HERMES
INVESTMENT MANAGEMENT

Excellence. Responsibility. Innovation.

Q1 2016

Hermes EOS

Public Engagement Report

Corporate governance blossoms in Japan – Stewardship in the land of the rising sun

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 2016.

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.

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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 our clients' investments 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 £169.8 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, ex-fund managers 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 chair Colin Melvin led the committee that drew up the original principles and we are actively engaged in a variety of workstreams through the PRI Clearinghouse. This insight enables us to help signatories in meeting the challenges of effective PRI implementation.

How does Hermes EOS work?

Our corporate, 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 and 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 360 companies are included within our core engagement programmes. 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 press.

For these reasons, this public report contains few specific details of our interactions with companies. Rather 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 2016

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

Hermes EOS team

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Head of Business and Client Development

Nina Röhrbein
Reporting and Communications

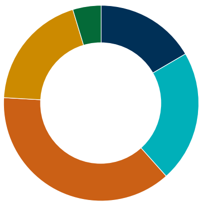
Lucy Saville
Client Relations

Engagement by region

Over the last quarter we engaged with 182 companies on 427 environmental, social, governance and business strategy issues. Our holistic approach to engagement means that we 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

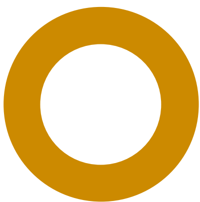
We engaged with **182** companies over the last quarter.



- Environmental **16.6%**
- Social and ethical **21.8%**
- Governance **37.5%**
- Strategy and risk **19.4%**
- Stewardship **4.7%**

Australia and New Zealand

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



- Strategy and risk **100.0%**

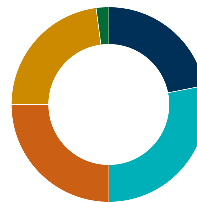
Developed Asia

We engaged with **32** companies over the last quarter.

- Environmental **8.0%**
- Social and ethical **24.1%**
- Governance **36.8%**
- Strategy and risk **21.8%**
- Stewardship **9.2%**

Emerging and Frontier Markets

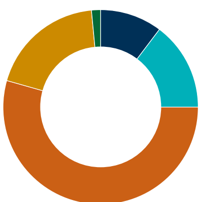
We engaged with **38** companies over the last quarter.



- Environmental **21.9%**
- Social and ethical **28.1%**
- Governance **25.0%**
- Strategy and risk **22.9%**
- Stewardship **2.1%**

Europe

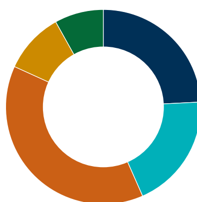
We engaged with **29** companies over the last quarter.



- Environmental **10.3%**
- Social and ethical **14.7%**
- Governance **54.4%**
- Strategy and risk **19.1%**
- Stewardship **1.5%**

North America

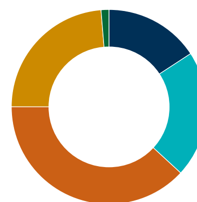
We engaged with **51** companies over the last quarter.



- Environmental **24.2%**
- Social and ethical **19.2%**
- Governance **38.4%**
- Strategy and risk **10.1%**
- Stewardship **8.1%**

United Kingdom

We engaged with **31** companies over the last quarter.



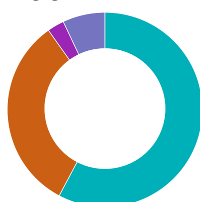
- Environmental **15.8%**
- Social and ethical **21.1%**
- Governance **38.2%**
- Strategy and risk **23.7%**
- Stewardship **1.3%**

Engagement by issue

A summary of the 427 issues on which we engaged with companies over the last quarter is shown below.

Environmental

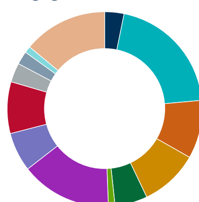
Environmental issues featured in **16.6%** of our engagements over the last quarter.



- Climate change/carbon intensity **57.7%**
- Environmental management **32.4%**
- Waste **2.8%**
- Water stress **7.0%**

Social and ethical

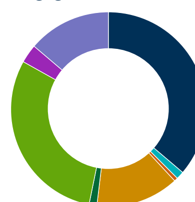
Social issues featured in **21.8%** of our engagements over the last quarter.



- Access to medicine **3.2%**
- Bribery and corruption **20.4%**
- Community relations **9.7%**
- Corporate culture **9.7%**
- Customer relations **5.4%**
- Diversity **1.1%**
- Health and safety **15.1%**
- Labour rights/employee relations **6.5%**
- Licence to operate **8.6%**
- Munitions manufacture **3.2%**
- Operations in troubled regions **2.2%**
- Political risk management **1.1%**
- Supply chain management **14.0%**

Governance

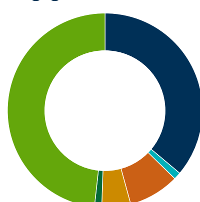
Governance issues featured in **37.5%** of our engagements over the last quarter.



- Board structure **36.3%**
- Committee structure **1.3%**
- Conflicts of interest **0.6%**
- Other governance **13.8%**
- Related party transactions **1.3%**
- Remuneration **30.0%**
- Separation of chair/CEO **3.1%**
- Succession planning **13.8%**

Strategy and risk

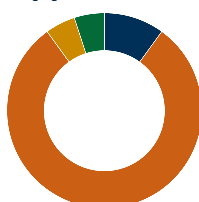
Strategy and risk issues featured in **19.4%** of our engagements over the last quarter.



- Business strategy **36.1%**
- Capital structure **1.2%**
- Reporting/disclosure **8.4%**
- Reputational risk **4.8%**
- Returns to shareholders **1.2%**
- Risk management **48.2%**

Stewardship

Stewardship issues featured in **4.7%** of our engagements over the last quarter.



- Accounting or auditing issues **10.0%**
- Shareholder communications **80.0%**
- Shareholder rights **5.0%**
- Stewardship code **5.0%**

Environment

A wake-up call – Implications of the low oil price for the extractives industry

The low price of oil has influenced the strategy of companies in the oil and gas sector and our engagement with them.

Setting the scene

Just a few years ago, the long-term forecast by energy experts and organisations was that the only way for the oil price to go was up. Increasing demand for the commodity, fuelled by more industrialisation in developing countries, as well as shrinking reserves and geopolitical conflict in oil-producing countries bolstered the price a decade ago. However, with the advent of the shale oil and gas revolution in the US the price of oil began to slide, creating the low oil price environment of today.

Oil price development

Source: Bloomberg

Causes

A glut of shale oil and gas in the US, subdued global demand for oil, coupled with strong supplies, including increasing production from Iran and stable output from the Organization of Petroleum Exporting Countries (OPEC) despite ongoing geopolitical tensions in the Middle East, have created a weaker environment for the oil price. OPEC's ability to affect prices has been limited as Saudi Arabia has chosen not to reduce production.

As a result the price of WTI crude oil plummeted from over $100/barrel in 2014 to below $30/barrel in February 2016. Although the oil price has recovered since, a long-term recovery to $100/barrel is not in sight anytime soon.

Implications

This has been a wake-up call to the industry, which had been resting on its laurels for too long in the belief that oil prices would never be low over long periods of time. Oil companies are now more accepting that longer periods of low oil prices are increasingly likely future scenarios although they continue to bank on the recovery of the oil price to $60-70/barrel. And this has had major impacts on the activities and strategies of extractive companies.

