climate Breakdown' is looking more possible. Both of these assume that there is some level of carbon pricing at least in the EU, so in some ways both are rosier predictions than would be possible now.

Mercer's analysis suggests that these now most likely scenarios lead to negative investment impacts across the piece of traditional asset classes, and are negative (or at best neutral) for investment across all regions of the world. The analysis suggests that the world we now appear to be in will be a highly problematic one for long-term investors. The consultant's proposed recommended portfolios for these two scenarios are different, but also markedly different from those currently deployed by long-term investors. For each, around half of the recommended portfolio would be in investment grade credit; for

climate breakdown the other half would be equities, predominantly developed, while for delayed action there would be more variation, with around a quarter in private equity and the remainder in agriculture, emerging market equity and cash, in that order. In neither case would there be significant holdings in sovereign fixed income, and in both cases investors would still suffer significant losses as the climate change scenarios played out.

And perhaps in that recommendation to avoid investments in sovereign fixed income lies a further clear way forwards for institutional investors to create a Big Stink. It seems clear so far that the science, and the passing of threshold numbers, are not enough to amount to a Big Stink on climate change. Even such events as Hurricane Sandy and its dramatic destruction in parts of the US coastline usually unaffected by such weather patterns, seem to have drawn little attention among our political classes.

So, as well as further lobbying and challenging the political activities of investee companies, investors need to consider further actions in creating their own Big Stink. Those countries with the least formulated responses to climate change are likely to face significantly worse risks than those with lower exposures and greater preparations – they would need to increase significantly their national expenditures on mitigation and adaptation costs, and by delaying such costs they are probably already increasing that burden. In the context of Mercer's recommended negligible or zero exposure to sovereign bonds given the political context, maybe there is scope for investors collectively to reconsider their exposures to the sovereign debt issued by such countries. And if this were associated with private letters and in due course public debate it might amount to The Big Stink our new environment seems to require.

Paul Lee
Director



Social

Bangladesh and the importance of supply chain management.

Together we stand: companies, unions and workers are key in preventing a repeat of 'Rana Plaza'.

The Rana Plaza tragedy shows how the failure to properly manage supply chains can cause human tragedy and damage companies' reputations. Companies that source clothing from Bangladesh must drive necessary reforms.

Overview

More than 1,000 people were killed when Rana Plaza, a garment factory on the outskirts of Dhaka, collapsed on April 24, 2013. To date, it is the worst industrial accident in Bangladesh's history. Televised scenes of the dead, injured and their grieving relatives shocked the world. The tragedy was not an isolated incident: many other accidents have cost the lives of garment-industry workers in the south Asian country, and several have killed more than 100 people, such as the fire that broke out at the Tazreen Fashions plant in November and took 111 lives. It is clear that there are industry-wide problems among the country's clothing manufacturers. Resolving these problems will require a co-ordinated, systematic approach because these flaws are entrenched in the way the industry is organised. Working towards such a solution will also provide lessons that can be applied in other industries worldwide. In the wake of the Macondo spill in the Gulf of Mexico, oil companies examined other industries for techniques to improve health and safety practices. In a similar way, every industry should learn from Bangladesh: only by investigating the risks in their supply chains can the possibility of similar events be eradicated.

This neglect of adequate health and safety standards is driven by the low-cost production model that is the Bangladeshi industry's competitive advantage. Low costs are usually achieved by a lack of investment in safe working environments and staff wellbeing, insecure employment and, of course, low wages. These problems are compounded by widespread corruption. For example, agents, who are often bribed, are widely used to help source production capacity and audit standards on health and safety and other matters, leading to work being conducted in unsafe factories. Because the garment industry is increasingly critical to the Bangladeshi economy, factory owners have considerable influence on government and society. The industry is estimated to account for around 80% of exports and more than three million jobs. This exacerbates the poor enforcement of health, safety and other laws. Given that the voluntary efforts of the international retail industry and the legal system in Bangladesh have failed to solve the problems, we believe that the employees themselves – who are best placed to identify hazardous conditions – and their trade unions should be an integral part of any solution.

