

OUTCOMES
BEYOND
PERFORMANCE



CORPORATE GOVERNANCE PRINCIPLES

Mexico

Hermes EOS
December 2018

For professional investors only

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HERMES
INVESTMENT MANAGEMENT

CORPORATE PURPOSE AND HERMES RESPONSIBLE OWNERSHIP PRINCIPLES

Companies aim to provide goods and services for customers and society at a competitive quality and price. This can only be achieved sustainably if they create and preserve value over time, not only for their shareholders but also for stakeholders, society and the environment. Our expectation, therefore, is that companies should be run not only for shareholders, but should also have a wider purpose that benefits society. In turn, this supports the needs of savers and pensioners, who rely on sustainable returns from their investments, to provide them and their families with a secure future.

This document should be read in conjunction with the Hermes Responsible Ownership Principles¹. They provide our views on corporate purpose and other issues that we believe are important for companies globally.

INTRODUCTION

We generally endorse the recommendations of the Mexican Code of Best Practices in Corporate Governance and encourage companies to comply with these or to explain their reasons for non-compliance. However, these recommendations do not sufficiently cover all the issues we regard as important. In our Mexican Corporate Governance Principles, we therefore address additional issues, highlight specific points and set out our preferred approach to particular matters. For instance, we outline priorities that will assist companies in taking concrete steps to improve corporate governance and thereby help increase investment and improve sustainable company performance. We also seek to work with companies and regulators to help them move towards best practice, or to further enhance existing practices. The following sections are intended to assist Mexican companies and their directors in understanding our views on these issues.

We expect all companies to comply with the principles contained in the Code. However, when implementing the principles, companies may choose to adopt practices different from those recommended by the Code, in order to suit their circumstances. In this case, we expect companies to explain, carefully and clearly, which recommended practices are not being adopted and the reason for not adopting them, as well as how their actual practices are consistent with the Code's principles, and how they will contribute to good governance.

BOARD OF DIRECTORS

Composition and independence

We place a strong emphasis on the overall balance in the composition of a board. The board should comprise members with a diverse range of attributes, competencies, knowledge and experience to enable it to discharge its duties and responsibilities effectively. These include leadership skills, decision-making expertise, and the necessary characteristics and independence, to be able to hold executive management to account. We also encourage companies to have

effective mechanisms for assessing board performance and to refresh the board as the needs of the company evolve. This can also help to prevent excessive tenures and assist the process of replacing poorly performing directors or those whose skills are no longer required.

The board of directors has a duty to represent the interests of all shareholders. Therefore, even directors proposed by major shareholders have a duty to represent all shareholders and not just the interests of those that recommended appointing them.

While we understand that it can be often justified and useful for major shareholders to play an active role on the board, we expect at least one third of directors to be independent from management and major shareholders to protect the interests of minority shareholders. In circumstances where the board composition does not meet this requirement, we expect an explanation as to whether and how the interests of minority shareholders are represented on the board.

We may recommend a vote against the election of board slates where less than a third are independent directors. Where directors are elected individually, we may recommend a vote against non-independent candidates if less than a third of candidates are independent.

Board diversity

Boards are most effective when they have access to knowledge and experience from a wide range of backgrounds that are relevant to the company, including with regard to its long-term strategic direction, suppliers, employees, customers and geographic footprint. In addition, a wide variety of viewpoints and perspectives is likely to result in a better quality of debate and therefore decision making. Boards that have too much commonality of background run the risk of groupthink and complacency, both clear signs of governance failure. We believe that boards should take account of diversity in its broadest sense, including gender, nationality and ethnicity, as well as skills, experience, character and other attributes when considering possible candidates for the board and other senior positions.

We may oppose the election of board slates without female non-executive representation. In the case of individual election, we may oppose the re-election of board chairs and/or nomination committee chairs.

Where there is an under-representation of women on the board, in comparison with the market average, we expect companies to develop a gender diversity target and to set a timescale for achieving it.

Separation of chair and CEO roles

We believe that the chair should manage the board, which in turn oversees management. The chief executive should manage the company. As the responsibilities and competencies of the chair of the board and the chief executive are different, we believe the roles are most effectively undertaken by two different individuals. The separation of the roles ensures the focus of the chief executive on the management of the company, while a separate chair introduces an additional element of overview and accountability.

¹ <https://www.hermes-investment.com/ukw/wp-content/uploads/sites/80/2018/03/final-responsible-ownership-principles-2018.pdf>

Time availability

We remain concerned about the ability of some directors to devote sufficient time to the boards of which they are members. In some cases, this is because they are already seemingly over-committed and cannot dedicate sufficient time to each of their boards. We therefore welcome reassurance by boards that particularly heavily committed non-executives have enough time available for board matters – otherwise, they are unlikely to gain our support for re-election. Our view is that over-commitment by directors reflects a failure to draw candidates from a wide enough pool.

Alternate board members

Board members should have the sufficient skills, time and experience to carry out their supervisory tasks, without the need for alternate directors.

Board committees

We encourage the implementation of formal, independently chaired audit, remuneration and nomination committees, where the majority of members are independent. If this is not the case, companies should explain how potential conflicts of interest in relation to audit, remuneration and nomination are dealt with.

Importance of board and shareholder engagement

Dialogue between boards and serious, committed long-term shareholders on strategy, finance, corporate governance and risk management – including the management of risks and opportunities stemming from environmental and social issues – is essential. Through this exchange of views, shareholders can better comprehend, and if necessary, attempt to influence the boards of companies in which they invest, developing relationships of trust based on an improved mutual understanding. Our experience has shown that constructive engagement between shareholders and directors in these areas can lead to improvements in the governance, performance and value of companies. Conversely, lack of engagement can lead to increased risk. Chairs and other non-executive directors, in particular board committee chairs, should make themselves available for meetings and teleconferences with minority shareholders, as an essential part of their responsibilities. Developing relationships of trust with long-term shareholders can be invaluable for boards. We therefore expect boards to welcome more and better quality engagement between long-term investors and directors and for independent directors to participate in engagement.

EXECUTIVE REMUNERATION

We are increasingly concerned that executive remuneration structures and practices around the world are not fit for purpose, neither serving long-term investors nor, in many cases, aligning properly with the core long-term objectives of companies.

Therefore we continue to hold many discussions on reforming pay with remuneration committee members, executives, human resource professionals, remuneration consultants and other investors around the world. We are often encouraged by their response to our views. However, pay practice within companies rarely reflects our discussions on our pay principles². Our current thinking on executive pay can be summarised as follows:

Simplicity: pay schemes should be clear and understandable for investors as well as executives. Pay structures should be much simpler and less leveraged than they are at present, for example taking the form of a single incentive scheme and lower variable and total possible pay.

Shareholding: the executive management team should make material investments in the company's shares and become long-term stakeholders in the company's success. Significant shareholding requirements for directors should remain in place for a specific period of time following departure from the company, with no share sales allowed for at least one year.

Alignment and quantum: pay should be aligned to the long-term success of the company and the desired corporate culture, and is likely to be best achieved through long-term share ownership. Pay is often too high and pay schemes often seem to pay out significant sums which conflict with many shareholders' and other stakeholders' views of performance. Boards should be able to justify to investors, the workforce and the public the rationale for the CEO's and the most senior management's pay, taking account of the pay of the wider workforce. If they are not able to do so, directors should use their discretion to adjust actual or potential pay downwards. The rules of pay schemes should support this. Remuneration reports must explain how alignment with long-term shareholders is achieved.

Accountability: remuneration committees should use discretion to ensure that pay properly reflects business performance. Pay should reflect outcomes for long-term investors and take account of any decrease in the value of, or drop in the reputation of the company. Remuneration committees should take a more robust view on pay, using their judgement and being accountable for their decisions. They should avoid paying more than is necessary and not place too much reliance on existing practice and benchmarking which help to perpetuate many of the problems that we seek to address. The potential outcomes of a pay policy should be rigorously scenario tested with a cap on the total possible pay published in advance, to help reduce the risk of unintended consequences.

Stewardship: companies and investors should regularly discuss strategy, long-term performance and the link to executive remuneration. Executives should be encouraged to achieve strategic goals, rather than focus attention on total shareholder return or stock price appreciation. They should take account of the company's effect on key stakeholders.

² <https://www.hermes-investment.com/wp-content/uploads/2017/09/Remuneration-Principles-Clarifying-Expectations.pdf>

We expect senior executives to willingly embrace these principles and, if they do not, for boards to consider the implications. Remuneration committees must take responsibility for the design, disclosure and dialogue on executive pay and we will hold them accountable for this.

EQUITABLE TREATMENT OF SHAREHOLDERS

Multiple-class share structures

Multiple-class share structures disenfranchise minority shareholders and often increase the power of one shareholder for a disproportionate economic stake. We encourage issuers with multiple-class share structures to adopt the concept of one-share one-vote for all shares. We are very unlikely to support the issuance of shares with reduced or no voting rights, share buybacks or capital raising exercises that discriminate against minority shareholders.

TRANSPARENCY AND DISCLOSURE

Meeting notification and proxy documents

For minority shareholders, the annual general meeting (AGM) is a formal opportunity to obtain information about management's and the board's stewardship of their investments and, if necessary, to request clarification of any decisions taken during the year. The AGM is therefore an important accountability mechanism, and the communication of detailed information on all agenda items at least 30 days in advance of the meeting is a prerequisite for its effectiveness. All documents should be clearly displayed and accessible on the company's website.

Importance of good quality reporting

We believe that the quality of narrative reporting reflects the thought processes behind the board's strategy and indicates its ability to execute it. In addition, effective reporting means that engagement between share owners and boards is more productive. For this to be most useful, boards must report openly and transparently on the performance of the company and their stewardship of it over the year. It is fundamental that risk is reported in a way that allows investors to understand the main risks that the board has identified for the business and how the company manages and mitigates those. We encourage companies to adopt the International Integrated Reporting Framework³.

Related party transactions

We urge boards to thoroughly review related party transactions to ensure they are sufficiently scrutinised. Companies should establish oversight and disclosure procedures that are in line with international

best practice, requiring the full disclosure of direct and indirect interests of managers and directors. We therefore encourage Mexican companies to follow the guidance of the International Corporate Governance Network, which states that: "Every corporation should have a process for reviewing and monitoring any related party transaction. Typically, a committee of independent directors should review every related party transaction to determine whether such transaction is in the best interests of the corporation and if so, ensure that the terms of such transaction are fair to the corporation. The corporation should disclose details of all material related party transactions in the annual report of the corporation."

Auditor's quality and independence

Minority investors rely on the board to provide true and fair reporting of the company's performance and prospects. The external audit should provide significant assurance to outside investors. However, we have significant concerns about the quality of audit. We therefore rely on the audit committee to ensure that management prepares the financial statements and other disclosures to a rigorous standard and that the external audit is conducted to the highest possible quality. Where we have concerns about a company's performance or reporting that we believe the audit firm should have identified to the audit committee or to investors, we will consider not supporting the audit firm's reappointment and/or not recommending the audit committee for re-election.

We consider that excessive payment of non-audit fees to the external auditor may compromise its independence. Although we acknowledge that the auditor may be well placed to provide urgent advice on taxation and transaction due diligence, or provide other consulting services, this should not happen on a regular basis and the non-audit fees should not exceed the audit fees. Where non-audit fees exceed audit fees on a regular basis, we may oppose the re-appointment of the auditor and the re-election of the chair of the audit committee.

Social, ethical and environmental responsibility

Companies should effectively manage environmental and social factors that are relevant to their business, with a view to enhancing long-term sustainability. They should also disclose to shareholders on a regular basis how they identify and manage the relevant risks and provide evidence that these structures are effective. In addition, companies should clearly define board and senior management responsibilities for environmental and social issues. We believe that directors of companies are accountable to shareholders for the management of social, ethical and environmental risks and opportunities in the same way that they are accountable for the company's financial performance.

³ <https://integratedreporting.org/wp-content/uploads/2013/12/13-12-08-THE-INTERNATIONAL-IR-FRAMEWORK-2-1.pdf>

Ethical leadership

We expect companies to have best practice anti-corruption and anti-bribery policies and processes in place and robust compliance mechanisms to enforce them. However, these are not enough on their own. We expect the board to oversee the anti-bribery and corruption controls and – just as importantly – to set the tone from the top, to encourage the highest ethical standards, to drive the expectations and values of the organisation. This is to ensure that the culture is one in which corruption cannot thrive, and that the necessary organisational measures exist to provide the best possible defence against corruption. We therefore seek to engage with companies where we judge the culture and values to be lacking or the effective oversight, management of, or reporting on anti-bribery and corruption to be insufficient.

Climate change

Climate change is a systemic risk to the value of the portfolios of our clients because of its economic and geopolitical consequences. We therefore support the goal of the 2015 Paris Agreement, which 195 countries signed up to, to limit global warming as a result of climate change, to well below 2°C. This historic commitment was helped by the intervention of companies globally, which publicly encouraged political action in the run-up to the Agreement.

Because of the systemic risk to the global economy, we expect every company to publicly support the Paris Agreement and to make this commitment a central tenet of its public policy and sustainability activity. In particular for companies whose value chain relies on significant energy usage or is exposed to the effects of climate change, the board should ensure that support for the Paris Agreement underpins the company's strategy. Every board should ensure that it has climate change on its board meeting schedules at least annually, and that it and senior management engage with experts who can advise them on the strategic risks and opportunities that climate change represents, and challenge the company's approach, if necessary.

We understand that companies may have different views on climate change from organisations of which they are members or from other organisations which they may be able to influence. Every board should make sure that the company uses all available avenues to influence these third parties, to encourage effective action on climate change in line with the Paris Agreement. Where a company and one of these third parties disagree on climate change, the company should explain publicly the action it has taken to argue for effective advocacy or action on climate change by that third party. It should also explain its reasons for continued participation in, funding or membership of the organisation despite this disagreement.

Task force on Climate-related Financial Disclosures

We welcome the recommendations of the Financial Stability Board's Task Force on Climate-related Financial Disclosures. We expect companies to adopt the recommendations in full. Companies should conduct scenario analysis to assess future transition and physical risks which will be brought about by climate change. As part of this scenario analysis, they should also identify and discuss their strategic options for a net zero emission world. In addition, we expect companies, especially those in sectors where climate risks are most material, to demonstrate clearly that they are managing both their current and possible future risks effectively. Furthermore, we expect companies to report on the opportunities presented by climate change. For instance, companies in the financial sector should report how they will help to finance the energy transition.

UN Sustainable Development Goals

We expect companies to assess the relevance of each UN Sustainable Development Goal (SDG) to their business and to consider how best to incorporate those which may be material into their business models and strategies. We urge companies to report on how they are responding to the SDGs and encourage them to participate with civil society on how best to support them.

Tax

We expect companies to:

- comply with all tax laws and regulations in all countries of operation;
- recognise the importance of taxation to the funding of good public services on which they and their stakeholders rely, and their commitment to pay their fair contribution;
- ensure that their tax policies and practices do not damage their social licence to operate in all jurisdictions in which they have a presence; and
- disclose the taxes paid by or collected by them in each country.

Human rights

Licences to operate are increasingly affected by the reputation of companies, including their performance on human rights. We support the UN Guiding Principles on Business and Human Rights and the UN Global Compact. We expect companies to use the reporting framework of the Guiding Principles to disclose how they manage human rights issues that are salient to their business.

HERMES INVESTMENT MANAGEMENT

We are an asset manager with a difference. We believe that, while our primary purpose is to help savers and beneficiaries by providing world class active investment management and stewardship services, our role goes further. We believe we have a duty to deliver holistic returns – outcomes for our clients that go far beyond the financial – and consider the impact our decisions have on society, the environment and the wider world.

Our goal is to help people invest better, retire better and create a better society for all.

Our investment solutions include:

Private markets

Infrastructure, private debt, private equity, commercial and residential real estate

High active share equities

Asia, global emerging markets, Europe, US, global, small and mid-cap and impact

Credit

Absolute return, global high yield, multi strategy, global investment grade, unconstrained, real estate debt and direct lending

Stewardship

Active engagement, advocacy, intelligent voting and sustainable development

Offices

London | New York | Singapore | Denmark

Why Hermes EOS?

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

For more information, visit www.hermes-investment.com or connect with us on social media:



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