Companies in the sector have had to cut back on their overall costs. While some have reduced the dividends they pay to their shareholders, others have been trying to conserve cash and borrow to maintain their dividend policy. Others have stopped the buy-back of their shares.

Some oil and gas companies are increasing their debt to increase the dividends to investors. BP, for example, reported that its net debt increased by 20% in 2015.

The low oil price has also led to sharp reductions in the capital expenditure of oil companies. High-cost, long-lived projects have been slowed, postponed or even cancelled, with oil companies believing that the restriction of supply will help prices to increase.

After spending billions of dollars on its two drilling seasons off Alaska, oil major Shell, for example, announced the withdrawal from its Arctic drilling programme in 2015. The company has written off its investment, blaming its failure to find meaningful oil and gas reserves and the uncertain regulatory climate in the US for the aborted mission. We came across varying estimates of the operational costs of each barrel of Arctic oil extracted, but if there was little imminent prospect of recouping the capital expenditure already spent and likely to be spent in a low oil price environment, Shell's decision was maybe a matter of business economics, made more simple by the reputational and regulatory difficulties it experienced there. Its balance sheet is under particular pressure following the company's strong commitments concerning its dividend policy and the acquisition of UK peer BG Group, which again was predicated for higher oil and gas prices.

Most US shale exploration and production companies are in varying degrees of financial distress and only able to pay the interest on their debt by using the revenue from existing production and cutting costly drilling. This will allow others to begin to buy distressed assets cheaply, particularly as their debts mature and hedges expire.

Canadian company Suncor Energy has already bought other Albertan oil sands assets, as players in the region have also been struggling. In addition to the low oil price, the introduction of an emissions cap and a higher tax on greenhouse gas emissions by the provincial government of Alberta in Canada have put further pressure on oil sands activities.

Renewables

Solar and wind are beginning to reach cost parity with prices from the electric grid in the developing world. However, superficially, it is still a higher oil price that strengthens the case for renewables. Prolonged low prices for oil and gas reduce the attractiveness of investments in energy efficiency and renewables as investments will take longer to pay back. However, the oil and gas industry has a history of betting on high oil and gas prices as they invest in massively capital-intensive projects that often overrun their budgets. This suggests that investors may

increasingly find investments in the low-carbon economy much more attractive. This will be particularly the case if the momentum of the post-COP21 climate agreement is maintained.

Any exposure to renewables by oil majors is generally limited. Instead they prefer to conduct early stage research into cleaner energy options, such as carbon capture sequestration, whereby CO2 emissions from fossil fuels are captured and stored and converted into other materials, as well as biofuels.

And so, the pause in oil and gas investment provides a great opportunity to speed up the move beyond fossil fuels to other energy sources and a low-carbon economy.

Gas

In an attempt to position themselves as helping in the fight against climate change, oil companies are increasingly turning to the lowest carbon-producing fossil fuel in their portfolio – gas. When oil prices were high, large gas fields were less attractive but now they are seen as the big saviour in the battle against carbon emissions and supply is plentiful.

Through anti-pollution and climate regulation, gas is rapidly replacing coal in the developed world and there are encouraging signs that China is moving to reduce its coal consumption similarly.

Coal has already begun to strand in the US as a result of shale gas exploitation and clean air regulations. Coal-fired power stations have been closing in favour of gas-fired power plants, therefore resulting in a drop in the price of coal and an increase in the number of US coal producers seeking to export the fuel. In Europe, however, due to cheap coal prices and the phasing out of nuclear power in Germany, the trend has begun to reverse, and coal use by utilities has been on the rise, at least in the short term. The slide into bankruptcy protection of Peabody Coal in the US is a harbinger of similar events, despite the likelihood of it re-emerging free of debt, with lower wages and benefits under new owners.

Our engagement

Although health and safety has improved across the industry, which is backed up by statistics, companies can easily become complacent, as the memories of the 2010 Macondo oil spill disaster in the Gulf of Mexico begin to fade.

With corporate balance sheets often stretched and contractors under even more pressure, we seek to ensure that companies are not cutting corners on health and safety, environmental protection and investment in their social licence to operate.

We urge companies to maintain their advances on energy efficiency and not make false economies in preventative maintenance. The Aliso Canyon disaster, which vented almost 100,000 tonnes of methane in California between October 2015 and February 2016, serves as a reminder that, fugitive methane, leak detection and repairs must remain a priority for the oil and gas value chain, particularly amid tightening industry legislation. While the focus is often on new projects, methane and other leaks are generally associated with existing projects and ageing infrastructure.

As part of our engagement in this area, we, for example, gained an insight into the response to low oil prices at an investor meeting with the outgoing CEO and the appointed co-CEOs of an extractives company. Management presented its new operating model, which is on track to deliver sustainable cost savings. Through its cash conservation plan, aimed at positioning the company for a low oil price environment, the company's management has reduced headcount and paced capital expenditure. We challenged the CEO on the impact of significant cost savings on the company's environmental and social performance and were reassured that its sustainability performance has not been compromised but seek further meetings on this and other issues.

Against the backdrop of more mergers and acquisitions, we also encourage companies to apply their best practices to the newly acquired parts of the business.

In a meeting with a US oil and gas company, we made the point that it was rightly proud of the conservatism with which it runs its business, its balance sheet, capital discipline and commitment to minimising operational and project risk. But we highlighted that this conservatism could also be its blind spot in relation to the energy transition that the global economy is facing in the next two to three decades if the world is to avoid the worst effects of climate change. We reminded the company that the industry had done a great job after the Macondo oil spill in reviewing, improving and rehearsing for possible catastrophic accidents. By doing this work, we believe that the industry as a whole has worked well to improve its risk management and operational standards. The industry accepts that this type of stress-testing and rehearsal of different scenarios is a vital part of the risk management it needs to conduct. We argued that it needs to think about low oil prices and climate change with the same attention as it has done on the lesson from Macando.

It is crucial that the industry continues this work, even in a low oil price environment.

For further information, please contact:

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Social

The balancing act – Companies and indigenous rights

Many companies, particularly those in the extractives sector, develop and operate projects on lands inhabited by indigenous communities. We urge companies to take this into account to minimise their financial, operational and reputational risks.

Setting the scene

Our planet is home to approximately 400 million indigenous people and more than 5,000 tribes, according to the UN. While indigenous peoples represent only about 6% of the world's population, they account for 15% of the world's poor. They live on 20% of the earth's land mass but that land harbours 80% of the world's remaining biodiversity. Crucially, an estimated 46% of the reserves of extractives companies is on that land, as is 39% of their current mineral production, according to First Peoples Worldwide, an indigenous-led NGO. Projects, such as oil sands exploration and mines, have significant physical impacts on the local communities and their environment, but even agriculture, forestry and public transport can leave a substantial footprint. Banks meanwhile can come under fire for financing projects that threaten indigenous rights. The relationships of companies with indigenous peoples are therefore increasingly critical to the profitability, operations and reputation of businesses.

Concerns and benefits

As indigenous peoples have lived on lands earmarked for exploration by companies for a long time, they are particularly vulnerable to the change in environment that accompanies extractive projects. Concerns are the possible eviction from native lands and the physical removal or stripping of natural assets, including mineral resources, timber, water and agricultural lands. This can destroy sacred sites, impact traditional hunting routes and upset the ecological balance necessary to sustain indigenous cultures, often leading to impoverishment of the communities.