Many international retailers and brands have publicly expressed their commitment to vastly improve safety standards in the industry. Many companies – mainly European – have signed the *Accord on Fire and Building Safety in Bangladesh*. This agreement, which was being developed by unions and non-government organisations before the latest tragedies, is a good stepping stone to far-reaching reform in the Bangladeshi industry. It mandates a program of credible, independent inspections of the factories used by suppliers, together with sanctions for companies that do not resolve the inspectors' concerns. Crucially, its governance structure has under its founding constitution a majority on its steering committee of trade unions and the International Labour Organisation rather than the garment industry and its customers. It has also obtained firm commitments from signatory retailers and apparel brands to fund the remedial work needed in suppliers' factories. This is a radical turnaround from past failed practices. We support its development.

A number of North American companies have not signed the Accord, citing concerns about its governance and dispute resolution mechanisms – which enable recourse for unresolved disputes in the country of domicile of the retailers. Many of these companies are working with the Bipartisan Policy Center, a US think tank, on an alternative model. We believe it is essential that these companies contribute their fair share of the cost of remediation within the Bangladeshi industry and demonstrate publicly and transparently that their programs in response to the tragedies are sufficiently robust to solve problems that they have previously failed to cure. This would give workers in the industry a real say in health and safety management without fear of victimisation. It would require recognition of, and collaboration with, independent trade unions.

We have engaged specifically on these points with a number of the largest North American retailers and signatories to the Accord since the Rana Plaza tragedy. We believe that both groups of retailers will need to collaborate with each other and the trade unions to solve the systemic problems within the industry, notwithstanding their different approaches.

At one US company, we explicitly linked wider problems with corruption and the recent tragedies in Bangladesh to a failure by the board to properly oversee management's activities. We challenged another US company, which is not directly linked to the tragedies, to demonstrate that its processes are sufficiently robust. We have called for both to forge links with signatories of the Accord. At a UK company, which is also not linked to tragedies, we obtained significant comfort that its practices are better than many in the industry and that it is improving them. We also received a full response to the tragedies from a large Scandinavian retailer and intend to follow up further. We also plan to continue our engagement activity in this area again including visits to a number of textile manufacturers in the Indian sub-continent.

We should remember that the garment industries of other countries are notorious for paying low wages to workers and often have questionable health and safety standards. Let us hope that the recent tragedies spur the first steps to remedying the chronic problems in Bangladesh, and that a template for solving similar problems in other countries is created. We will work towards this end. Moreover, other industries that rely on relatively unskilled and cheap labour in developing countries face similar issues, and businesses should not forget their obligations under the *UN Guiding Principles for Business and Human Rights*. Companies must manage their supply chains as part of their licence to operate. We will continue to work with them to ensure that this is a focus of their risk management.

Tim Goodman

Associate Director – North America



Nominating and electing directors in Latin America

Promoting better corporate governance and minority shareholder representation

EOS works closely with companies and regulators in Brazil, Colombia and Mexico to promote corporate governance in director elections.

Overview

Most Latin American companies provide no information to investors regarding director candidates in advance of annual general meetings (AGMs). This effectively disenfranchises international investors who vote by proxy, at least a week before the meeting takes place, and with no knowledge of the identities of the candidates they are asked to support or oppose. Typically, companies only disclose the names and backgrounds of the candidates very close to the meeting date and company law in Latin America allows nominations to be made on the day of the AGM. We strongly encourage companies to develop mechanisms that will require candidates to be nominated for election to the board well in advance of the vote at AGMs.

EOS is engaging with regulators and institutions across a number of markets, with an initial focus on Brazil, Colombia and Mexico where clients' exposure is concentrated to Latin America to promote best practice and encourage better governance practice. In the past quarter we have met with the President of Colombia's Bolsa de Valores to encourage better protection of minority shareholders' rights and press for improvements regarding the nomination and election of directors. We also met with the Chairman of Brazil's securities exchange commission the Comissão de Valores Mobiliários (CVM) and the Mexican Stock Exchange to put forward our recommendations regarding the nomination and election process and board composition. We have raised concerns about the fact that directors are elected as a slate, which leaves investors with an all-or-nothing choice, and argued for candidates to be presented as separate voting items instead of a board slate proposal.

