HERMES
INVESTMENT MANAGEMENT

Excellence. Responsibility. Innovation.

Q4 2015

Hermes EOS

Public Engagement Report

Consequences of Volkswagen's emissions scandal – Engaging with car manufacturers

www.hermes-investment.com

This report contains a summary of the stewardship activities undertaken by Hermes EOS on behalf of its clients. It covers significant themes that have informed some of our intensive engagements with companies in Q4 2015.

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 £154.7 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 chief executive Colin Melvin chaired 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. 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:
Colin Melvin on +44(0)207 680 2251

* as of 31 December 2015

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

Hermes EOS team

Leadership

Colin Melvin
Chief Executive

Roger Hirst
Director

Dr Hans-Christoph Hirt
Director

Emma Hunt
Director

Leon Kamhi
Director

Engagement professionals

Roland Bosch
Sector lead: Financial Services
Sectors: Consumer Goods and Retail

Darren Brady
Sector lead: Technology
Sectors: Oil and Gas, Pharmaceuticals

Dominic Burke
Sectors: Consumer Goods and Retail, Financial Services, Utilities

Christine Chow
Sectors: Financial Services, Mining, Oil and Gas, Technology

Natacha Dimitrijevic
Sector lead: Pharmaceuticals
Sectors: Consumer Goods and Retail, Financial Services, Industrials, Oil and Gas

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Martina Macpherson
Sector lead: Consumer Goods and Retail
Sectors: Industrials, Technology

Naheeda Rashid
Sector lead: Consumer Goods and Retail
Sectors: Industrials, Technology

Sachi Suzuki
Sector lead: Industrials
Sectors: Technology

Michael Viehs
Sectors: Consumer Goods and Retail, Mining, Oil and Gas, Pharmaceuticals, Utilities

Maxine Wille
Sectors: Consumer Goods and Retail, Financial Services, Industrials, Technology

Business and Client Development

George Clark
Voting and Engagement Support

Rochelle Giugni
Client Relations

Bram Houtenbos
Voting and Engagement Support

Amy Lunn
Head of Business and Client Development

James O'Halloran
Head of Voting and Engagement Support

Nina Röhrbein
Reporting

Lucy Saville
Client Relations

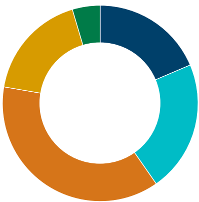
Michael Wills
Client Relations

Engagement by region

Over the last quarter we engaged with 198 companies on 452 social, environmental, business strategy and governance 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

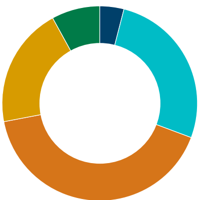
We engaged with **198** companies over the last quarter.



- Environmental **18.6%**
- Social and ethical **21.7%**
- Governance **37.4%**
- Strategy and risk **17.7%**
- Stewardship **4.6%**

Developed Asia

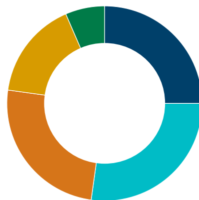
We engaged with **23** companies over the last quarter.



- Environmental **4.0%**
- Social and ethical **26.7%**
- Governance **41.3%**
- Strategy and risk **20.0%**
- Stewardship **8.0%**

Emerging and Frontier Markets

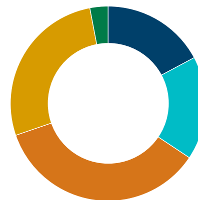
We engaged with **36** companies over the last quarter.



- Environmental **25.0%**
- Social and ethical **27.3%**
- Governance **25.0%**
- Strategy and risk **16.3%**
- Stewardship **6.5%**

Europe

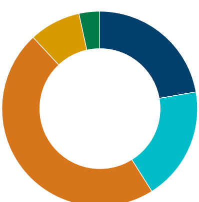
We engaged with **44** companies over the last quarter.



- Environmental **17.2%**
- Social and ethical **17.2%**
- Governance **35.4%**
- Strategy and risk **27.3%**
- Stewardship **3.0%**

North America

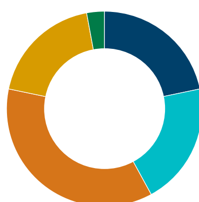
We engaged with **66** companies over the last quarter.



- Environmental **22.2%**
- Social and ethical **18.8%**
- Governance **47.0%**
- Strategy and risk **8.5%**
- Stewardship **3.4%**

United Kingdom

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



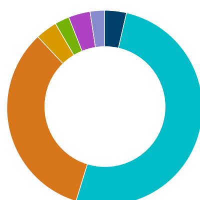
- Environmental **21.7%**
- Social and ethical **20.3%**
- Governance **36.2%**
- Strategy and risk **18.8%**
- Stewardship **2.9%**

Engagement by issue

A summary of the 452 issues on which we engaged with companies over the last quarter is shown below.

Environmental

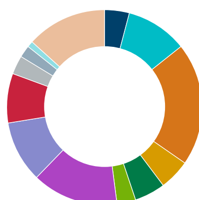
Environmental issues featured in **18.6%** of our engagements over the last quarter.



- Biodiversity **3.6%**
- Climate change/carbon intensity **51.2%**
- Environmental management **33.3%**
- Forestry **3.6%**
- Oil sands **2.4%**
- Waste **3.6%**
- Water stress **2.4%**

Social and ethical

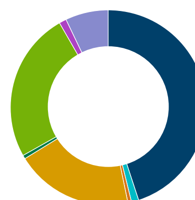
Social issues featured in **21.7%** of our engagements over the last quarter.



- Access to medicine **4.1%**
- Bribery and corruption **10.2%**
- Community relations **20.4%**
- Corporate culture **5.1%**
- Customer relations **5.1%**
- Diversity **3.1%**
- Health and safety **14.3%**
- Labour rights/employee relations **10.2%**
- Licence to operate **8.2%**
- Munitions manufacture **3.1%**
- Operations in troubled regions **2.0%**
- Political risk management **1.0%**
- Supply chain management **13.3%**

Governance

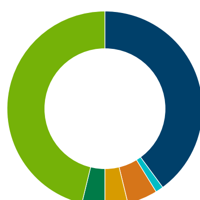
Governance issues featured in **37.4%** of our engagements over the last quarter.



- Board structure **45.0%**
- Committee structure **1.2%**
- Conflicts of interest **0.6%**
- Other governance **19.5%**
- Related-party transactions **0.6%**
- Remuneration **24.9%**
- Separation of chair/CEO **1.2%**
- Succession planning **7.1%**

Strategy and risk

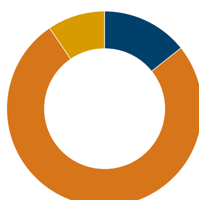
Strategy and risk issues featured in **17.7%** of our engagements over the last quarter.



- Business strategy **40.0%**
- Capital structure **1.3%**
- Reporting/disclosure **5.0%**
- Reputational risk **3.8%**
- Returns to shareholders **3.8%**
- Risk management **46.3%**

Stewardship

Stewardship issues featured in **4.6%** of our engagements over the last quarter.