Even if the communities remain on their native lands, they may be adversely affected by the effects of exploration activities. These may include deterioration in public health due to pollution of the air, land and water. In addition, an influx of migrant, predominantly male, workers can lead to the threat of sexual violence against natives, as well as anti-social behaviour, often linked to alcohol or drug abuse.

However, projects can also undeniably benefit communities by providing them with access to potable water, infrastructure such as sewage systems and even medical facilities, housing and schools, as well as training and jobs. These are particularly crucial as indigenous peoples tend to be marginalised and disadvantaged economically.

Rights

Historically, few countries have recognised indigenous peoples as legitimate groups and so denied them political and legal rights. However, in some parts of the world legal frameworks have been improving for indigenous peoples, leading to better recognition of their rights, for example in Latin America.

The UN Global Principles on Human Rights, the 2007 UN Declaration on the Rights of Indigenous Peoples, the ILO Convention 169 on Indigenous and Tribal Peoples, as well as the Indigenous Peoples and Mining Good Practice Guide by the International Council on Mining and Metals have helped to increase awareness of the issue and companies have become more alive to the rights of indigenous peoples, in particular in their recognition of free, prior and informed consent (FPIC). FPIC entails that companies – and authorities – planning to operate in an area home to indigenous peoples must engage with the communities and reach an agreement through FPIC before a project can commence. FPIC also means that indigenous peoples have some right to withhold consent to a project, in line with their right to self-determination, without being put under constant pressure to agree. FPIC should not be seen as a legal compliance checkbox but as an opportunity to communicate and engage with a community and establish good relationships, according to indigenous-led NGO First Peoples Worldwide (FPW).

Risks

Indigenous rights are important to companies as any breaches or shortcomings of expected standards can expose them to reputational and legal risk, particularly in the age of social media, and lead to conflict with indigenous communities. Furthermore, controversy and protests can lead to interruptions and shut-downs in exploration, project development and operations, as well as to problems in obtaining and maintaining a social licence to operate – thus potentially resulting in financial damage. Moreover, increasingly indigenous communities and NGOs are using legal remedies to enforce their rights.

Balancing act

Many companies are improving and best practices are evolving, however, this is not happening as quickly as many investors would like to see. Often, engagement with indigenous peoples is also more complex than companies expect.

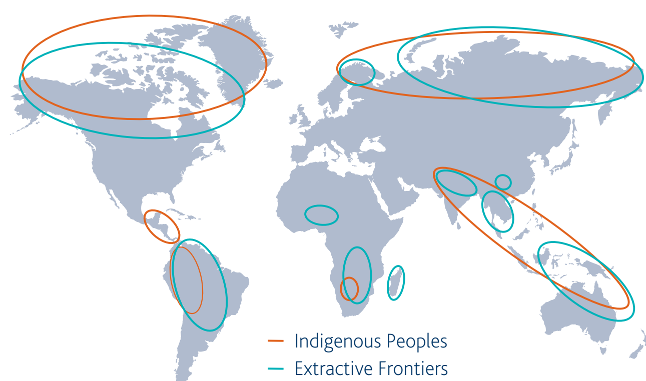
Any construction projects undertaken – especially as these typically take place in remote areas – will always have some impact on the environment and communities. In our engagement with companies, we therefore urge them to minimise that impact and the associated risks by putting in place appropriate mitigation measures.

In Brazil, for example, some dam projects had a severe impact on their locations, through flooding of a significant area and the displacement of communities through a large number of workers. More recent projects are managing this more carefully. Brazilian utility Eletrobras appears to have learned from past projects and in planning for its Tapajós dam is engaging much more intensively with local communities on the developments and informing them about the dams and hydroelectric power plants. It is also seeking less disruptive methods to transport materials to the site and to house the construction workers.

However, assessing the social impacts and ascertaining what is good for the affected communities and what a company should and can do can be a difficult balancing act. If companies can negotiate positively using FPIC, the project is more likely to be successful. But even establishing whether an entire community is in favour of a project or a select few representatives of a community are presenting their own views can be challenging. In our dialogue with companies operating in areas home to indigenous peoples, we urge them to take a multi-faceted approach to engaging with the community. This should include different parts of the community, such as tribal and other leaders. It is crucial that companies familiarise themselves with the community to ensure negotiations are conducted properly and to find out how they can manage the issues affecting indigenous peoples. In addition, we press companies on the extent to which their boards oversee their social licence to operate.

Apart from indigenous rights policies and ensuring their correct implementation, companies need to look at the country risk. They need to be aware of how they manage their relations with the government controlling the country, especially those that grant indigenous groups fewer legal rights. For example, does the company choose to be the preferred partner to the government and make concessions on indigenous rights or does it decline work in countries where it cannot ensure that indigenous rights are upheld? We believe companies should not step into the role of the governments and must be careful that they do not substitute themselves for the state. Often the infrastructure they build, such as roads and medical facilities, is welcome. However, providing infrastructure such as a school is arguably beyond the company's role and the funding of teaching staff even more so.

Major extractive frontiers



Source: Russell Barsh in cooperation with First Peoples Worldwide

The resettlement of local communities can be a controversial issue for projects on indigenous lands. However, companies are more concerned than previously about keeping the relocation of communities to a minimum. Today the focus often lies on land reclamation after a project has come to an end. Companies need to address the social consequences of finishing a project, such as an increase in the local unemployment rate, in addition to minimising the environmental legacy of the project.

At the other end of the spectrum, companies and investors also need to assess how representative NGOs are about the claims they make about the impact that operations have on indigenous communities and their environment. It can be difficult to assess the truth in this environment.

Seeking indigenous views

As part of our due diligence and risk assessment of companies that operate on lands home to indigenous peoples, when necessary, we go beyond the information provided by them and pursue direct contact with community members.

On our trip to the Arctic in 2015 to investigate offshore oil and gas activity in the region, for example, we met leadership representatives of the indigenous peoples from the nearest settlement to the proposed offshore activity and from across the region. While they were selected by the company, their support for the development of the Arctic was nevertheless striking. The leaders saw this development as the only way to maintain the living standards and basic amenities of their communities, such as electricity, sanitation, television and telecommunications. However, other indigenous people also pointed out that there was a complete spectrum of opinion about the exploration activities. We requested more detail from the company on the extent of its community outreach programme. While we were pleased that it confirmed that it had held more than 500 meetings with the community since 2006, we sought contact with community representatives who had reservations about its activity to better understand their perspectives via FPW.

As part of our engagement on Canada's oil sands, we met a representative of one of the First Nations peoples local to the oil sands developments and a doctor who has been advocating on their behalf. The doctor, who appears to be a credible source due to his experience of living in the region and making sacrifices on behalf of his patients, believes that the significant increase in acute and chronic diseases in the indigenous communities is caused by developments of the oil sands. The local First Nations blame the provincial and federal governments for what they view as a crisis in their communities and seek greater regulatory protection. In response to our questioning, the company involved argued that there was decent baseline data on the environment prior to oil sands activity and pointed out that the oil occurs in the water and land naturally so could not be attributed to the oil sands industry. Companies confronted with such claims need to investigate any causes of ill health or similar matters through an independent third party with an open mind and explain their findings. The company concerned in this case said that it was developing a survey to provide better data.

