THE SHAREHOLDER RIGHTS DIRECTIVE II

How Hermes EOS supports compliance
The rights of shareholders in EU companies are on the rise, and investors will soon be required – on a comply-or-explain basis – to publicly report on their engagement activities and voting decisions. This is a watershed in the evolution of shareholder rights, but are investors fully aware of the responsibility that comes with greater powers?

What is happening?
In May 2017 the European Parliament and Council agreed an amendment to the 2007 Shareholder Rights Directive (SRDI), to further encourage long-term shareholder engagement. Implementation of the amendment (SRDII) by member states is required by 10 June 2019.

Who does it apply to?
In the main, institutional investors (asset owners) and asset managers operating in Europe.

The requirements relate to shareholdings in companies with registered offices in, and whose shares are admitted to trading on a regulated market situated or operating within, an EU member state. Third-country intermediaries who provide services with respect to shares of such companies should be subject to the rules on shareholder identification, transmission of information, facilitation of shareholder rights, and transparency and non-discrimination in relation to costs.

What are the objectives of SRDII?
(See page 8)
Shareholder rights are a key tool for institutional investors to achieve effective stewardship of their assets. The Directive aims to:

- Contribute to the sustainability of EU companies – by requiring investors to report on how the main elements of their investment strategy contributes to the medium to long-term performance of their clients’ assets.
- Enhance the efficiency of the chain of intermediaries – through identification of shareholders, improving the transmission of information along the investment chain, including on engagement, voting and manager reward, and alignment between investment strategy and client/beneficiary liability.
- Encourage long-term shareholder engagement – by requiring policies and reporting on engagement with investee companies regarding performance (on strategy, governance, and environmental and social issues), and providing investors with a vote on company remuneration policy and reports.

The amendment includes elements found in existing stewardship codes which have emerged over the last decade, such as those of Denmark, Italy, the Netherlands and the UK.

Additional Implementing Acts underpin the Directive’s aim of efficiency along the investment chain and greater consistency across member states through defining requirements for consistent disclosure along the investment chain on shareholder identity, meeting notices, methods of participation and exercise of voting rights.

What impact will it have?
We believe the Directive, if implemented effectively, will create a step change in the quality and quantity of stewardship through raising the awareness and expectations of investors and beneficiaries, and ultimately contribute to the sustainability of EU companies. The Directive will achieve this through:

- encouraging institutional investors to actively engage and vote their holdings, and therefore increasing use of shareholder rights and powers;
- raising institutional investors’ awareness of whether asset manager reward is driving the right behaviours and outcomes;
- requiring both passive and active managers to understand, engage and report on long-term and environmental, social and governance matters; and,
- increasing awareness in the investment chain on how strategies, engagement and voting contribute to the longer-term success of companies, and through this positive impact on society, the environment and economy.

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SRDII: Helping to boost stewardship standards

The new baseline for stewardship, provided by SRDII, should drive an evolution in the best practices advocated by the codes

1 Though the definition of ‘shareholder’ has variations across the Union.
**What needs to be done to comply?**

The Directive sets out requirements on disclosure and the facilitation of that disclosure along the investment chain. However, various actions will need to be undertaken in order to provide such reporting. Through increasing transparency and awareness, the Directive will shed light on the extent to which investors fulfil their responsibility as delegated stewards of financial stakes in a company and the assets of their clients and beneficiaries.

The disclosure requirements are summarised in the diagram below.

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**SRDII: Improving Transparency**

Investors are required to provide this information or explain why not

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* Information from the company is to be provided to shareholders, though often this will be via intermediaries as depicted here

What are the key dates to be aware of?

<table>
<thead>
<tr>
<th>Event</th>
<th>Date</th>
</tr>
</thead>
<tbody>
<tr>
<td>Adoption of Implementing Acts by the Commission</td>
<td>10 September 2018</td>
</tr>
<tr>
<td>Member state compliance with the Directive</td>
<td>10 June 2019</td>
</tr>
<tr>
<td>Member state compliance with the Implementing Acts</td>
<td>September 2020</td>
</tr>
</tbody>
</table>

Is it legally binding?