- Accounting or auditing issues **14.3%**
- Shareholder communications **76.2%**
- Shareholder rights **9.5%**

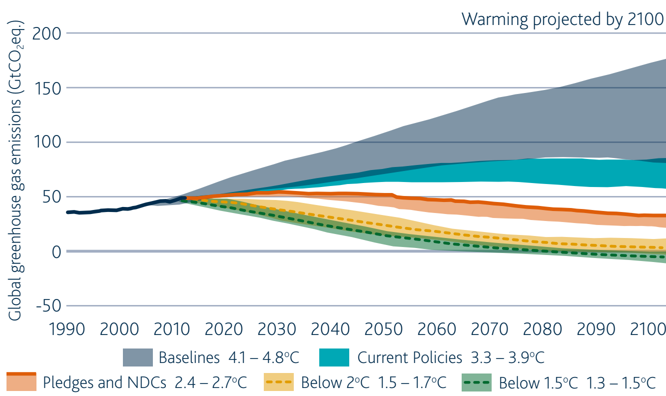
The Paris Agreement – Progress and limits

Following our intensive dialogue on climate change in its run-up, we are now engaging with companies and regulators in the aftermath of the Paris Agreement.

Setting the scene

After the de facto expiry of the Kyoto Protocol in 2012 and the lack of agreement reached at the 15th Conference of the Parties (COP) in Copenhagen in 2009, COP21 in Paris in December 2015 was the third big attempt at reaching a global deal on climate change. The deal was agreed by 196 countries which committed to keeping the increase in the global average temperature to below 2°C and to pursuing efforts to limit the temperature increase to 1.5°C above pre-industrial levels. In addition, it was agreed that greenhouse gas emissions should peak as soon as possible and that the world economy should emit net zero emissions by a point in the second half of the century. The climate deal consists of two halves – a legally binding Agreement consisting of 29 articles and the non-binding Decision part, which contains among others, details on the financing of climate change mitigation and adaptation. The Agreement component will need to be ratified by 55 countries accounting for at least 55% of global greenhouse gas emissions before it can be enforced. This process will begin in April 2016 with implementation scheduled for 2020.

Global warming projections as a result of submitted Nationally Determined Contributions (NDCs)



Source: Climate Action Tracker

Success or disappointment?

The Paris Agreement has been widely hailed a success – by developed as well as developing countries and many commentators. Given the parlous state of global negotiations in the immediate aftermath of the failed Copenhagen climate conference in 2009 and the de facto expiry of the 1997 Kyoto Protocol, this was in many ways an achievement in its own right. However, a number of commentators have justifiably questioned its value, given that it is based on a set of voluntarily submitted obligations which do not meet the aspiration of limiting climate change to the intended safer level of 2°C and which, although in part legally binding, are effectively unenforceable. For some, the raising of the aspiration to limit climate change to 1.5°C only adds to the sense of political detachment from reality, given the stretch necessary compared to current efforts.

We have some sympathy for this view. However, despite its obvious flaws, we believe the negotiation was a success, provided it is accepted for what it is, and not judged against a standard that the two-year negotiating process never set out to achieve. The Paris Agreement offers the prospect of being the first successful global platform for carbon reduction involving carbon reduction efforts by all nations, including the first recorded commitments by the world's largest emitters, China and the US. Given the prior starting point, the negotiations were remarkable for obtaining the agreement of 196 countries to take specific pre-emptive actions to solve a global problem at the heart of our economies which will mainly benefit future generations at some cost today.

The right framework?

While the voluntary nature of the framework can be challenged, past precedent suggests that it is unrealistic to expect sovereign nations to devolve control over their permitted greenhouse gas emissions, which are at the heart of their energy systems and economies. This is primarily because it is not possible for nations to work out the full implications given the enormous uncertainties of future energy needs, available technology and costs and therefore the fairness of a more binding approach. Thus, we are forced to accept the logic of the Paris framework, which introduces a series of smaller steps, all bound together in a growing sense of trust and mutual dependency. It is perhaps the only way to resolve the fundamental paradox of climate change, which is that only collective action can solve the problem, yet no country is willing to yield sovereign control of its emissions through energy or land use.

Progress

The Paris Agreement exceeded all reasonable pre-conference expectations by committing countries to limit the rise in global temperature to 1.5-2°C. It also sets a long-term goal to entirely decarbonise the planet over the course of the second half of the century, sounding the ultimate death knell for fossil fuels, albeit over a long-term horizon.

Individual commitments submitted to the UN Framework Convention on Climate Change (UNFCCC) – the Nationally Determined Contributions (NDCs) – were made by 188 of 196 countries covering 95% of global emissions. While these currently lack the ambition of the Agreement itself, delivering an emissions reduction equivalent to limiting climate change to approximately 3°C, they are subject to a ratchet mechanism requiring review every five years from 2020.

The Paris deal is set to mobilise finance from developed countries of $100 billion a year, with the intention that this is delivered from 2020 and increases thereafter. However, unresolved disputes over the precise

nature and timing of this funding mean that these commitments are contained in the non-binding Decision part of the deal.

Furthermore, the Agreement contains important references acknowledging the concept of loss and damage, the role of forests in reducing emissions, technology transfer and capacity building, all of which will help vulnerable and developing countries to survive and perhaps thrive in the transition.

Limits

Prior to the Paris Agreement, national and regional plans were ahead of global negotiations, with important commitments made in 2014 by leading economies including the US, China and the EU. Post-Paris, the ambition of global leaders is ahead of national plans as there is a clear difference between the likely 4°C outcome of current policies, the outcome of the submitted NDCs which, discounting certain non-binding pledges, is likely to be around 3°C and the 1.5-2°C ambition of the Agreement.

Keeping global warming to 1.5°C would require the world's economy to commence a dramatic decarbonisation pathway to zero emissions by 2050 across the globe, which is more than twice the pace of any national case study of decarbonisation to date. However, the aspiration can also be interpreted as indicative of a will to go faster than even the most ambitious levels articulated previously and that therefore any breakthroughs in technology and consumer preference will be embraced openly in pursuit of this goal.

Regardless of the viability of meeting the 1.5°C goal, national plans now need to catch up with global ambition which will lead to a tightening of national and regional policy. The pace of change will depend on the outworking and interplay of a range of factors. These include the level of trust between the parties, innovation leading to breakthroughs in technology, the costs of the transition and the frequency and intensity of severe weather-related events, such as droughts and storms, which serve as a necessary reminder of the need for further action.

A platform for further negotiations

The Paris Agreement is perhaps best seen as a framework for further international negotiations. In addition to reviewing progress every five years, there are some obvious areas of unresolved business. These include finalising the financing to developing countries, towards and beyond $100 billion per year and further developing a transparency framework for monitoring national emissions that is non-intrusive and non-punitive. Also needed are new approaches to the fraught issue of loss and damage to enable financial and non-financial assistance for countries already significantly harmed by climate change, without opening up the floodgates to broader claims for compensation which could ultimately threaten the whole Paris framework.

Investors

Investors played a significant role in the run-up to the Paris Agreement, forming a coherent and progressive long-term voice calling on governments to deliver a strong and effective deal on climate change, thereby unlocking further investment in clean energy and climate solutions. The Institutional Investors Group on Climate Change (IIGCC) says the Paris Agreement sends a strong signal that the transition to a low-carbon economy is irresistible and irreversible.

The Agreement sets the stage for accelerating levels of investment in low-carbon solutions. Investors will need to continue to prepare for further policy on climate change through the integration of ESG factors in their investment portfolios, as well as through their engagement with companies. Investors also need to continue to explore alternative scenarios, recognising that the timetable for policy tightening is uncertain and that events could occur to speed it up or slow it down.

Our engagement

Our engagement with companies and policy-makers on climate change will continue with broadly the same intensity that we have applied in the run-up to the Paris Agreement.

In the lead-up to Paris, we supported the secretariat of the UN climate negotiations, meeting UNFCCC executive secretary Christiana Figueres to summarise investor concerns and attending roundtables to engage with the CEOs of the world's largest companies as part of the CEO dialogue in New York in September 2015, at a smaller group meeting in London in October 2015 and in Paris in December 2015. We co-authored an investor letter to G7 leaders explaining the need for a long-term goal on climate change, which was successfully adopted and formed the basis for the decarbonisation goal in the Paris negotiations. Furthermore, we are core supporters of the IIGCC, acting as lead author of its publication summarising investor expectations of mining companies.