We commended a US materials company for providing a detailed report on the outcome of its human rights risk assessment at its mine in the Democratic Republic of Congo, which it had identified as the riskiest in relation to human rights. We were impressed by its willingness to share what it is doing in such a difficult human rights environment and pleased that it will undertake a similar report on another controversial mine. The company has already taken some of our suggestions on board to improve its reporting.

It remains important to take a balanced view on the controversies that often accompany proposed projects on indigenous lands. But we believe that an equilibrium can be found between companies and indigenous peoples so that any developments are undertaken sensibly and carefully with economic and social benefits for the communities involved.

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Corporate governance blossoms in Japan – Stewardship in the land of the rising sun

The introduction of the Stewardship and Corporate Governance Codes in Japan has added momentum to our engagement in Japan although challenges remain.

Setting the scene

Japan formally made huge strides in corporate governance and stewardship in recent years. In 2014, led by its government and driven by the regulator, the country published its stewardship code, the Principles for Responsible Institutional Investors, in an effort to foster sustainable, longer-term growth and attract foreign investors. The development of the principles-based code by Japan's financial services industry represented a sea change for Japanese companies, which were used to hard laws and rules. In 2015, the country followed suit with the introduction of its first ever Corporate Governance Code in order to improve the governance structure of Japanese companies. Through our engagement with the relevant regulators and our response to the consultations, we were involved in the development of both codes and contributed towards their implementation.

Accountability

One of the main issues we have come across in our engagement in Japan is the lack of accountability of company boards to shareholders. Although access is improving at some companies, it remains difficult for investors to engage directly at the board level. This is in part a cultural legacy, with the CEO and chair often assuming the role of sole decision-makers for a company.

We therefore continue to press for enhanced dialogue between companies and shareholders, including for direct contact with non-executive directors. This would enhance accountability and could change the mind-set of such directors. Moreover, it would allow shareholders to assess their effectiveness.

Independence of board directors

Another prominent corporate governance challenge Japan still battles with today is the limited level of independence on its company boards.

The Corporate Governance Code requires Japanese companies to have two independent directors. From the moment it came into force in June 2015, companies have been obliged to comply with this requisite or explain why they do not have the required number in place. Research by the Tokyo Stock Exchange indicates a high compliance rate, with nearly 80% of listed companies stating that they comply with 90% of the principles. Many of them rushed to have the required two independent directors in place when the Corporate Governance Code took effect.

However, for us, engagement on the independence of board directors is not over yet. We still have doubts about their quality and genuine independence, as sometimes directors are declared independent when in reality they are affiliated with the company, which reduces their effectiveness. They can, for example, originate from a major shareholder or businesses the company has a relationship with. This has in part been due to the loose definition of independence by the Tokyo Stock Exchange published in December 2009. In its listing rules, the stock exchange initially required companies to appoint at least one independent director or one independent statutory auditor. Unsurprisingly, most opted for the weaker statutory auditor. However, this has since been revised to one independent director. Still, there is no clear definition of independent directors in the Companies Act and the Japanese concept of a board is more akin to that of a senior management committee that meets regularly to make operational decisions than an entity with strategic oversight of the company.

We assess on a case-by-case basis whether we believe two independent directors are sufficient or whether we should encourage the company to go beyond this minimum requirement set by the Corporate Governance Code and strive for best practice. In our view, a large company should aim for an independence level of one third. In addition, companies should ensure that the board comprises directors with the right mix of skills, backgrounds and experience, although this is not specifically mentioned in the Corporate Governance Code.

Board size

In our engagement with Japanese companies, we also often address the appropriate size of company boards. Until recently, Japanese companies typically had large boards because these were positioned as management committees, consisting of senior executives from various parts of the business. Being invited to serve on the board of a company has traditionally been viewed as the ultimate accolade in social status, which is why companies have struggled to reduce the size of their boards by limiting the scope for such promotion. This has resulted in the creation of executive officer roles at many companies in the past few years to limit the influx of board members. As they are supposedly of equal high status, these senior management roles help to decrease the size in the board while at the same time ensuring a pipeline of talent. Although we welcome the reduction in the board size, we continue to engage with companies to ensure that the creation of executive officer positions adds value and leads to the genuine separation of monitoring and executive functions and improved efficiency of the board.

Depending on the size of the company, we believe a company board should contain no more than 15 members. Anything above is likely to be too large to be effective.

Cross-shareholdings

Large listed Japanese companies traditionally own shares in each other, the practice of which is known as cross-shareholding. This is a result of the post-World War 2 break-up of the industrial and financial conglomerates whose influence and size allowed control over significant parts of the Japanese economy.

However, to us cross-shareholdings are not an efficient use of shareholding capital and potentially contribute to poor governance at investee companies. The main reason why companies have cross-shareholding in other companies is to maintain or strengthen relationships with their business partners and suppliers and ensure preferential treatment, for example in sourcing and distribution. This also means that companies with cross-shareholdings tend to support management of the investee companies instead of exercising their voting rights appropriately to hold management to account.

The Corporate Governance Code asks companies to disclose their policy on cross-shareholdings. In addition, it says the board should examine the mid- to long-term economic rationale and future outlook of major cross-shareholdings on an annual basis, taking into consideration associated risks and returns. The annual review should result in the board's detailed explanation of the objective and rationale behind cross-shareholdings.

However, while some companies try to justify their cross-shareholdings, they do not understand that fundamentally investors are not supportive of this practice and ultimately would like to see it disappear.

At Hermes EOS, we believe that business partners should be elected on the quality of services rather than shareholder relationships, which is a questionable use of capital. While the trend to cross-shareholdings is indeed declining and major Japanese banks have announced plans to sell many of these, questions remain about the extent of this, as well as about such holdings by other financial institutions and companies.

Diversity

Part of our engagement agenda is to improve the diversity of company boards. An increasing body of research[1] shows that greater diversity leads to better performance of companies and different forms of diversity bring values, change corporate risk-taking behaviour and may even have an impact on the likelihood of fraud. In our engagement with companies, we have called for greater diversity on boards in order for their members to provide a different perspective necessary to challenge senior executives and non-executives, as well as to counter groupthink and unconscious biases that might dominate decision-making.

This is particularly crucial in Japan which has one of the poorest track records in terms of gender equality of the developed countries. It does not fare much better in terms of nationality, background and expertise and to date, the majority of company boards are still made up of predominantly Japanese men.

The Corporate Governance Code calls for the promotion of diversity of personnel, including the active participation of women. However, for Japanese companies a lack of talent pool can be a genuine problem. Traditionally, graduates would enter employment at one company and remain at the same organisation until retirement. People moving across companies is still not common practice in Japan, resulting in a less liquid talent pool, in particular for women in senior positions. The number of companies looking to appoint outside directors in 2015 added to the pressure on the already limited candidate pool.

Case study

At the start of our engagement with telecommunications company KDDI in 2012, its board consisted of 12 directors, made up of 10 executive and two non-executive directors. While presented as outsiders by the company, in reality the two non-executive directors represented the two major shareholders of KDDI. We believed that the interest of minority shareholders would therefore not be adequately addressed. The board also lacked diversity, which added to our concerns.

In a number of meetings and calls with the company, we argued persistently that the interests of the affiliated directors could differ from that of minority shareholders and that the board needed genuinely independent elements to protect the latter. At KDDI's AGMs, we thus continued to withhold support for the affiliated directors.