We endorse the *OECD Latin American Roundtable's White Paper on Corporate Governance* and encourage companies to implement its recommendations where possible.

EOS has made a number of recommendations to improve the nomination and election process for directors in Brazil, Colombia and Mexico and these form the basis of our discussions with regulators and issuers on this topic.

Firstly, we believe disclosure and transparency is vital. The ability of responsible shareholders to exercise their voting rights at AGMs depends on the timely supply of adequate information regarding each agenda item to all shareholders. In particular, this applies to important items such as the election of directors. Companies should make every effort to ensure that shareholders are provided with adequate information well ahead of a general meeting. Failure to provide information on director candidates effectively disenfranchises international investors who vote by proxy, often with no knowledge of the identities of the candidates they are asked to support or oppose. The timely publication of such information is therefore particularly important for international investors. Changes sought by EOS are as follows:

- An official meeting notification, including an agenda, should be published at least 30 days prior to the meeting in the local language as well as English.
- A proxy statement containing the above information should be distributed to all shareholders at least 30 days before the AGM.
- Meeting results must be published on the company's website within 15 days of the AGM [shown by individual resolution].

Secondly, the nomination procedure and election process is key. In line with best practice, we expect the governance and/or nominating committee to assist the board on director evaluation and to use the outcomes to ensure that the right mix of skills and expertise are represented on the board. In order to ensure objectivity and fresh thinking, we encourage nominating committees to promote succession planning to guarantee that appropriate board refreshment is undertaken when long tenures may compromise independence. The roles and agendas of all key committees and their members should be articulated in the annual report and should be evaluated on a yearly basis and updated as necessary. In particular, we recommend the following approach:

- Nominating committees to promote succession planning to ensure that appropriate board refreshment is undertaken and that long tenures do not compromise independence.
- The board should ensure that there is a sufficient number of independent directors in place within the nomination committee to assess and promote potential candidates. These directors should ultimately be accountable to shareholders.
- The nomination committee should not be chaired by a representative of a major shareholder, and members of the committee should comprise of a majority of independent directors.

- Consultations with shareholders regarding the selection criteria or any "skills gap" on the board should be taken into consideration when short listing candidates.
- The election of each board member should be presented as a separate resolution at the AGM.

While we understand that it is common practice in Latin American markets for major shareholders to be represented on the board, in line with best practice, EOS engages with companies to press for a strong core of independent directors to give minority shareholders the confidence that their interests are properly represented and protected.

Following our intensive engagement, Petroleo Brasileiro (Petrobras) has become the first Brazilian company publicly to disclose the names of minority shareholders nominated for election to its board and the Conselho Fiscal at its AGM. This sets an important precedent. Significantly, the company has accepted recommendations from an investor group in which EOS took a leading role in coordinating the engagement and nominated a candidate that represents minority ordinary shareholders on the board, as well as two candidates put forward by the investors for the Conselho Fiscal.

The governance structure of Petrobras specifically designates board positions for the purpose of representing minority investors. It is critically important that the nomination process for these seats is credible, transparent and aligned with the interests of minority shareholders. Last year, in a clear dismissal of these principles, a candidate disclosed ahead of the AGM was supplanted by a politically connected individual at the last minute.

Since November 2012, Hermes EOS, F&C and Aberdeen Asset Management have led a group of the world's largest investors and prominent Brazilian fund managers in the engagement with Petrobras.

The company has shown willingness and openness throughout this process. We expect that constructive dialogue will continue to drive change at the company for the benefit of its stakeholders. We are encouraged by the dialogue we have had with Petrobras and its acknowledgement of the importance of board-level representation for minority shareholders.