In the summer of 2015, we joined the Aiming for A coalition of investors which acts at the forefront of climate change engagement, taking a supportive but stretching approach to the dialogue with the boards of climate-exposed companies. We supported the shareholder resolutions seeking greater disclosure of the potential long-term impacts to their business portfolio from public climate change policies at oil and gas companies BP, Shell and Statoil in 2015. We have already seen progress at those and several other oil and gas companies and co-filed a further resolution at Chevron. Following our engagement with diversified mining companies Anglo American, Glencore and Rio Tinto on their disclosure of climate change-related risks, we are leading the co-filing of similar resolutions at their AGMs in 2016 as part of Aiming for A.

We will continue our dialogue with utilities to ensure they have a strategy in place for dealing with tighter climate policies and with the automotive sector and industrials on their emissions reduction ambitions and governance. In our engagement with banks, we seek to ensure that they manage effectively their exposure to high-carbon projects such as coal-fired power stations. Meanwhile, all companies will need to prepare for stricter climate policies to best protect and preserve value.

The adoption of the Paris Agreements signals that nations are taking the threat of climate change seriously. It is now the task of those who have signed the Paris Pledge for Action – the opportunity for non-state actors to welcome the Paris Agreement on climate change and commit to implementing it – which includes Hermes EOS and over 1,000 companies, to accelerate ways to limit global warming to 2°C or below.

For further information, please contact:

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Digging deep – Engagement on conflict minerals

We are engaging with policy-makers and companies on supply chain transparency.

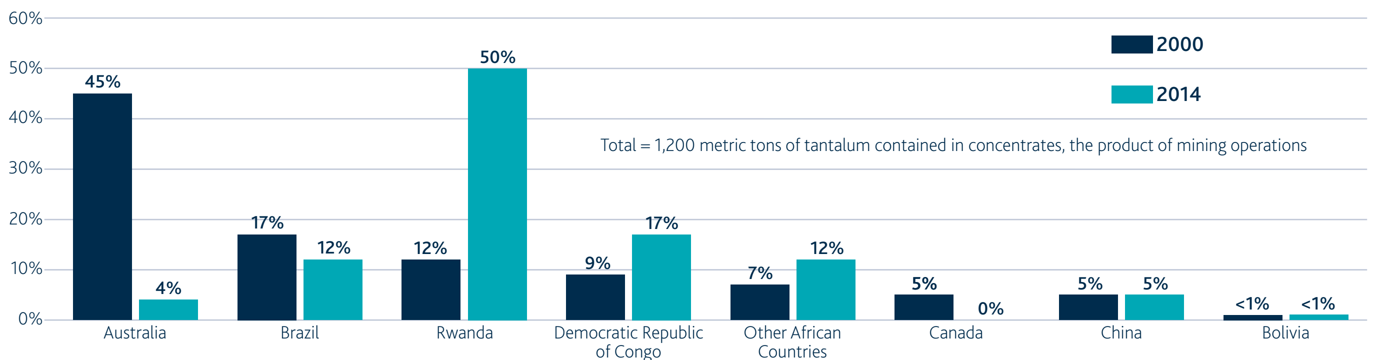
Setting the scene

The central African state of the Democratic Republic of Congo (DRC), formerly called Zaire, has been a conflict zone for over 15 years. According to a study by the International Rescue Committee, by 2007 the conflict and humanitarian crisis in the DRC had taken the lives of an estimated 5.4 million people since 1998 and continues to leave as many as 45,000 dead every month.[2]

The war-torn country is home to vast quantities of natural resources, with its untapped mineral reserves estimated to be worth $24 trillion, according to the UN.[3]

Armed groups have used the trade in gold, tin, tungsten and tantalum to fund the wars, which, according to environmental consultant Global Witness, has displaced 2.7 million people within the country. While not the original cause of the violence, which is rooted in the history and leadership of the country, the trade in minerals continues to fuel the conflict. The metals mined in eastern Congo enter global markets and make their way into nearly all electronic products, including mobile phones, as well as cars, aeroplanes and jewellery. They are also used in industry manufacturing. It has been difficult for consumers to find out if the products they buy contain minerals that have contributed to the violence in the DRC, while companies have struggled to find substitutes for the minerals.

Shift in global tantalum mine production 2000–2014



Source: US Geological Survey[4]

Dodd-Frank Act

In 2010, the US Congress passed the Dodd-Frank Act, one provision of which requires companies filing reports with the US Securities and Exchange Commission (SEC) to disclose whether conflict minerals – namely tin, tungsten, tantalum and gold – are used in the manufacture of their products.

Congress enacted Section 1502 of the Act because of concerns that the exploitation and trade of conflict minerals by armed groups has helped to finance conflict in the Democratic Republic of Congo (DRC) and adjoining regions and contributed to an emergency humanitarian crisis. The minerals must be certified by the country of origin before they cross any borders. This is done by a so-called tag-and-bag system operating in the DRC.

A company that uses any of the four minerals in its products is required to determine whether they originated in the DRC or adjoining regions and declare publicly in the required conflict minerals report whether they are "DRC conflict-free", "DRC non conflict-free" or "DRC conflict undeterminable". The latter status is only temporary, two years or four years for smaller reporting companies, and means that companies do not need to obtain an independent private sector audit for their conflict minerals report. Minerals from scrap and recycled rather than mined sources are considered conflict-free.

The due diligence measures that companies apply in determining and disclosing the existence of conflict minerals in their supply chain must conform to a nationally or internationally recognised due diligence framework, such as the comprehensive guidance approved by the OECD.

We worked together with other shareholders, beneficiaries, NGOs and industry bodies such as the OECD, Enough Project and the Electronic Industry Citizenship Coalition on the implications of the Dodd-Frank Act. The Act has recently been accused of contributing rather than alleviating the conflicts it tries to address.[5] But despite causing regulators and companies some difficulties since its introduction, it has undoubtedly brought the issue to the front of the industry's attention, enshrined the human relevance in civil and corporate law and increased visibility into the supply chains of companies.

Impact in the US

When the Dodd-Frank Act came into force, we engaged intensively with US companies on their preparedness for the legislation to ensure that they managed legal and reputational risks arising from conflict minerals.

As part of industry working groups, including one set up by the Principles for Responsible Investment, we collaborated to encourage the expansion of disclosure beyond the requirements of the Dodd-Frank Act and for companies to introduce auditing in their supply chain. We had a good degree of success and were able to conclude a large number of our engagement objectives on the issue.

Software giant Microsoft, for example, acknowledged that additional reporting and further discussion on this issue, internal as well as external, was warranted. The company substantially improved its disclosure and committed to adhering to industry best practice on conflict minerals in its supply chain. After gaining significant reassurance about the extensive supply chain management procedures the company has in place, we met our engagement objective.

Similarly, we successfully completed our engagement objectives on conflict minerals with peer Intel after the company's submission to the SEC, detailing its efforts to discover and eliminate conflict minerals from its supply chain. In addition, our assessment of its further efforts to combat conflict minerals, such as expanded smelter auditing and certification, indicated the company's leadership on this issue. This meant Intel was able to confirm that its suppliers are conflict-free.

Many Japanese technology companies have significant presence in the US, which is why they – to satisfy the requests from their US customers – have also significantly improved their supply chain visibility.