Member States are required to bring into force laws, regulations and administrative provisions necessary to comply with the Directive. Institutional investors and asset managers will be subject to such new law set by the member states.

What happens if I don’t comply?

The Directive states that: “Member States shall ensure that institutional investors and asset managers either comply with the requirements… or publicly disclose a clear and reasoned explanation why they have chosen not to comply with one or more of those requirements.”

Member States are required to implement rules on measures and penalties applicable to infringements of national provisions adopted.

These penalties, and the details of when an explanation of non-compliance is acceptable, are yet to be confirmed through transposition in each member state.

Stewardship and the exercise of shareholder rights...is increasingly being viewed as an effective tool to improve returns, reduce downside risk, and achieve additional outcomes.

Why embrace the Directive?

The amendment to the Directive will empower investors through greater transparency along the investment chain, an extended set of rights and the removal of barriers to the exercise of those rights. Stewardship and the exercise of shareholder rights, when implemented effectively, is increasingly being viewed as an effective tool to improve returns, reduce downside risk, and achieve additional outcomes in the broader interests of beneficiaries. Ultimately, it can create greater long-term value for all stakeholders. These outcomes are borne out by independent research.

HOW CAN HERMES EOS HELP?

Hermes Investment Management has a long track record of promoting responsible investment and active ownership. Its stewardship arm, Hermes EOS, has been helping clients become active stewards in the companies in which they invest since 2004. Hermes EOS’ purpose is to assist asset owners and asset managers in adding long-term value to their investments and managing their risks, by engaging with companies and policy-makers on environmental, social, governance, strategic and financial issues. Further detail on our services can be found in the Hermes EOS Stewardship Brochure.

Hermes EOS assists some of the largest and most respected global institutional investors to comply with stewardship codes and initiatives such as the UN Principles for Responsible Investment (PRI). In fact, Hermes helped draft and was one of the founding signatories of the Principles. As a value-added service, we help our clients with their PRI reporting obligations by providing data and narrative related to the activities we have performed on their behalf. We have a strong and respected reputation for our expertise, recognised by clients, as well as by the companies that we engage with. Companies often ask us for our investor perspectives and insight on behalf of the assets and clients we represent as our overall focus is on encouraging long-term, positive change in the businesses we engage with. Hermes EOS evaluates the link between engagement and improved long-term value on an ongoing basis, to inform and structure its activities.

Hermes EOS supports institutional investors in relation to engagement and voting. Hermes Investment Management can provide additional support to institutional investors in complying with aspects of the Directive regarding investment strategy (i.e. those requirements of the Directive in grey text in the first column), however these are not described in this document.

**Requirements of Chapter 1b: Transparency of Institutional Investors, Asset Managers and Proxy Advisors**

Grey highlighted cells under the Institutional Investor and Asset Manager columns show where the requirements of the Directive apply to these two groups. Requirements in grey text in the first column are not areas where Hermes EOS can directly support.