In a meeting in 2013, KDDI for the first time told us that its board was considering appointing independent directors. This was a reflection on the result of the previous AGM where the two affiliated directors received a significantly lower level of support than the rest of the board members. As the company said it struggled to find suitable candidates from the telecoms industry, we shared our views that non-executive directors do not necessarily all need to have industry experience. We explained that individuals with backgrounds in different business sectors could also add significant value. In 2014, we welcomed the appointment of KDDI's first truly independent director. Pleased to learn that messages from investors and other stakeholders, including ourselves, had influenced the decision, we encouraged the company to consider enhancing the level of the board's independence further. We applauded the subsequent appointment of a new female independent director to the board in 2015, which was in line with our request to increase board independence and diversity.

Remuneration

While we do not have much concern about the quantity of remuneration of executives in Japanese companies, the link between pay and performance is often unclear. In our engagement, we have therefore pressed companies to improve the disclosure on their remuneration policy and metrics.

Improvements

As a result of the introduction of the Stewardship and Corporate Governance Codes, asset owners and fund managers have become more active in their engagement with Japanese companies. We understand from our discussions that local private pension funds and insurance companies would like to engage for change and are looking for ways to achieve this.

We have contacted the council of the Financial Services Agency in Japan in charge of following up on Japan's Stewardship and Corporate Governance Codes to deliver our messages regarding the effective implementation of the codes. Welcoming the comply-or-explain approach employed by the codes, we shared our views on effective interpretation of the requirements and the meaningful explanation companies are expected to provide in case of non-compliance.

Positively, the influential Government Pension Investment Fund signed up to the UN-backed Principles for Responsible Investment in 2015 and has hired staff with particular responsibility for stewardship. This has set a good precedent to others.

The launch of the Stewardship and Corporate Governance Codes has helped to pave the way for better corporate governance at Japanese companies. Together with increasing pressure from shareholders, the outlook for more impactful engagement and better corporate governance is positive. We continue to call on companies in Japan to provide shareholders with better access to senior management and members of the board whom they elect, including independent directors, to enable them to discuss strategy, capital policy and corporate governance.

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Strategy

The value-add of intangibles – Engaging on environmental and social issues

Our engagement on material ESG factors such as climate change, health and safety and labour rights has increased over the years and research is pointing towards a value-add in investment portfolios as a result of the integration of these factors.

Setting the scene

Environmental and social issues, such as climate change, health and safety standards and labour rights have become increasingly important to companies, as failing to adhere to best practice standards can lead to public scrutiny and debate. Apart from their adverse reputational effects on companies, scandals and accidents can also lead to a significant decline in company value, as demonstrated by the Volkswagen emissions scandal in 2015 and BP's Macondo oil spill in the Gulf of Mexico in 2010. A better awareness of environmental, social and governance (ESG) factors, such as corporate governance or health and safety standards, might have contributed to protecting the companies from significant financial losses or to upholding their reputation.

Evidence

The materiality of climate change, health and safety standards and labour rights is more pronounced in some sectors than in others. However, companies that pursue sustainable business strategies and have superior environmental, social and governance (ESG) standards are often the preferred investment targets for some of the world's largest institutional investors[1] as they tend to deliver better risk-adjusted returns and have a lower volatility of cash flows, both ultimately leading to higher company value and thus benefitting shareholders.[2] Robust and convincing evidence points to a positive correlation between good sustainability practices and company performance.[3] Nonetheless, the mainstream investor community tends to think of environmental and social factors as less of a value driver[4] than corporate governance because the latter is perceived to be directly linked to company valuation and comprises some of the mechanisms controlled by investors, such as the composition of board of directors. A plethora of studies reveals that well-governed companies tend to outperform[5] their poorly-governed counterparts, even though there is some evidence that this effect may have been fading in recent years.[6]

Surprisingly, environmental and social issues have been under much less scrutiny by researchers and institutional investors alike. This might be due to the common misperception that topics such as climate change, health and safety and labour rights are difficult to quantify and as intangibles might not be directly linked to company performance or correlated with a company's cost of capital. Their lack of tangibility makes it difficult to incorporate these factors into a standard company valuation analysis, which mainly rests on financial information, while in general financial markets have found it difficult to price in ESG information.

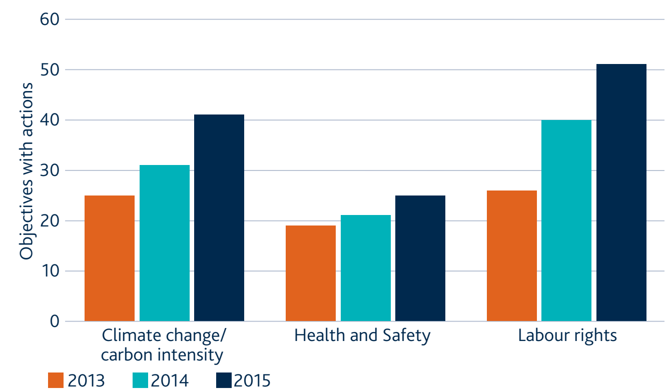
A good example for this is employee well-being, which, as an intangible ESG issue, is mostly assessed with the help of employee surveys and questionnaires. While these methods can be a good indicator for the well-being of employees, the nature of a survey might influence the generalisability of the findings. Nevertheless, researchers and investors eventually realised the potential value-add from employee well-being, which has led to the issue becoming an important social topic. Nowadays, there is robust evidence which suggests that employee satisfaction, or well-being, not only increases the productivity of the workforce, but that this productivity gain also translates into an overall better financial and operational performance. Research shows that a portfolio consisting solely of the companies with the highest employee satisfaction delivered a risk-adjusted outperformance of 3.5% per annum between 1984 and 2009.[7] This is an economically meaningful return and further evidence implies that asset owners could benefit from investing in the best-in-class companies in relation to any ESG dimension. Research also shows that better and more sustainable policies with respect to intangible factors[8] benefit not only shareholders but also non-financial stakeholders.

It is therefore crucial that investors assess a company's ESG performance by paying attention to topics such as climate change, health and safety standards and labour rights.

Our engagement

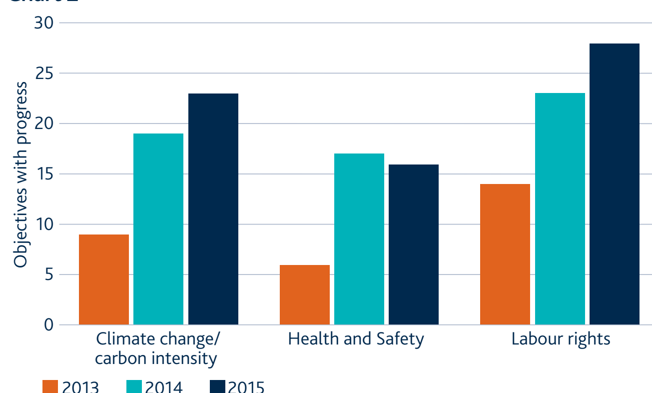
Over the course of the last three years, we engaged with many companies on climate change, health and safety and labour rights. As Chart 1 reveals, we increased the intensity of our engagements over the last few years in all three areas. The number of objectives we engaged on in relation to climate change/carbon intensity rose from 25 in 2013 to 41 in 2015. The trend is similar for health and safety and labour rights, which show an increase from 19 to 25 and from 26 to 51 respectively.

Chart 1



Our proprietary milestone systems allows us to identify and track progress in our engagements. Looking at the number of objectives for which we observed progress, such as a change in the milestone rating, we also noted several positive trends, as shown in Chart 2. The number of objectives on climate change/carbon intensity issues where we were able to achieve progress rose from nine in 2013 to 23 in 2015 and from six to 16 for health and safety issues. The number of objectives with progress also doubled for labour rights objectives from 14 in 2013 to 28 in 2015, reflecting the growing success we have in our engagements.

Chart 2



The way forward

Engagement by institutional investors on the aforementioned issues is increasingly important because stock markets are slowly but steadily picking up the value-add from ESG information. When a growing number of market participants is incorporating this intangible yet material information, in combination with more media coverage, the correlations observed between sustainable ESG practices and financial market performance may disappear at some point in the distant future when ESG factors will already be priced in.

From a corporate finance theory point of view, this might have immediate consequences for ESG investment strategies which exclusively rely on a best-in-class approach whereby only the companies with the highest ESG standards are included in the investment portfolio. To benefit from these ESG investment strategies in future, we believe investors should back up their investment strategies with corporate engagement on ESG and strategy issues, which allows them to take advantage of a company's improvements in ESG. This approach would reflect the fact that ESG is a dynamic approach which can only be harvested if engagements are undertaken.

Research undertaken of Hermes EOS' proprietary ESG engagement data in the extractives sector by Andreas Hoepner, Ioannis Oikonomou and Xiao Yan Zhou of the ICMA Centre at the Henley Business School in the UK has revealed how engagements on the aforementioned topics can increase value and provides a convincing argument for institutional investors to conduct engagements with investee companies.[9]

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3 For the latest and to date one of the most comprehensive evidence, see Friede, G, Busch, T and Bassen, A. ESG and financial performance: aggregated evidence from more than 2,000 empirical studies (2015) Journal of Sustainable Finance and Investment, 5(4), pp210-233.

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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

Appointment of independent chair

Lead engager: Tim Goodman

We were delighted that the executive chair of a North American extractives company had been forced out and that the lead independent director has become the independent chair. We had pushed over a number of years for increased power for the lead independent director to counteract the dominance of the company's entrenched management. The former chair had presided over a poorly governed company struggling with low commodity prices, which has some assets in high-risk areas. While there has been evidence that the company has been slowly improving its governance and environmental and social performance, this change provides a catalyst for further improvement and more than completed our objective for increased power for the new chair. We will write to the company to advocate a strong specification for the independent chair and that it should keep in place this role. We will also seek assurance that the specification for the chair's role be adopted by any future lead independent director should the role of chair and CEO be recombined.

In a further sign of the company's much improved approach to engagement, we received details from the company about the human rights assessment it has carried out at one of its sites in the Democratic Republic of Congo (DRC) and the webinar it held on this subject in 2015. The company plans to conduct a similar assessment at another site which it has identified as having the second most acute human rights risks in its portfolio. At this stage, however, we were satisfied with the human rights work it is conducting in the DRC.

Governance reform

Lead engager: Sachi Suzuki

We obtained insights into the progress in governance reform at a Japanese company. It is one of a few hundred companies in Japan which, following reform of the Companies Act in 2015, have adopted a new board governance structure with an audit and supervisory committee. We commended its rationale for the shift, which was to clearly separate the executive and monitoring functions of the board in order to speed up the decision-making process for its increasingly globalised business. This is in contrast to many others which adopted the system to increase the number of independent directors by simply redesignating independent statutory auditors as independent non-executive directors, without going through a search process for candidates. We also welcomed the voluntary establishment of the council on executive nomination and compensation, which consists of the CEO and outside directors. As the council is positioned as advisory and does not have clear decision-making authority, we encouraged the company to give the council more authority on these matters. We applauded the introduction of an earnings-based performance share scheme on top of the existing variable pay to increase the overall proportion of long-term incentives against base pay. While we welcomed the disclosure of the company's policy on strategic shareholdings, we shared our views that this practice is fundamentally questionable and we would like the company to phase it out. These holdings, which are undertaken for the sake of maintaining business relationships, can hamper fair competition between potential business partners. Those undertaken for pure investment purposes should also be reconsidered and the funds aimed at such holdings should be re-directed for investment into the business or be returned to shareholders.

Low-carbon strategy

Lead engager: Natacha Dimitrijevic/Bruce Duguid

We were reassured that a European company has developed a strategy for the transition to a low-carbon economy. The company has developed science-based targets consistent with limiting climate change to 2°C. Through this exercise, it has strengthened its 2020 emissions performance target and has a long-term goal of zero carbon emissions by 2050, with 85% of new growth capital expenditure allocated to renewables. The company is also retiring 20 fossil fuel plants over the next five years, although it has not set an end-date for the use of coal or oil for power. We challenged the company on why it has not set medium-term targets over the period 2020-2050. We also expressed concern that regulation could change and require the early closure of all coal plants in certain geographies. The company explained that it is further developing its strategy, but that it currently plans on a five-year basis. It believes the key risks to its strategy arise from low commodity prices, particularly of gas and coal, and also the complexity of delivering its strategy which has resulted in a recent reorganisation of the business. We will continue to engage with the company to ensure that it delivers on its strategy and to seek further transparency of its longer-term decarbonisation targets.

Sustainability report

Lead engager: Hans-Christoph Hirt

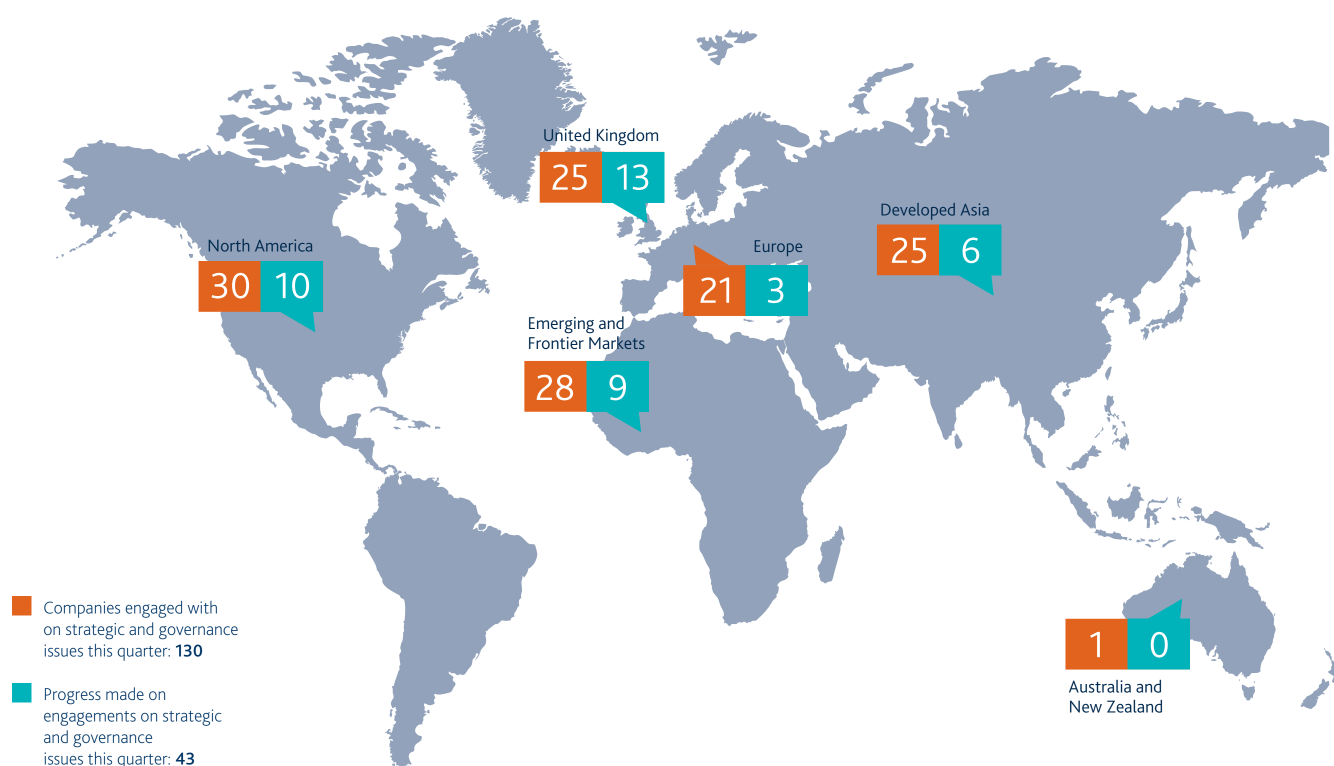
Positively, many of the suggestions we have made over the last couple of years on the reporting on product safety by an emerging markets company have been incorporated in its 2014 sustainability report. We were particularly pleased about a case study on the latest safety incident and the measures taken in response which we had encouraged in our engagement. Our feedback focused once more on encouraging the company to go beyond describing the measures it has taken over the last few years to demonstrating that they are effective in practice. In this context, we urged for more explanations of some of the data presented and recommended putting it into an industry and best practice context. We also encouraged the inclusion of targets relating to key performance indicators. The company was grateful for our feedback and promised to take it on board when compiling the next report. We also commended the company for introducing some slides on product safety management in its general investor relations presentation. Disappointingly, the construction of the company's new product safety centre is delayed. We plan to visit the centre once it is in operation and then, depending on a final assessment of progress made since the first major safety issue, close the objective on product safety management following the company's decisive actions and improvements over the last few years.

Supply chain risk management

Lead engager: Dominic Burke

Our call with the company secretary and sustainability director of a UK firm convinced us that it is credibly managing supply chain risks in Bangladesh and transferring best practice to other sourcing markets. We were pleased to hear that the business has a team of 12 based in Bangladesh's capital Dhaka, with an additional 50 focusing on ethical trade in other regions, and that it has appointed chemical and structural engineers, as well as a safety expert from the Bangladeshi fire service, to provide support to its suppliers. In addition to those required of the Bangladesh Accord on Fire and Building Safety, an industry safety initiative, the business carries out its own structural surveys of all suppliers and has extended this approach to Pakistan, with a view to rolling it out across all sourcing markets in time. Positively, the business has now finished mapping its tier two and three suppliers in Bangladesh. Despite the progress and ambition in its approach, we conveyed our desire to see clearer targets and tracking of progress at the group level. We were disappointed to hear that oversight of supply chain risk is not considered a matter for the audit committee but is something discussed by the entire board as part of annual updates or in response to notable concerns. We will seek a meeting with the audit committee chair to explore this arrangement in more detail. The business' head of ethical trade welcomed our feedback on improved disclosure of its management of supply chain risks and undertook to review the example of best practice we shared from a European peer.

Engagements on strategy and governance issues



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 – particularly companies, lawyers and accounting firms, which tend to be more active than investors in these debates – whose interests may be markedly different.

Highlights

Global stewardship code

Lead engager: Darren Brady

We provided the International Corporate Governance Network (ICGN) with our views and suggestions on the work it has begun to introduce a global stewardship code in a response to its consultation. The proposed code seeks to build on ICGN's existing policy framework, including the ICGN Global Governance Principles, and to add to its guidance on international stewardship. It is meant to complement rather than supersede national stewardship codes. We welcome the creation of a global code for investors seeking to implement their stewardship policies in markets without such codes or across multiple markets with differing stewardship codes. Signing up to stewardship codes in many markets or referring to foreign codes is likely to be inefficient and may lack credibility in a specific market. The global stewardship code could also act as a helpful resource for regulators in markets considering the development of their own local or regional stewardship codes and principles.

Nevertheless, it is crucial to recognise different legal and cultural frameworks and environments and, most significantly, different models of corporate finance and ownership of listed companies in markets globally. Some concerns remain about how to address stewardship activities in family- or state-controlled companies often found in Asia or continental Europe – as opposed to the widely dispersed share ownership typical for the UK. We have encouraged more thinking on this important issue. The proliferation of stewardship codes is positive, as they increase awareness of the role of institutional investors in the governance of the companies in which they invest. In continuing to promote and influence the development of stewardship codes globally, we can ensure they are to the benefit of shareholders and companies and support sustainable economic development.

Taiwan stewardship code

Lead engager: Hans-Christoph Hirt

Following our intervention at the public hearing of the draft local stewardship code, in a written consultation response, we commended the Taiwan Stock Exchange for its work on corporate governance and stewardship over the last few years and welcomed the publication of the code's principles. We believe that over time the principles will make an important contribution to the development of corporate governance and stewardship in Taiwan. The proposed principles were well drafted and comprehensively covered most of the important issues. Moreover, the guidance presented provides a good starting point to build on. We welcomed the code's comply-or-explain approach but strongly encouraged the introduction of a principle encouraging collaboration between institutional investors. In our experience, collaboration between local and foreign investors can be crucial in making stewardship effective. This is particularly the case when ownership is dispersed and no single institutional investor holds a significant stake or investors are dealing with a block or majority holder.

Task Force on Climate-related Financial Disclosures

Lead engager: Bruce Duguid

We attended the first session of the G20 Financial Stability Board's (FSB) Task Force on Climate-related Financial Disclosures. The Task Force was convened by Mark Carney, the Governor of the Bank of England, as chair of the FSB. It is mandated to develop consistent, climate-related financial disclosures for use by companies in providing information to lenders, insurers, investors and other stakeholders. The Task Force heard input on its proposed scope from a range of industry experts, including the Institutional Investors Group on Climate Change. Our view is that the disclosure of climate change data by companies needs to improve in breadth and consistency. We advocated the framework crafted by the Aiming for A coalition, of which we are a member, and which was used in recent shareholder resolutions. We put particular emphasis on the need for companies to publish more comprehensive forward-looking risk statements together with supportive analysis from stress tests, instead of focusing on metrics alone. The Task Force is expected to make recommendations by year-end. Key issues to be addressed include whether its scope will focus exclusively on corporate reporting or whether it will include investors and other financial services players. It will also need to decide whether reporting will be voluntary or potentially mandated through soft-law mechanisms such as the listing rules of stock exchanges. We will continue to engage with this project as an important tool for improving transparency of climate change risks to investors.

Other work in this quarter included

Promoting best practice

- We spoke at a panel organised by the **French Association for Corporate Governance AFGE** on the governance of state-owned companies, alongside directors representing the state in French blue ship companies and the head of the French agency of state holdings (APE). We highlighted the need for the state to implement good, transparent and consistent governance practices. We also pointed at the potential conflict of interests, as well as the positive role the state could play as a long-term owner. We had an open discussion on double voting rights, promoted by the French State, which in our view enable some investors to gain control without paying the price and thus hinder market efficiency.
- We met the CFO of the **Bombay Stock Exchange** to discuss progress in sustainability reporting and how the exchange coordinates with the Indian securities regulator SEBI to ensure disclosures on related party transactions are consistent with the requirements under the Companies Act 2013. We also addressed trends on board governance and composition, the short-listing of director candidates and concerns about how companies seek to fulfil the quota for women on boards. In addition, we discussed the implementation of CSR and associated reporting in India. We shared our views on the importance of ESG integration and that CSR needs to move beyond philanthropic activities.
- We discussed the support that the Hong Kong Stock Exchange will provide to the 1,800 companies listed there when the **ESG comply-or-explain reporting requirements** come into effect in 2017. The exchange was about to hold training sessions, covering topics from the global trend in sustainability to sample calculations using emissions factors. They were targeted at companies with no prior experience of producing sustainability reports and aimed at the company secretariat to increase the board level commitment to sustainability. We recommended the exchange to sign up to the Sustainable Stock Exchanges Initiative.
- We participated in a meeting to discuss the **Hermes EOS Remuneration principles for building and reinforcing long-term business success** with the other organisations that endorsed them when they were first published. The consensus of the meeting was that they had stood the test of time well and we agreed to work on ways to republicise them in the UK and internationally. We noted that most UK companies will need to bring their remuneration policies to a further binding vote in 2017, which is why we should work to ensure that the principles are considered by remuneration committees in the review of their policies during the next year.
- We were the only investor representative invited to a workshop by the World Economic Forum Global Agenda Council on Human Rights on **human rights in supply chains**, where we shared our views based on our experience of engagement. We discussed the concept of shared responsibility and how to implement it, while overcoming various obstacles and challenges. We agreed on the need to first achieve full visibility of the entire supply chain, which has grown much more complex over the years, and on collaboration within each industry, including fishery, agriculture and construction.
- We hosted a meeting of the **Institutional Investors Group on Climate Change** to focus on investor expectations of mining companies concerning climate change risks and opportunities. We presented the report which we published in November 2015 outlining the principal climate-related trends affecting mining companies and the six categories of engagement topics for mining companies, which cover governance of climate change risks, operational efficiency, the reduction of greenhouse gas emissions, strategic risks, preparedness for the physical impacts of climate change, public policy positioning and transparency and disclosure.
- Following our corporate engagement activities and investor collaboration efforts to tackle the seafood controversies in Thailand and elsewhere, we were asked to join the **Seafood Peer Group** set up by NGO Solidaridad in the Netherlands. The Seafood Peer Group has launched a platform called the seafood trade intelligence portal. This tool aims to systematically disclose performance and compliance information on the traceability, as well as social and environmental sustainability of seafood buyers and suppliers. It aims to make the industry more transparent and help facilitate investment partnerships in the sustainable seafood industry. We have been asked to review the tool, its metrics and functionalities to ensure its usability for investors.
- We co-signed a letter to the Financial Reporting Council (FRC) to set out our expectations that fossil fuel dependent companies – notably oil, gas and coal companies – should address climate-related risks in the newly introduced **viability statements** in their annual reports. The letter is aligned with and seeks to reinforce a number of other initiatives pushing for improved disclosure of climate risks, such as the resolutions filed by the Aiming for A investor coalition and the Task Force on Climate-related Financial Disclosures of the Financial Stability Board.

Public policy

- We had a meeting with senior executives of the **Korea Corporate Governance Service**, a quasi-governmental organisation set up by the local stock exchange and other key regulators. We obtained an update on the draft stewardship code and the public hearing that took place on it in December 2015 and learned that a further public consultation or launch before the second half of the year is unlikely. We again offered our support and guidance in the development, launch and implementation of the code but it seems that, like in other markets in the region, some political will and agenda is needed to develop corporate governance and stewardship in this important Asian market further.
- We firmly endorsed the proposal by the Singapore Exchange to move the **sustainability reporting** by companies from a voluntary to a comply-or-explain basis, as well as the emphasis it places on materiality in reporting. In our response to the consultation on the matter, we stated that we want to see oversight of ESG reporting by management boards.
- We co-signed an investor letter to the US Securities and Exchange Commission (SEC) to support its proposed rules for the implementation of the Dodd-Frank Act in relation to improving the **transparency of payments made to governments by the extractives sector**. In particular, we welcomed the SEC's proposed alignment of its rules with those in place in the EU or drafted in Canada to enable more international consistency. If implemented unamended, the rules will further strengthen global transparency and reduce the scope for corruption.
- We responded to a consultation on **UK board succession planning** by the country's Financial Reporting Council (FRC). We agreed with the premise of the FRC's discussion paper that planning for succession of board members, particularly the CEO and chair, is crucial to a company's long-term success. We also explained that it is important to distinguish between three types of succession planning, namely contingency planning for the sudden departure of key personnel, medium-term planning for the anticipated orderly replacement of current personnel and longer-term planning for the future shape of the organisation in line with its strategy.

Hermes EOS makes voting recommendations at general meetings wherever practicable. We take a graduated approach and base our recommendations on annual report disclosures, discussion 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 our clients' concerns. 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 company meetings all over the world, wherever its clients own shares.

Overview

Over the last quarter we made voting recommendations at 1,347 meetings (11,582 resolutions). At 554 of those meetings, we recommended opposing one or more resolutions. We recommended voting with management by exception at one meeting and abstaining at eight meetings. We supported management on all resolutions at the remaining 784 meetings.

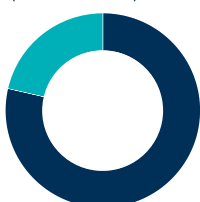
Global

We made voting recommendations at **1,347** meetings (**11,582** resolutions) over the last quarter.

- Total meetings in favour **58.2%**
- Meetings against (or against AND abstain) **41.1%**
- Meetings abstained **0.6%**
- Meetings with management by exception **0.1%**

Australia and New Zealand

We made voting recommendations at **14** meetings (**40** resolutions) over the last quarter.



- Total meetings in favour **78.6%**
- Meetings against (or against AND abstain) **21.4%**

Developed Asia

We made voting recommendations at **422** meetings (**2,995** resolutions) over the last quarter.

- Total meetings in favour **56.6%**
- Meetings against (or against AND abstain) **43.4%**

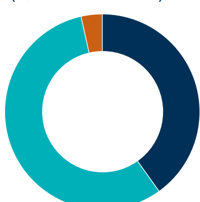
Emerging and Frontier Markets

We made voting recommendations at **314** meetings (**2,415** resolutions) over the last quarter.

- Total meetings in favour **49.4%**
- Meetings against (or against AND abstain) **50.6%**

Europe

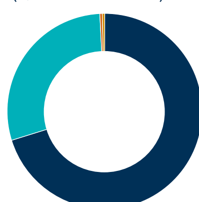
We made voting recommendations at **202** meetings (**2,768** resolutions) over the last quarter.



- Total meetings in favour **40.1%**
- Meetings against (or against AND abstain) **56.4%**
- Meetings abstained **3.5%**

North America

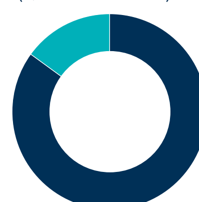
We made voting recommendations at **255** meetings (**1,962** resolutions) over the last quarter.



- Total meetings in favour **70.2%**
- Meetings against (or against AND abstain) **29.0%**
- Meetings abstained **0.4%**
- Meetings with management by exception **0.4%**

United Kingdom

We made voting recommendations at **140** meetings (**1,402** resolutions) over the last quarter.



- Total meetings in favour **85.0%**
- Meetings against (or against AND abstain) **15.0%**

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