For example, we welcomed the progress Panasonic made in its work towards eliminating conflict minerals from its supply chain. It told us that it had surveyed 1,500 suppliers in 2015, 86% of whom responded. No conflict minerals have been found in its supply chain to date. However, Panasonic assured us that it has policies and procedures in place in case conflict minerals are found. If they were detected, the company would request the supplier to rectify the problem and cease trading in the absence of improvement. Positively, Panasonic has reiterated its position that it does not want to withdraw sourcing from the entire DRC and neighbouring conflict regions as it would penalise legitimate suppliers and workers producing conflict-free minerals.

Europe

Australia released due diligence guidelines for the responsible supply chain of minerals in 2010 to mitigate the risk of providing direct or indirect support for conflict in the DRC.

European law-makers have been catching up and the EU has over the last year begun to develop a similar piece of legislation, in which we continue to be involved.

In 2015, the European Parliament voted to require all EU importers of tin, tungsten, tantalum and gold to be certified to ensure they do not fuel conflicts and human rights abuses. We had previously called on the European Commission to consider introducing such legislation and go beyond the much weaker and more limited voluntary rules it had proposed earlier in 2015. We were part of a group of global investors that urged the European Parliament to strengthen its proposal by expanding the scope of the legislation to ensure that all companies placing minerals on the market, be they raw, semi-finished or finished goods, are legally required to source responsibly. Members of the European Parliament backed a law covering not just European importers sourcing minerals from conflict zones but also companies that use the four minerals in their manufacturing process. We view this as a significant step that will put European companies more in line with their US-based peers. We are also encouraged that the European Parliament voted to support a mandatory and inclusive approach that will stimulate more robust supply chain due diligence and public reporting along global supply chains.

In collaboration with other investors, we petitioned the European Commission to respect the outcome of the European Parliament's vote by taking steps to enact a mandatory conflict mineral due diligence reporting framework for companies placing conflict minerals on the European market. We pushed the European Commission to seize the important opportunity to show leadership and mainstream a risk-based approach to conflict minerals along global supply chains, as envisaged in the OECD Due Diligence Guidance standards.

We will maintain our work with European policy-makers to make sure a good final version of the conflict minerals law is drafted and implemented. The passage of the law is likely to take place in 2016.

Wave of reform

The wave of reform on conflict minerals is spreading. China introduced new industry guidelines for carrying out mineral supply chain checks in December 2015. These set a precedent for Chinese companies to recognise and reduce supply chain risks. It also indicates that more countries and regions are likely to take up conflict minerals legislation.

Many technology companies have also introduced their own individual guidelines.

As a result of the impending European law, we are now focusing on the preparedness for and implementation of the legislation by European companies affected by it. We will ask those companies to look into their supply chain, disclose their traceability efforts and declare that they are free from conflict minerals.

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[5] http://foreignpolicy.com/2015/02/02/how-dodd-frank-is-failing-congo-mining-conflict-minerals/ Open letter https://ethuin.files.wordpress.com/2014/09/09092014-open-letter-final-and-list.pdf

Conquering the world – The success of stewardship codes

We have been longstanding promoters of stewardship codes globally.

Setting the scene

As a representative of responsible investors, we encourage and support the development of regional stewardship codes, a set of principles or guidelines aimed primarily at institutional investors who hold shares and thus voting rights in companies. Implying that it is part of the fiduciary duty of investors to behave as good owners of companies, stewardship codes require investors to monitor and, where necessary, engage with companies on material matters, including environmental, social, governance, strategy, performance and risk issues and to vote their shares at company AGMs and EGMs. We believe that effective stewardship benefits companies, investors and the economy as a whole, a view that is supported by the UK's Financial Reporting Council, which drafted the country's Stewardship Code.

The first Stewardship Code was published in 2010 by the UK's Financial Reporting Council (FRC) in response to criticism about the role institutional investors had played in the run-up to and during the recent financial crisis. Changes to the code made as part of its 2012 revision clarified the respective stewardship responsibilities of asset managers and owners, including those stewardship activities they have chosen to outsource or undertake in collaboration with others. The code is implemented on a comply-or-explain basis, meaning that all its signatories have to produce a statement of commitment to the code or explain why it is not appropriate to their business model. More than 300 signatories have signed it to date. It is too early to come to a conclusion about the success of the code. However, there is room for improvement in stewardship across all listed companies, involving engagement on a variety of issues beyond board composition and remuneration. According to the FRC, the quality of engagement between major investors and large companies has improved following the introduction of the code. But concerns about the disclosure and reporting on stewardship by fund managers remain, which is why the FRC has announced that disclosures by signatories will be assessed and a tiering system introduced in July 2016.

After the publication of the UK code, other countries followed suit with their own, including the Netherlands' Best Practices for Engaged Ownership developed by Dutch corporate governance forum Eumedion, South Africa with its Code for Responsible Investing and Switzerland with its Guidelines for Institutional Investors Governing the Exercising of Participation Rights in Public Limited Companies. In 2011, the European Fund and Asset Management Association provided a framework of six high-level principles and best practice recommendations for asset managers to follow when engaging with investee companies. In addition, the revised EU Shareholder Rights Directive is expected to tackle significant aspects of stewardship and engagement.

Big in Japan

One of the biggest launches of stewardship codes took place in Japan in 2014. To date, the country's Principles for Responsible Institutional Investors is the only other code apart from the UK to have been drafted by a regulator, Japan's Financial Services Agency (FSA). The development of the code represented a switch from a traditionally rules-based corporate culture to one based on principles and has been a significant step forward in responsible investment and ownership activities in Japan. The country intends to foster sustainable, longer-term growth and attract foreign investors and has made a clear link between improved stewardship, corporate governance and economic success.

We were involved in the Japanese Code's development and responded to the public consultation on its draft version. We were particularly supportive of the notion that the stewardship responsibilities of institutional investors should go beyond voting to include proper monitoring of and constructive dialogue with investee companies. We suggested that the FSA develop practical guidance and best practice for disclosing and implementing key principles. We also welcomed the proposal for the FSA to review the code periodically. We were one of the first signatories to the code, which as of 30 November 2015 had 201 signatories.

Although many Japanese companies have started to engage with overseas investors, discussions between Japanese asset managers and companies seem to have stayed as requests for information and generally lack an engagement objective and targeted outcomes. 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 FSA council in charge of Japan's Stewardship Code and Corporate Governance Code to encourage 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 meaningful explanation companies are expected to provide in case of non-compliance. We pressed for enhanced dialogue between companies and shareholders, including direct contact with non-executive directors.

Lessons from Malaysia

Hot on the heels of Japan's code, Malaysia launched its Code for Institutional Investors in 2014, the second code in emerging markets after South Africa. Again, we were involved in its development. However, there has been a lack of commitment by local funds to the code and as a result, its uptake and implementation to date have been poor. The lesson learned from the Malaysian Stewardship Code is that prior to the launch of any stewardship code or principles, the code needs to have the support and commitment of local funds.

Malaysia has since set up an Institutional Investor Council (IIC) to promote the code and its implementation, as well as overall corporate governance in the country. As a member of the IIC, we work closely alongside local funds and have used the opportunity to put stewardship code implementation and training on the agenda of its working committee.

While the market faces some real corporate governance challenges and stewardship is a new concept, the establishment of the IIC seems to

have generated some momentum, with at least one of the major local funds committed to formally signing up to the code.

Taiwan

Following our engagement, speeches and workshops in Taiwan over a number of years, we were pleased that the local stock exchange published the draft of a stewardship code in December 2015. It means that another leading Asian capital market is likely to introduce stewardship guidance for institutional investors in the near future. Our contribution to the process leading to the local code's publication was acknowledged by the stock exchange. We will respond to the consultation on the draft, which is due to conclude in February 2016.

Hong Kong

We met Hong Kong's Securities and Futures Commission (SFC) in 2013 and 2015 to exchange views and share our experience in other markets of introducing local stewardship codes and engagement activities. Encouragingly, in March 2015 the SFC launched a public consultation on the draft of the Principles of Responsible Ownership, which follow a comply-or-explain approach. Overall, there was broad support. The SFC was pleasantly surprised by the support from family offices, large fund management companies and many of the listed companies. The more negative responses came from family-controlled companies worried about shareholder activism. The SFC was expected to announce the adoption of the Principles in late 2015 but this has since been delayed. It has also asked us to step up our education efforts in the market. In the meantime, the Hong Kong Exchange has strengthened the ESG reporting of listed companies. This should improve disclosure and help the introduction of stewardship. We welcome the initiative taken by the SFC and will continue our involvement in the implementation of the stewardship code in Hong Kong.

Singapore

As a result of our engagement in Singapore on the topic in 2014, we were invited to join the Singapore Stewardship Working Group, chaired by the think tank the Stewardship Asia Centre, to develop a stewardship code for the city state. We participated in a series of conference calls throughout 2015 and provided extensive written feedback based on our international experience with stewardship codes. We were also the only representative of foreign institutional investors to address the inaugural forum of Stewardship Asia, explaining the reasons for the surge in interest in stewardship codes by institutional investors and reflected upon adjustments to their role in Asia, where family and state ownership is widespread among listed companies.

We are pleased that following our feedback on the initial draft, the code now primarily targets institutional investors and has an additional principle on collaboration between investors, which we strongly pushed for. Based on the experience in Malaysia, we supported the idea to hold a series of meetings with key local investors and stakeholders to gather support ahead of the launch of the code, which we expect to take place in the first half of 2016.

South Korea

After calling for the introduction of stewardship guidance for institutional investors in our keynote speech at a conference hosted by South Korean regulators in 2014, we welcomed the development of a draft local stewardship code in 2015.

We understand that there has been a hearing on the code and plan to encourage a formal, public consultation open to foreign investors in 2016 during our next visit to Seoul. We believe such consultation could improve the quality of the code and most importantly contribute to its acceptance among local and international investors. This is crucial as in South Korea political appetite for stewardship appears to be limited and a progressive corporate governance agenda absent.

Brazil

Brazil's Association of Capital Market Investors (AMEC) has also started a project to develop a stewardship code for Brazil, in which we are heavily involved. As a drafting member of the working group for the code, we are looking at best international stewardship practice, for example using the UK code as a benchmark. The first meeting of the stewardship code working group took place in late 2015, with the consultation scheduled for mid-2016. The code's launch is set to coincide with AMEC's 10th anniversary in the fourth quarter of 2016.

To ensure a good uptake of the code by local pension funds, education is necessary in the Brazilian market as the country's institutional investors are not yet familiar with the stewardship concept and often lack resources.

A global code

In addition to the various national stewardship codes, the International Corporate Governance Network (ICGN) has begun work to introduce a global stewardship code template. The 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, other 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 with 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.

We responded to the ICGN's consultation and aim to create a comparison matrix of stewardship codes in the first half of 2016. We will continue our thinking on how institutional investors can effectively and efficiently undertake stewardship activities in markets globally.

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.

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Consequences of Volkswagen's emissions scandal – Engaging with car manufacturers

Since the emissions scandal broke at Volkswagen, we have been engaging intensively with the company and its peers.

Setting the scene

One of the biggest corporate scandals to emerge in 2015 was that German car manufacturer VW had installed defeat devices in 11 million of its vehicles, which detected when they were subject to emissions tests. According to the US Environmental Protection Agency, the cars would switch on emissions-control devices for tests but on the road emit much higher levels of nitrogen oxide. Further allegations of defeat devices followed, implicating other types of VW, Porsche and Audi models, while internal investigations by VW discovered that approximately 36,000 cars, including those with petrol engines, had been sold with their carbon dioxide levels stated too low and fuel efficiency stated too high. The negative news at one point led to a drop in VW's share price of more than 40%[6] in 2015 although it has since recovered significantly. The company announced in September 2015 it had set aside an initial €6.5 billion provision for the costs of putting right the 11 million vehicles. Due to the risk to VW's reputation and earnings, the company's debt was downgraded by rating agencies S&P, Fitch and Moody's. The scandal has cast a shadow over VW and the entire car manufacturing industry, particularly as corporate emissions reductions were thrown into the spotlight ahead of the COP21 UN climate change summit in Paris.

Governance concerns

We had an intensive engagement with VW between 2006 and 2009, with a focus on the company's board composition, partly a result of its shareholding structure, and the role of its – now former – chair Ferdinand Piëch. Our engagement involved meetings with the company and speaking at its 2006 and 2007 AGMs. Through our activities we successfully managed to encourage some structural change, for example, the establishment of a corporate governance committee and greater focus on corporate governance.

However, particularly following the tie-up with the Porsche company, we realised the impact of our engagement on board issues would be limited as VW's board is dominated by two families, who control the majority of voting shares, and also comprises representatives of the German state of Lower Saxony, as well as 10 powerful employee representatives. Since the significant investment of Qatar Holdings in 2009, the board has also included several sovereign wealth fund representatives. The supervisory board has been short of strong, genuinely independent non-executives for many years and at present only has one independent director. Due to the infeasibility of our engagement, we therefore temporarily scaled back our efforts. Nevertheless, in 2012 we still wrote an open letter to the company regarding the ineffectiveness and increasingly questionable composition of the supervisory board, as it proposed to shareholders to elect Piëch's wife as a non-executive director and the now former CEO Martin Winterkorn was awarded €20 million as a result of an non-transparent remuneration system.

Despite the abrupt departure of Piëch in April 2015, we continued to have and communicate our serious concerns about the influence of the Porsche/Piëch families, the composition of VW's supervisory board, management board remuneration and the implementation of the company's ambitious growth strategy.

There are indications that VW's corporate governance and culture may have contributed to the emissions scandal or at least allowed it to remain undetected for many years.

Emissions scandal

We made contact with the company immediately after the emissions scandal broke and discussed what further actions to take with a number of other institutional investors. We welcomed the resignation of VW's CEO and the departure of other key executives as a first step in dealing with the fallout from the scandal.

However, after VW appointed two corporate insiders as CEO – the former head of Porsche – and chair – a former VW CFO – we publicly voiced strong concerns about these choices although we understood the apparent lack of alternatives. The appointments made by the supervisory board suggested the company has not recognised the need for fundamental reform.

We strongly believe that the new CEO and chair should overhaul VW's corporate governance, in particular the composition and effectiveness of its supervisory board, and create a corporate culture which ensures that the trust of its customers and the societies in which it operates and distributes its vehicles will not be compromised again in the way it has been. In our view the culture, processes and the decision-making of the supervisory board are the fundamental problems at VW, which trickle down to the whole organisation.

Following VW's announcement that the supervisory board had decided to have the court appoint the CFO as chair-elect instead of having a discussion and a vote about this move at a shareholder meeting, we wrote a strongly worded letter to all of the supervisory board members. We once again highlighted that this move not only goes against best corporate governance practice in Germany but gives rise to serious conflicts of interest. The chair-elect has served as a member of the management board since 2003 and as CFO played a key role among the most senior VW executives for over a decade. We questioned his ability to robustly and objectively investigate what happened at the management board level which is responsible for the company's culture and – should there be any grounds for legal claims – enforce these against his former colleagues, and possibly himself.

Outlook

While we remained critical of the appointments of CEO and chair at VW, we firmly welcomed the external appointments to VW's management board and senior executive team – responsible for integrity and legal affairs and group strategy respectively. The appointment of the two outsiders is a starting point in addressing the concerns we have about the new CEO being an insider.

Even though VW has had a compliance officer since 2001, the fact that there will now be direct board level responsibility for integrity and legal affairs seems to signal that VW will take governance and compliance much more seriously in future. With a background in legal matters, the new board member should contribute to dealing with the current allegations and future matters related to the scandal. Her experience – also gained at competitor Daimler – will help in the development of a compliance system that detects problems earlier. Just as with her selection, the appointment of head of group strategy shows that the company is opening up to external candidates, as the individual previously held senior roles at a General Motors' Opel division and will put greater emphasis on exploring strategic options than in the past.

We were pleased about VW's introduction of five top priorities, which its new CEO outlined in its third quarter earnings call. These are regaining trust by helping customers, uncovering the causes for the emissions scandal, introducing a new decentralised structure, creating a new corporate mindset and re-defining targets.

However, the lack of effective communications with investors in the wake of the scandal has been concerning. We need more substantial and specific information on what happened, how VW intends to rectify the issues and deal with the consequences and, most importantly, about a more proactive strategy on changing corporate processes and governance as well as the company's culture. We challenged the quality of VW's communications regarding the crisis and encouraged an update in our dialogue with the company. We were therefore pleased when VW's new chair and CEO provided a detailed update on the company's investigations, co-ordinated by a special committee of the supervisory board, and initiated changes. The company claimed to be progressing on all five of the priorities, including on devising technical solutions for the vehicles affected, implementation of which was due to begin in January 2016.

VW's internal investigations indicate that the large-scale cheating on nitrogen oxide emissions was due to the combination of three factors: the misconduct and shortcomings of individual employees, weaknesses in certain processes and a mindset in some areas of the company that tolerated breaches of rules. It outlined some of the deficiencies in processes and explained how it plans to address these. VW confirmed that it in future, emissions tests will be evaluated externally and independently and that randomly selected real-life tests to assess emissions behaviour on the road will be introduced.

While we welcomed VW's update on the emissions scandal, we remain concerned about the lack of discussion of wider corporate governance reform, including with regard to the composition and effectiveness of the supervisory board. We believe this is essential to address effectively the underlying problems and will therefore continue to focus on this in our engagement and seek meetings with the chair of VW's supervisory board and management board members. While VW seems to have recognised the need to change its culture, it has not yet indicated whether it plans a systematic review of the underlying grievance issues and will implement a structured programme to bring about the necessary changes. In addition, we felt the tone and body language of the company's presenters were not suited to the seriousness of the crisis, suggesting that there may be limited appetite for real and sustained changes. The company has indicated that we will have an opportunity to meet its chair in early 2016, after which we will consider together with other institutional investors what further steps to take ahead of VW's AGM in April 2016.

Public policy

The emissions scandal however goes beyond VW. It questions the validity of laboratory emissions testing from vehicles. Several studies have shown that on-the-road emissions and fuel consumption can be substantially higher than the levels reported during lab tests[7]. For that reason, relevant policy-makers need to ensure tests are more reliable and coherent, particularly as they are setting standards for CO2 and other emissions.

Under the auspices of the Institutional Investors Group on Climate Change (IIGCC), we collectively wrote to European policy-makers to call on them to make changes to the EU's carbon-emissions testing programme for road vehicles to restore confidence in testing procedures.

Peer responses

We also raised a series of questions with other car manufacturers in relation to their potential exposure to the issue. All of the car manufacturers we engaged with stated that they conduct emissions testing in accordance with all the relevant standards and to the best of their knowledge do not engage in illegal practices which enhance emissions performance of their engines in assessments. But there was wide acknowledgement of the discrepancy between emissions levels on the road and in test environments.

Sector-wide engagement

Because the VW scandal is likely to have implications for the global automotive industry, as part of our sector-wide engagement on environmental issues, carbon and climate change we continue to review the corporate governance, compliance structures and processes and internal risk management of car manufacturers. We are also seeking to clarify their position and lobbying activities on EU and US emissions targets and new testing procedures.

We are assessing manufacturers' product portfolios and progress on introducing sustainable vehicle technology, such as hydrogen-powered engines. We also continue to assess progress on reducing CO2 fleet emissions and preparedness for future emissions targets.

As part of our public policy engagement, we will also collaborate further with key industry bodies and NGOs, including the IIGCC.

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Engagement on strategy

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

Overview

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

Examples of recent engagements

Board composition and corporate culture

Lead engager: Tim Goodman

Following a positive meeting with the lead independent director of a US company, we were able to complete three of our outstanding objectives – on board composition, corporate culture and bribery and corruption, as well as risk management related to product recalls. The strong specification for the lead independent director role is reflected in how she fulfils the role in practice and we obtained a number of examples of how the board, under her leadership, both supports and challenges management. The board continues its ongoing refreshment and acknowledges that more non-US, particularly Asian, directors would strengthen it. However, the time and travel commitments required by the board prove to be a difficult hurdle to recruitment. The board has worked hard on improving the company's performance on quality and ethics after the product recalls it experienced a few years ago. We also obtained good comfort on how the performance of the CEO and other senior management in relation to leadership, quality and other strategic goals is measured. Furthermore, we were pleased that the company is going to introduce proxy access – the right of shareholders to nominate candidates for the board – and congratulated it on its recent announcement relating to climate change targets.

Disclosure on climate change

Lead engager: Natacha Dimitrijevic

In a meeting with the climate and sustainability project leader of a European extractives company, we were pleased to hear that the company is making substantial efforts to improve its disclosure on the resilience of its asset portfolio and planning for climate change. As a response to a shareholder resolution requesting improved climate change reporting, which we supported, the company designed a roadmap to enhanced carbon transparency. We discussed its envisaged disclosure for the 2016 investor documents, including its use of asset carbon intensity and financial indicators under different climate scenarios as core indicators. In addition, we welcomed that the company will link executive compensation packages to CO2 intensity reduction targets in future. The company welcomed our feedback on the steps it has undertaken thus far, and we agreed to continue the discussion.

Independent board directors

Lead engager: Sachi Suzuki

We were impressed by the progress a Japanese capital goods company is making in improving its corporate governance practice. Following the appointment of a second independent director in 2015, the company plans to replace an affiliated director with a genuinely independent one in 2016. We welcomed this move as we had concerns that this individual would not be able to provide sufficiently objective views because he represents an entity with which the company has cross-shareholdings and business relationships. We particularly applauded the company's willingness to share details of its nomination process for non-executive directors, which involves a third party recruitment firm as well as the nomination advisory committee, which is still rare among Japanese companies. The company also hinted that we can expect to see the nomination of a first female director in the near future, which we would welcome. We shared our views that board evaluation should ideally be undertaken by a third party organisation to ensure objectivity and include key points to evaluate the ability of individuals to discharge their duties as directors.

The company is continuously revising its executive remuneration structure, including rebalancing the proportions of fixed and variable pay and linking variable pay more clearly to performance. As it currently uses operational profit as effectively the sole indicator for performance pay, we suggested combining multiple metrics to more accurately link performance to pay. Furthermore, we provided feedback on the company's first integrated report and suggested including data on carbon intensity along with key financial indicators because climate change remains one of the key areas for investors and society.

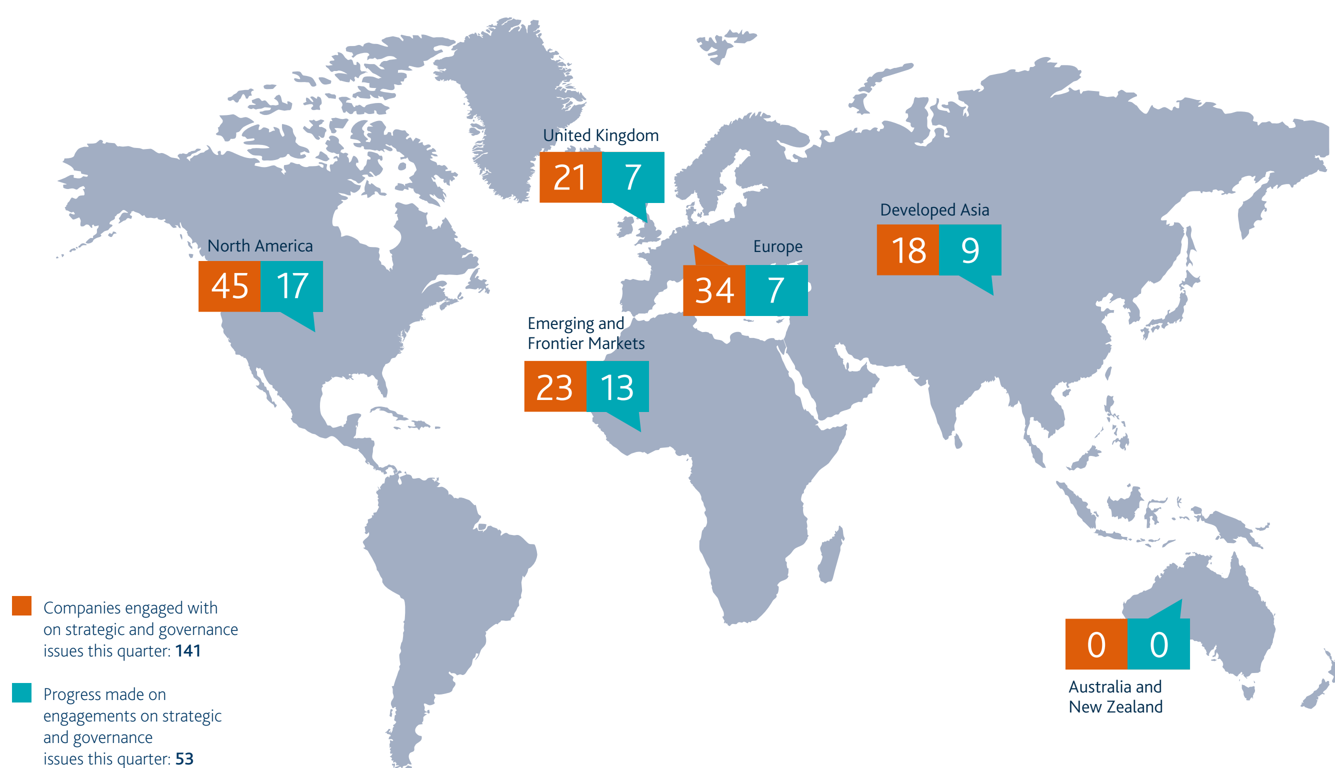
Sustainability policy

Lead engager: Sachi Suzuki

We firmly welcomed the launch of a group sustainability policy in 2014 by an emerging markets company, which we had called for. Following this, we were encouraged to learn that the company has conducted educational visits to suppliers and smallholders to communicate the policy and share its experience in relation to its zero burning policy, non-deforestation and avoidance of new developments on peat lands. It has surveyed some of the suppliers on their compliance with the policy, although it has not undertaken audits or spot checks to date.

The company provided a detailed account of its work in relation to the large-scale fires and haze in Indonesia, including the education it provides to smallholders. It was encouraging to learn that the company, drawing from past allegations of poor labour conditions among its contractors, is now providing education on each element of labour standards to its suppliers and has communicated its policy to terminate contracts in case of a breach. We applauded its collaboration with customers to financially support smallholders to achieve certification by the Roundtable on Sustainable Palm Oil (RSPO), as obtaining the certification is expensive for smallholders. While all of the company's own plantations and mills in Malaysia have been RSPO-certified, the company aims to achieve the same in Indonesia by the end of 2016. RSPO certification has been one of our engagement objectives with the company. Overall we were impressed with the level of progress the company has made in recent years, including the work it has undertaken with its suppliers and the level of its public reporting on sustainability. The company subsequently confirmed that it will adopt the methodology of the High Carbon Stock study called HCS+ which focuses on a carbon-neutral approach to future developments. It provided details of the impact the moratorium on new developments had on its business and the outlook following the launch of HCS+. Furthermore, it elaborated on measures to improve yield efficiency.

Engagements on strategy and governance issues



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 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.

Highlights

Bangladesh Accord on Fire and Building Safety update

Lead engager: Dominic Burke

During a call with the head of the Bangladesh Accord on Fire and Building Safety, we received confirmation that the remediation process is behind schedule. The Accord was established by European retail brands following the Rana Plaza factory collapse in 2013 in an attempt to lead to improvements in the ready-made garment industry. We have been engaging with stakeholders on this issue, which included a visit to garment manufacturers in Bangladesh in 2014. The key obstacles appear to be resistance by the Bangladeshi government, which has strong ties to the garment industry, to the Accord's mandate and a related lack of will on the part of factory owners to undertake improvements, up to the point at which their contracts with retail brands are at risk of termination. While there continues to be effective technical cooperation with the Alliance for Bangladesh Worker Safety, largely representing North American brands, the Accord claims to go further in its promotion of safety grievance mechanisms and believes this is an area where brands can do more. Instead of accepting the formation of safety committees by the government and factories, brands should insist that factory workers are represented and receive appropriate training from the Accord. Since union capacity continues to be limited, any programmes which rely on domestic organisation are unlikely to succeed. We will raise these insights into worker safety committees and government obstruction in our engagements with brands about their supply chains.

Climate change reporting

Lead engager: Bruce Duguid

We attended a roundtable by the International Petroleum Industry Environmental Conservation Association in Paris to explain how investors want to see oil and gas companies improve their reporting on climate change-related issues. Climate change reporting should be relevant either to the long-term strategy of the company or to current operational performance. We explained that investors not only want to know that current and future capital investment will deliver long-term returns, but that the public policy position of oil and gas companies is aligned to the desire of investors to see climate change limited to 2°C. We highlighted the need for oil and gas companies to explain their asset portfolio resilience to low-carbon scenarios, which is the key strategic question related to climate change. We also called on companies to explain the relevance of climate change to their long-term strategy, their key performance indicators and whether performance on ESG is a driver of executive remuneration. We will continue to engage with individual companies to ensure that they improve their reporting in these areas.

Indigenous peoples seminar

Lead engager: Tim Goodman

Representatives from the asset manager and owner community in London, together with associated NGOs, attended a Hermes EOS-hosted event by First Peoples Worldwide (FPW). FPW seeks to work with investors to highlight risks to their portfolios posed by strained community relations and encourages them to engage their investee companies to better manage the risks associated with the rights of indigenous peoples. The participants became more familiar with indigenous rights and the types of questions that they should ask companies on this issue, which is particularly important to the extractives industries.

PharmaDiplomacy initiative

Lead engager: Natacha Dimitrijevic

The fair and affordable pricing of drugs is a key topic for the pharmaceuticals industry, policy-makers and long-term institutional investors. Alongside other investors and academics, we participated in a panel discussion organised by The PharmaDiplomacy Group on the newly developed checklist for collaborative, mutually acceptable drug pricing. The discussion focused on whether current pricing trends in the pharma industry are sustainable, how to incentivise managers to pursue different goals other than shareholder value maximisation and whether the pharma industry should work with investors to improve the incentivising features of executive compensation practices within the pharma industry. Access to medicine and affordable drug pricing are important topics in our engagements with pharma and healthcare companies. We outlined our perspective that more transparency on drug pricing and executive compensation practices in the pharma sector is important for sustainable value creation. We agreed to continue the discussion with the PharmaDiplomacy initiative and shared some of our research work with other participants.

Other work in this quarter included

Promoting best practice

- We played a vital role in ensuring that the approach to UK and European oil and gas majors, which is delivering results on their disclosure on climate change risk, is not lost as the **Aiming for A coalition** begins to work in the US. We participated in a number of calls concerning the coalition's work on oil and gas companies in the US and steered some of the participants away from filing shareholder proposals in a confrontational way in favour of the collaborative, long-term approach promoted by Aiming for A.
- We signed a petition to the Federal Drug Administration to encourage the wider use of cheaper **biosimilar drugs in the US** at the request of a large asset owner that funds the healthcare costs of former workers in the US car industry. We believe that the wider availability of biosimilars will encourage fairer competition in the pharmaceutical industry and reduce the costs, while not damaging the standards, of healthcare in the US. Over time this should also increase the coverage of healthcare in the US, which in turn should help employee wellbeing and corporate profitability over the long term.
- We took part in a survey by Borsa Italiana on the new **Corporate Governance and Stewardship Code in Italy and the Italian Development Decree**. In contrast to the suggestions made by new Italian proposals, we remain in favour of single voting rights and are cautious about the voto di lista system with its multiple voting rights and loyalty shares. We support the role Borsa Italiana has taken in encouraging best ESG practices for listed companies.
- We were invited by the OECD to speak at a panel about the **corporate governance priorities of investors in Russia**. The focus of the roundtable was the implementation of the 2014 Corporate Governance Code. The main topics covered were comply-or-explain reporting, the level of board independence and harmonisation of the code and the listing rules. We highlighted the importance of engagement between companies and investors and the role of corporate governance best practices in promoting long-term value creation.
- Our meeting with the executive director and programme manager of the new **Corporate Human Rights Benchmark** gave us insights into the mission and operating model of the initiative. The benchmark aims to incentivise a better human rights performance by businesses through improved disclosure and transparency. We look forward to participating in the consultation and the launch of the Corporate Human Rights Benchmark in the third quarter of 2016.
- We spoke at a conference organised by the European Commission to press for concrete and rapid improvements of the voting chain. The event brought together relevant stakeholders to exchange experiences with the **digitalisation of company law and corporate governance**. We welcomed the review of the Shareholder Rights Directive (SRD II) which seeks to encourage long-term investment by giving companies the rights to identify their shareholders and by granting voting confirmation to investors. We explained the current broken voting system and the necessary changes to sustain stewardship practice.
- We took part in the first **Italy Corporate Governance Conference**, which was organised by LSE Group – Borsa Italiana in Milan. The conference was designed to offer the international financial community an annual forum to discuss corporate governance topics to contribute to ongoing capital markets reforms and practice.
- We successfully persuaded NGO the Environmental Defense Fund to include our suggestions on commentary on its largely data-driven reporting requirements on **methane reporting** in the oil and gas industry. Publication of its methane white paper will have an important influence in the industry and we believe that narrative can provide a richer picture of companies' activity than only using data.
- At a meeting with the Institutional Investors Group on Climate Change, we agreed to carry out work to determine the collective investor position on the **proposed reforms to the EU Emissions Trading Scheme**, with a focus on the impact of rules protecting companies from the threat of adverse competition. We will add this to our engagement efforts with energy-intensive companies, including the issue of unjustified lobbying against necessary rules to limit greenhouse gas emissions.
- We were invited to an expert consultation on the **reporting and assurance framework initiative for the UN Guiding Principles for Business and Human Rights**. At the discussion with various stakeholders, including companies, audit firms, government representatives and civil society organisations, we provided investor perspectives on reporting and assurance guidelines. We gained an insight into what challenges the companies, particularly those with extensive supply chains, face in addressing and reporting on human rights issues.
- We spoke at a seminar organised by the Ethical Trading Initiative on **worker benefits from good business practices**. We discussed the relevance of making social factors more transparent at the corporate and supply chain level, going beyond the first tier. We also looked at metrics for investors to better assess the cost to capital of precarious working conditions for employees, contractors and suppliers. The focus was on the fair living wage, zero hours contracts and modern slavery.
- We have been liaising with the Principles for Responsible Investment to set up a new collaborative **working group on human capital management**. In a globalised job market, corporate human capital management practices often occupy a grey area and precarious working conditions are on the rise. Precarious workers are those who fill permanent job needs and want but are denied permanent employee rights. Simply shifting risk to workers will not guarantee sustainability and may make strong growth and steady progress impossible. It is therefore time to establish an outcome-led collaborative engagement coalition between investors, unions, policy-makers, NGOs, labour rights organisations and experts to identify and address systemic human capital management risks.

Public policy

- Positively, we heard from the CEO of Stewardship Asia that the feedback received during the consultation period on the **Singaporean stewardship code** for institutional investors has been broadly supportive and that a final draft was due to be presented to the Monetary Authority. A launch in early 2016 is now likely and we are delighted to participate in this and the implementation process.
- We are pleased that following our engagement, speeches and workshops in Taiwan over a number of years, the local stock exchange published the draft of its **stewardship code**. This means that another leading Asian capital market is likely to introduce stewardship guidance for institutional investors in the near future following in the footsteps of Japan and Malaysia. Our contribution to the process leading to the publication of the local code was acknowledged by the stock exchange.

Hermes EOS makes voting recommendations at general meetings wherever practicable. We take a graduated approach and base our recommendations on annual report disclosures, discussions with the company and independent analyses. At larger companies and those where clients have a 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 1,255 meetings (8,629 resolutions). At 530 of those meetings we recommended opposing one or more resolutions. We recommended voting with management by exception at three meetings and abstaining at three meetings. We supported management on all resolutions at the remaining 719 meetings.

Global

We made voting recommendations at **1,255** meetings (**8,629** resolutions) over the last quarter.

- Total meetings in favour **57.3%**
- Meetings against (or against AND abstain) **42.2%**
- Meetings abstain **0.2%**
- Meetings with management by exception **0.2%**

Australia and New Zealand

We made voting recommendations at **233** meetings (**1,242** resolutions) over the last quarter.

- Total meetings in favour **53.6%**
- Meetings against (or against AND abstain) **46.4%**

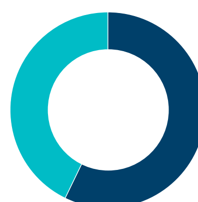
Developed Asia

We made voting recommendations at **99** meetings (**538** resolutions) over the last quarter.

- Total meetings in favour **49.5%**
- Meetings against (or against AND abstain) **50.5%**

Emerging and Frontier Markets

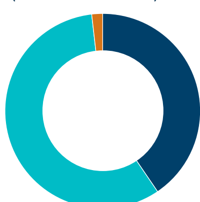
We made voting recommendations at **285** meetings (**2,057** resolutions) over the last quarter.



- Total meetings in favour **57.2%**
- Meetings against (or against AND abstain) **42.8%**

Europe

We made voting recommendations at **163** meetings (**1,126** resolutions) over the last quarter.



- Total meetings in favour **40.5%**
- Meetings against (or against AND abstain) **57.7%**
- Meetings abstain **1.8%**

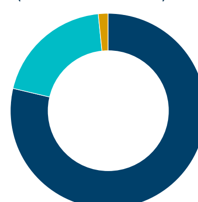
North America

We made voting recommendations at **292** meetings (**2,025** resolutions) over the last quarter.

- Total meetings in favour **58.9%**
- Meetings against (or against AND abstain) **41.1%**

United Kingdom

We made voting recommendations at **183** meetings (**1,641** resolutions) over the last quarter.



- Total meetings in favour **78.7%**
- Meetings against (or against AND abstain) **19.7%**
- Meetings with management by exception **1.6%**

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