<table>
<thead>
<tr>
<th>Requirement</th>
<th>Ref.</th>
<th>Institutional investors</th>
<th>Asset Managers</th>
<th>EOS service</th>
<th>How EOS supports SRDII compliance</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Engagement policy</strong></td>
<td></td>
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</tr>
<tr>
<td>Develop and publicly disclose an engagement policy that describes how:</td>
<td>3g1a</td>
<td></td>
<td></td>
<td>✔</td>
<td>Hermes EOS works with its clients to help them draft responsible investment policies, and to establish their approach to active ownership, including engagement and voting. Hermes EOS consults with its clients to develop an engagement plan, outlining engagement objectives for a three year period, to be carried out on behalf of and at the direction of each client. This is revised and updated on an annual basis, following input from our clients, to ensure that we are continuing to engage on the topics of most concern to their beneficiaries and stakeholders.</td>
</tr>
<tr>
<td>Shareholder engagement is integrated in investment strategy</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>We can provide information on engagement, in particular through our client portal, to support its integration into investment strategy.</td>
</tr>
<tr>
<td>Investee companies are monitored on relevant matters (including strategy, financial and non-financial performance and risk; capital structure; social and environmental impact; and corporate governance)</td>
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<td></td>
<td></td>
<td>✔</td>
<td></td>
</tr>
</tbody>
</table>
| ▪ In 2017 we engaged with 659 companies on 1,704 engagement issues and objectives. We approach the engagements on a holistic basis, focusing on the highest priority matters.  
▪ We select companies based on the size of our clients’ aggregate holdings, the materiality of the risks and the feasibility of achieving change through engagement. Engagement is then prioritised within a tiered system. Companies with more material corporate governance and sustainability-related issues and also the greatest potential for change are engaged with more intensively.  
▪ We made progress on 38% of all objectives in the year, measured using our milestone system.  
▪ We also have a core engagement programme which includes approximately 400 companies, with which we undertake structured engagement, prioritised based on materiality of identified risks. We set SMART engagement objectives to achieve and track our progress using a milestone measurement system. We engage with additional companies throughout the course of the year too, often in response to issues arising unexpectedly or around the time of the company’s AGM.  
▪ Milestones are tailored to reflect the nature of the objective, company and market it operates within, but generally follow the format below:  
  – Milestone 1 – Raised concern at appropriate level  
  – Milestone 2 – Company acknowledges issue  
  – Milestone 3 – Company commits to credible change  
  – Milestone 4 – Change implemented  
▪ This enables clients to easily monitor and view our progress engaging on the identified risks of their investee companies. |
| Dialogue is conducted                                                       |      |                         |                | ✔           | Our approach is to engage in person and at board or executive level wherever possible, in order to effect positive change. Our engagement is conducted by members of our senior team, with proven experience and expertise across industries, professions, cultures and languages. |
| Voting and other rights are exercised                                       |      |                         |                | ✔           | We provide voting recommendations for our clients, informed by insights from our engagement with companies. Hermes EOS has developed best practice voting guidelines based on our in-depth knowledge of key markets and experience of engaging with companies. We also have over 40 country specific policies that reflect local market characteristics. Most clients rely on our voting guidelines, however we are able to collaborate on specific client policies. |

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\(^6\) Institutional investors is the term used by the Directive; this refers to asset owners  
\(^9\) Specific, Measurable, Actionable, Realistic and Time Bound
### Requirement | Ref. | Institutional investors | Asset Managers | EOS service | How EOS supports SRDII compliance
--- | --- | --- | --- | --- | ---
Cooperation with other shareholders |  |  |  | ✔ | Where appropriate, we lead and participate in investor collaboration initiatives on thematic or sectoral issues, such as Climate Action 100+10 (where we are lead investor on a significant number of the company engagements globally), and collective engagements through the UN Principles for Responsible Investment (for example, cyber risk, tax and water stress).

Communication with relevant stakeholders |  |  |  | ✔ | We regularly engage with a wide range of stakeholders, including government authorities, trade bodies and NGOs. We are involved in a number of regional initiatives including the ICGN, IIGC, CII, ACGA, Eumedion and UKSIF.

Actual and potential conflicts of interest are managed |  |  |  | ✔ | We have a public statement on the management of conflicts of interest.

**Publicly disclose information explaining:**

- Annually, how the engagement policy has been implemented, including a general description of voting behaviour, an explanation of the most significant votes and the use of the services of proxy advisors.\(^{11}\)

  - Ref. 3g1b
  - ✔

  - We provide a range of high quality, formal, qualitative and quantitative reporting for clients (monthly, quarterly and annual) that can be used to communicate with internal and external stakeholders. Clients can view our engagement, voting and screening data on our dedicated online client portal.

  - We also already publicly disclose the information requested by the Directive, in the following:
    - How the engagement policy has been implemented (in our Annual and quarterly Public Engagement Reports and Case Studies);
    - Voting behaviour (in our Regional Corporate Governance Principles); and
    - An explanation of the most significant votes (votes against are listed in our Voting Disclosure).

  - This information is available on our website.