Bruno Bastit
Assistant Manager – Emerging Markets



China in focus

The human rights conundrum

Chinese companies have generally been highly protective when asked to discuss the significant human rights exposures that a number of them face. Our recent engagement dialogue and best practice efforts reveal some signs that this could be changing.

Overview

As China continues to assert its developing power in the global economy, its approach to human rights norms has come under increasing scrutiny, particularly from Western states. Despite this, the country and its corporations have appeared reluctant to engage openly on the topic, tending to regard it as an internal matter.

The result has generally been frustration and a lack of effective dialogue for foreign institutional investors looking to ensure that their investee companies are managing and mitigating human rights within their operations. International investors have been particularly keen to scrutinise the approach of Chinese companies (particularly those from the extractives sector) operating in what are perceived to be oppressive regimes. Companies often with the support often of the Chinese state as a major shareholder, frequently treat such investment decisions as national foreign policy matters, and therefore provide very little insight to investors.

EOS seeks to engage on this issue both directly with relevant companies and also through public policy by helping to create and promote best practice standards. On occasion it has been necessary carefully to tailor the language we use in order to encourage companies to open up and to begin the dialogue which has enabled us to gain some insights into their approach; discussing matters such as political risk management has enabled us to approach the relevant concerns without arousing undue sensitivity. This tailoring and our usual persistence have allowed us to make some limited progress. However, while the topic of human rights remains a highly sensitive one we have the strong impression that recently it has become far less of a taboo subject. This has led to some improvement in our ability to discuss the subject. However, our challenge is to convert this change in approach from companies into further changes in the substance of their management of human rights risks.

Over the years EOS's engagement in China has covered a wide range of issues, ranging from bribery and corruption to environmental exposures, from audit matters and board effectiveness to human rights risks. However, it has been extremely difficult to gain any traction in the last area. Discussions with Chinese companies about their policies and measures to guard against either complicity or direct involvement in human rights abuses have historically been difficult if not impossible. Some international NGOs and foreign governments have been critical of the country's alleged violations of international norms in troubled countries, and that criticism has also extended to a number of Chinese companies.

China as a nation is an active investor in developing countries, where the human rights standards it applies could be of great influence. In many cases, this investment has been through corporate vehicles, often state-owned companies. Occasionally these companies have been partly publicly listed, or more usually they have associated businesses which are publicly held. These companies, whether the parent or the associate, have come under criticism for perceived abuses. Some of the states where China has close economic ties, including Sudan, Myanmar, and Zimbabwe, have been criticised for obstructing international efforts to promote human rights. In many ways, it has seemed an implicit part of China's foreign policy not to seek higher standards of behaviour by host governments but rather to allow the status quo to persist.

Over the years, EOS has participated in a number of forums to share good practices and experiences related to Chinese companies' global operations, with particular attention to investing and doing business in troubled regions. Among other work, we supported the development of a PRI and UN Global Compact publication on the key risks arising from such issues (the *Guidance on Responsible Business in Conflict Affected Areas*). Our focus has been to encourage companies to contribute to the stability and development of these regions, by respecting internationally recognised human rights standards and developing a local corporate social responsibility programme. We have urged companies to ensure they are not complicit in abuses by local governments which have mistreated their own peoples.

Earlier this year we were invited to address a significant UN Global Compact Forum in Beijing. This in itself seemed to be a major step forward – it seemed to us remarkable to hold an event whose sole focus was how companies implement respect for human rights, especially in high risk regions in the Chinese capital. This was a major step forward from times when these issues had been regarded as too sensitive to discuss.

We used the opportunity of the Forum to express our disappointment about the lack of open and frank discussions with Chinese companies with regard to their operations in countries where oppressive regimes, weak governance and conflict hold sway. Our contribution was remarked on by several participants as being helpful in encouraging more accountability amongst the many companies represented in

the room. We also encouraged companies to go beyond boilerplate sustainability reporting that focuses on internal controls and instead seek to demonstrate how they monitor the successful implementation of their policies. We gave specific recommendations for companies to report on activities in troubled regions. These include the nature and extent of operations, the underlying rationale for the investment, placing it within the context of the overall business strategy given the considerable risks involved, the nature of the relationships with local governments and security arrangements for their personnel. We believe that this event marks a step-change in approach, demonstrating that many Chinese companies are now taking a keen interest in deepening their engagement on human rights issues and are willing to explore how to ensure they are operating according to Global Compact principles in all areas of their operations.

We have also held several engagement meetings with Chinese companies to discuss human rights issues and have met with a number of representatives from various companies in Beijing. We used these active dialogues to probe how boards manage the reputational risks arising from their association with operations in troubled regions and encouraged companies to disclose how they manage political risk effectively and consistently across all geographies. Through such disclosures we have looked to gain confidence that companies' presence in a troubled region is an influence for good. These are exactly the sorts of discussions that we have been seeking for some time, and dialogue during some of these meetings has felt surprisingly progressive, with companies now seeking an active exchange and welcoming our recommendations about raising the standards of disclosures to the level of international best practice. This atmosphere has been a marked contrast with previous years, when companies have been reluctant even to meet with investors.

We have also been given the impression by certain companies that they are keen to undertake responsible business in their overseas operations and to understand fully the implications of their duty of care to staff and local communities. In particular our focus has been on testing companies' culturally sensitive and social welfare work, including attention to the security of employees, local religion and customs, political stability risks and to make social assessments. To gain further confidence in the oversight we have encouraged companies to implement the *Guidance on Responsible Business in Conflict Affected Areas and the Voluntary Principles on Security and Human Rights*.

In prior years, Chinese companies have been uncomfortable using human rights language within our engagement dialogues. We hope that our engagement will lead to closer cooperation and dialogue with the companies and their sustainable management of these issues, on a less defensive attitude towards human rights. At the very least we believe that our engagement on human rights and encouragement of higher quality disclosure is a helpful mechanism to help mitigate some of the reputational risks that certain companies face.

Naheeda Rashid

Associate Director – Emerging Markets



Strategic engagements

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

Overview

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

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

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

Examples of recent engagements

We voted against a lead independent director at an oil and gas company for his failure to provide effective leadership, steward the company through succession, and poor communications with shareholders, which are all key fiduciary obligations of the board. As lead director he bears the greatest responsibility for the evident breakdown in this process and communications. Like many investors we were surprised by the company's announcement earlier this year that it would begin conducting a search for a successor to its CEO – an announcement that sparked investor confusion and controversy, strongly suggesting that the process was mishandled. Furthermore, the continued role of the ex-CEO, who is scheduled to retire as executive chair at the end of 2014 under the terms of his succession arrangements announced in 2011, led to speculation about dissent among directors about the company's strategic direction. Considerable noise also surfaced that the executive chair did not want to relinquish his position on the board and was instrumental in an effort to replace the CEO. Matters became further clouded in May when the company reversed its earlier announcement by confirming the continued service of the CEO through the end of

2014, and his assumption of responsibility for all of the company's operations, including international. While the company has wrestled with corporate governance problems in the past, we were pleased by the implementation of several positive changes: the adoption of a majority vote standard for director elections, the appointment of two new directors, enforcement of its mandatory retirement age policy, and changes to executive compensation. However, given their unique arrangements, a strong independent lead director position becomes the pivotal element in managing the succession process and communication to shareholders and recent events have made us question whether the current lead director has been effective. We note that following strong votes against both the chair and the lead director, they have resigned from the board.

In a lengthy conversation prior to the AGM of a Japan-based tobacco company, we obtained clarity and won assurances about the management commitment to continuously improve its capital policy and increase returns to shareholders, with a targeted dividend payout ratio for 2015 of 50%, comparable with global peers. Taking into consideration these assurances, the company's ongoing progress, growth strategy and the significantly improved board accountability

since last year, we felt able to lend our support to management’s proposed dividend. We supported a proposal authorising a significant level of share buybacks, as we believe there is still room for improvement in the company’s capital efficiency. While the maximum level of this request appears excessive, the proposed authorisation would not actually require the company to repurchase shares; the final decision on the buybacks would remain with the board. We will continue monitoring progress and engaging with the company as appropriate. On corporate governance, we welcomed the progress in 2012 in appointing two independent board directors for the first time. We further tested if and how effectively the board carries out active discussions on key strategic and financial issues, as well as seeking to understand expected contributions of the non-executive directors.

We spoke with the vice-secretary of the board and the head of governance at a European telecommunications company to continue our engagement on governance issues. Our conversation was timely given that it coincided with the publication of the AGM agenda.

We sought clarification on the various changes to the board structure and questioned the value that the new nominees will bring to the board. We stressed our disappointment that the company had not taken the opportunity of refreshment to improve the overall board balance, given the dominant position of the executive chair. We also expressed dissatisfaction with the lack of an independent lead director, despite the introduction of such a role in the bylaws. We focussed the company’s attention on the high level of opposition to the board elections last year, and urged further dialogue with institutional investors. On remuneration, we questioned the impact of the proposed changes, and expressed dissatisfaction with the lack of clear performance metrics in the short-term variable remuneration. We affirmed the company should present itself as a global company that is accountable to its investors disclosing transparent framework. We agreed to write to the company summarising our key concerns and made clear our expectation that we should have a meeting with the chair of the remuneration committee.

Strategic engagements map: Q2 2013





Public policy and best practice

Protecting and enhancing value by promoting better regulations

Hermes Equity Ownership Services (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

Launch of statement of principles for institutional investor responsibilities

We are delighted that our work on leading the development of the Statement of Principles for Institutional Investor Responsibilities has come to fruition. The Principles, which set high standards for both the governance of investment institutions and for investors' role in overseeing investee companies, were formally approved at the AGM of the International Corporate Governance Network. This marks the end of a year's work in crafting the guidelines and the start of a process of promoting them. For the first time, the ICGN sets out 12 principles for the accountability of institutional investors to their clients and beneficiaries and the accountability of companies to their investor owners, and the stretch embedded in those principles will, we hope, drive markedly better practice. We expect the guidance to help shape the ongoing debates on these issues in various markets around the world, and to influence public policy developments, in terms of stewardship codes and otherwise.

OECD roundtable on long-term investment

We participated in a wide-ranging roundtable meeting hosted by the G20 and the OECD on institutional investors and long-term investment. This covered the regulation of institutions and its impact on long-term investment, a discussion of the fund management chain, as well as the OECD's ongoing work in developing high level principles for long-term investment by institutions. The discussion in many ways

reflects points that we have been making for some time – and we particularly welcomed John Kay's adoption of our comments that the understanding of risk in the financial markets needs to be expanded beyond simple volatility. The focus on the mandates for fund managers also reflects our work leading this debate, not least through the creation of the ICGN's Model Mandate Initiative.

Investor address to International Forum of Independent Audit Regulators

We had the privilege of presenting the investor view on key issues to the plenary session of IFIAR, the group which gathers the globe's audit inspectors – a substantial gathering of senior representatives of regulators from more than 40 countries alongside others with global or regional responsibilities. We took the opportunity to emphasise the central importance of scepticism to an effective audit, noting that this lies at the core of shareholder expectations from the auditor. We highlighted a number of ways in which we believe the regulators' inspection regimes can shift from checking compliance to genuinely fostering and encouraging a sceptical mindset among audit teams. Using the analogy of the sniffer dog, we also raised concerns about whether audit firm business models are structured so as to enable the time and attitude of mind which will deliver scepticism in practice. We followed up with comments on the auditor report, reinforcing our formal position on the recent IAASB proposals, and on the complex issue of going concern.

Other work this quarter included

Promoting best practice

- As the shareholder representative member, we contributed to the Expert Review Committee of the Access to Medicine Index to work on the next index methodology. Alongside renowned experts, we provided feedback and recommendations on key strategic and methodological issues.
- We met with the head of policy at the AICD, the group representing the interests of Australia's business leaders. In a broad discussion we covered matters of reporting, director liability and particularly the issue of shareholder responsibilities.
- An EOS representative participated in an international roundtable event aiming to link companies responding to the Carbon Disclosure Project with investors interested in carbon data and sustainability.
- We met with the CEO of the Chamber of Mines, and colleagues, to discuss challenges faced by the mining industry. We queried perceptions about the industry's future, particularly with the rising cost of electricity and wages making South African mining less competitive. We also discussed social, economic and political factors and ways to improve the South African mining sector's continuing poor health and safety record compared with other countries.
- We took part in our first meeting of the Chartered Banker advisory board on professional standards. It was debated whether the proposed standard actually amounted to a leadership document, pressing that it needed to discuss directly the role of leaders in instilling appropriate behaviours amongst staff reporting to them, and in developing the right culture across the organisation.
- We were invited to address the significant UN Global Compact forum in China. It is a major step forward for China to hold an event whose sole focus was how companies implement respect for human rights, especially in high risk regions – this is often regarded as too sensitive an issue to discuss.
- We were the only foreign institutional investor representative to participate in the annual conference of the German Corporate Governance Code Commission, an exclusive invitation-only event. This year's main topic was the interplay between international and national regulation as well as new code recommendations and planned legislation on executive remuneration.
- We wrote to a significant number of Japanese companies setting out our general expectations and priorities for corporate governance in Japan, alongside our updated Corporate Governance Principles for the market, as a means of promoting best practices and fostering dialogue on key issues.
- We took part in the latest meeting of the EDTF, the private sector body brought together by Basel's Financial Stability Board to develop guidance on risk reporting by banks.
- We welcome Public Concern at Work's effort to consider the effectiveness of the UK's current whistleblowing protections and highlighted some ways in which the protections can be enhanced.

Public Policy

- As agreed in a recent meeting, we followed up with the CEO and the head of corporate governance of Colombia's stock exchange (Bolsa de Valores) with our recommendations regarding the nomination and election processes for directors.
- We followed up on our last meeting with Brazil's securities regulator in a letter to the chair setting out our recommendations regarding the nomination and election processes for directors in the country. We recommended that companies should make every effort to ensure that shareowners are provided with adequate information well ahead of a general meeting.
- We met with a Commissioner of Brazil's securities and exchange commission (the CVM). We discussed the announced consultation on revisions to the Brazilian Companies Code, which relate to board structure, director elections, disclosure and related party transactions.
- We met with the Secretary of State for business to discuss ways in which the government can support the delivery of more long-term investment and so foster growth in the wider economy. We won an invitation to set out our concerns in writing to share with the Minister.
- We met with the deputy director-general to discuss challenges faced by the South African mining industry and the role of investors. The Department greatly welcomed our interest in sustainability issues and emphasised the importance of our role in creating long-term value at companies.
- We raised concerns about widespread strikes in the mining industry as well as poor safety records, and asked how the Department saw the situation evolving. We gained some assurance that the peace and stability accord has shifted the dynamic, while the Department expressed its commitment further to bring down fatalities, to zero in the future. However, the Department did not articulate the specific measures it has taken to address these issues.
- In light of the lawsuit filed against the Securities and Exchange Commission by the US Chamber of Commerce, we joined an investor statement offering support for the conflict minerals section of the Dodd-Frank Act.
- We met with senior representatives of the Tokyo Stock Exchange to continue discussions on corporate governance in Japan. We highlighted the importance of accelerating structural reforms including the ongoing changes to corporate governance.
- Prior to its introduction of a comply or explain regime, the Tokyo Stock Exchange sought our input on policy guidelines and the right practical approach, particularly in the area of board structure and director independence. We regard it as a major step forwards that comply or explain is being actively considered in the Japanese market, something we have long been advocating.
- We wrote to Taiwan's Financial Supervisory Commission following up on a previous meeting, where we discussed in detail challenges regarding corporate governance practices in Taiwan. We highlighted the two early priorities which we believe the regulator needs to deliver in the near future: (1) enhancing board independence as a whole and appointing competent independent directors; and (2) making audit committees mandatory, starting with large companies and eventually applying this expectation to all listed companies.
- We sent a letter to the chair of the exchange providing our recommendations regarding the nomination and election processes for directors. At most Mexican companies, no information is provided to investors regarding director candidates in advance of the AGM.

Hermes votes at general meetings wherever practicable. We take a graduated approach and base our decisions on annual report disclosures, discussions with the company and independent analysis. At larger companies or those where clients have a significant stake, we seek to have dialogue ahead of voting against or abstaining on any resolution.

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



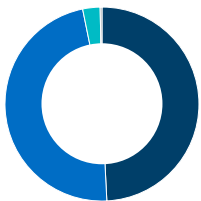
Hermes votes at company meetings all over the world, wherever its clients own shares.

Overview

Over the last quarter we voted at 6,769 meetings (69,742 resolutions). At 3,223 of those meetings we opposed one or more resolutions. We voted with management by exception at 18 meetings and we abstained at 199 meetings. We supported management on all resolutions at the remaining 3,329 meetings.

Global

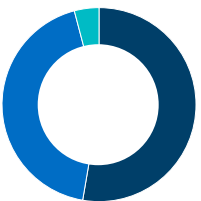
We voted at 6,769 meetings (69,742 resolutions) over the quarter.



- Total meetings voted in favour **49.20%**
- Meetings where voted against (or voted against AND abstained) **47.60%**
- Meetings where abstained **2.90%**
- Meetings where voted with management by exception **0.30%**

Australia and New Zealand

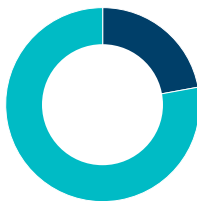
We voted at 74 meetings (337 resolutions) over the quarter.



- Total meetings voted in favour **52.70%**
- Meetings where voted against (or voted against AND abstained) **43.20%**
- Meetings where abstained **4.10%**

Developed Asia

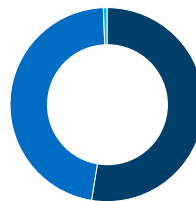
We voted at 1,926 meetings (19,613 resolutions) over the quarter.



- Total meetings voted in favour **22.10%**
- Meetings where voted against (or voted against AND abstained) **77.80%**

Emerging and Frontier Markets

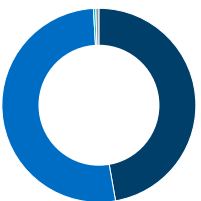
We voted at 944 meetings (9,591 resolutions) over the quarter.



- Total meetings voted in favour **52.50%**
- Meetings where voted against (or voted against AND abstained) **46.80%**
- Meetings where abstained **0.60%**

Europe

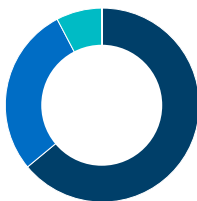
We voted at 917 meetings (11,124 resolutions) over the quarter.



- Total meetings voted in favour **47.20%**
- Meetings where voted against (or voted against AND abstained) **51.80%**
- Meetings where abstained **0.40%**
- Meetings where voted with management by exception **0.50%**

North America

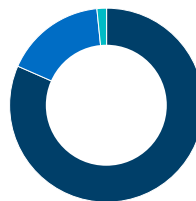
We voted at 2,480 meetings (22,953 resolutions) over the quarter.



- Total meetings voted in favour **64.00%**
- Meetings where voted against (or voted against AND abstained) **28.30%**
- Meetings where abstained **7.60%**
- Meetings where voted with management by exception **0.10%**

UK

We voted at 428 meetings (6,124 resolutions) over the quarter.



- Total meetings voted in favour **81.50%**
- Meetings where voted against (or voted against AND abstained) **16.80%**
- Meetings where voted with management by exception **1.60%**

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