- Where an asset manager implements the engagement policy, including voting, on behalf of an institutional investor, the institutional investor shall make a reference as to where such voting information has been published by the asset manager.

  - ✔

  - We publish information on our voting recommendations where we opposed management on one or more resolutions on behalf of our clients (found [here](http://link_to_voting_recommendations)).

  - We publish our voting disclosure one quarter in arrears so that we are transparently accountable, but our dialogue with companies around voting issues is not compromised.

**Transparency of asset managers**

- Disclose, on an annual basis, to the institutional investor:

  - Ref. 3/1
  - ✔

- How their investment strategy and implementation thereof complies with their arrangement with the investor and contributes to the medium to long-term performance of the assets of the institutional investor or of the fund.

  - N/A

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\(^{10}\) http://www.climateaction100.org/  \(^{11}\) Such disclosure may exclude votes that are insignificant due to the subject matter of the vote or the size of the holding in the company. Where an asset manager implements the engagement policy, including voting, on behalf of an institutional investor, the institutional investor shall make a reference as to where such voting information has been published by the asset manager.
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</tr>
</thead>
<tbody>
<tr>
<td>Key material medium to long-term risks associated with the investments</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Portfolio composition, turnover and turnover costs</td>
<td></td>
<td></td>
<td>N/A</td>
<td></td>
<td></td>
</tr>
<tr>
<td>The use of proxy advisors for the purpose of engagement activities</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>We can describe Hermes EOS support in delivering engagement activities, including tailored to specific asset manager clients.</td>
</tr>
<tr>
<td>Policy on securities lending and how it is applied to fulfil its engagement activities if applicable, particularly at the time of the general meeting of the investee companies</td>
<td></td>
<td></td>
<td></td>
<td>N/A</td>
<td></td>
</tr>
<tr>
<td>Whether, and if so how, investment decisions are made based on evaluation of the medium to long-term performance of the investee company, including non-financial performance.</td>
<td></td>
<td></td>
<td></td>
<td>N/A</td>
<td></td>
</tr>
<tr>
<td>Which conflicts of interests have arisen in connection with engagements activities and how the asset managers have dealt with them.</td>
<td></td>
<td></td>
<td></td>
<td>N/A</td>
<td></td>
</tr>
</tbody>
</table>
SRDII: THEORY OF CHANGE
SRDII targets corporate-governance FAILURES:

- **UNJUSTIFIED PAY**
  Excessive directors’ pay not justified by performance has led to mistrust among investors.

- **LACK OF TRANSPARENCY**
  Investors are often not transparent about their investment strategies, or their engagement policy and its implementation.

- **SHORT-TERMISM**
  Capital markets often exert pressure on companies to perform in the short-term, which may jeopardise long-term performance.

- **IMPEDED DECISION MAKING**
  Deficiencies in engagement and control exercised by shareholders impede good decision-making by companies.

- **LACK OF TRANSPARENCY**
  Investors are often not transparent about their investment strategies, or their engagement policy and its implementation.

To generate ACTIONS:

- **IDENTIFICATION**
  Identification of shareholders.

- **FACILITATION**
  Improved transmission of information along the chain of intermediaries to facilitate the exercising of shareholder rights.

- **SAY ON PAY**
  Votes on remuneration policy and reports.

Resulting in OUTCOMES:

- **EFFICIENT CHAIN**
  Efficiency of the chain of intermediaries.

- **ENGAGED SHAREHOLDERS**
  Increased exercising of shareholder rights.

- **HOLISTIC RETURNS**
  More effective integration of medium-to-long-term risks (including ESG matters) into investment processes.

- **IMPROVED ENGAGEMENT**
  Better quality and quantity of long-term shareholder engagement.

Resulting in IMPACTS:

- **SUSTAINABLE ECONOMICS**
  Long-term sustainability in the financial and non-financial performance of EU companies.

- **VALUE CREATION**
  Benefits to investors: improved returns, reduced downside risk and positive outcomes for beneficiaries.
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 | Denmark | Dublin | Frankfurt | New York | Singapore

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: