CORPORATE GOVERNANCE PRINCIPLES

United Kingdom

February 2019

For professional investors only

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HERMES EOS

COMPANY PURPOSE AND BOARD LEADERSHIP

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 with 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 andtheir families with a secure future.

We expect a board to promote the company's long-term success and the creation of sustainable value for stakeholders and wider society through effective governance, including the following actions:

- Establishing a company's purpose, values and strategy and promoting the desired culture;
- ensuring the necessary resources are in place for the company to achieve and measure its performance, while establishing prudent and effective controls to assess and manage risk;
- ensuring effective engagement with shareholders and stakeholders, and representing these views in board discussions and decision-making; and
- ensuring human capital policies and practices are consistent with the company's values and support its long-term sustainable success.

We welcome the changes to the UK Corporate Governance Code, which highlight boards' responsibility to understand and act on the views of a company's stakeholders, including employees, and to establish a mechanism for workforce engagement. We are particularly supportive of strengthening the role of employees within governance arrangements and, specifically, giving the workforce a greater voice in boardrooms. We believe that elected employee directors could be beneficial and encourage companies to consider this approach.

ENDORSEMENT OF THE UK CORPORATE GOVERNANCE CODE

We endorse the principles and provisions of the UK Corporate Governance Code (the Code), as well as its associated guidance, and expect companies to provide meaningful reporting on how they apply it.

We recognise that good governance cannot be guaranteed by adherence to the provisions of the Code. We therefore urge companies to consider carefully how best to apply the principles and the spirit of the Code to their own circumstances and clearly communicate to shareholders the rationale behind their chosen approach.

Smaller quoted companies

We believe that smaller listed companies – those outside the FTSE 350 Index – should comply with the Code in full, expect where it makes allowances for smaller companies, or explain the reasons for non-compliance. The Quoted Companies Alliance's Corporate Governance Guidelines for Smaller Quoted Companies provide good advice for companies outside the FTSE 350, including AIM-quoted businesses, on how to develop and manage their governance commensurate with their stage of development. The Guidelines may also help companies to provide explanations when their arrangements differ from the Code's recommendations.

In the following, we set out the key elements of corporate governance that guide our approach to responsible investment and stewardship in the UK. This document should be read in conjunction with the Hermes Responsible Ownership Principles.[1]

BOARD COMPOSITION, INDEPENDENCE AND DIVERSITY

Boards should ensure that they comprise members with diverse skills, knowledge and experience, including: leadership skills; technical expertise; and sufficient independence and strength of character to challenge executive management and hold it to account, including appointing and, when necessary, removing executive directors.

Independence and tenure

We support the Code's provision for companies in the FTSE 350 Index, which states that at least half the board, excluding the chair, should be made up of independent non-executive directors. A smaller company should have at least two independent non-executive directors. A board must provide a clear explanation for investors should it determine a director independent despite him or her meeting one of more of the Code's criteria for non-independence.

We support the provision of the Code that the length of service of the board as a whole should be taken into account and membership regularly refreshed. We generally permit some flexibility regarding the tenure of an independent director beyond nine years, provided the director's credentials, including his or her independence, are reviewed thoroughly by the board and explained to investors; that this period is not fully concurrent with any executive director, which may compromise independence; and that it is appropriate in the context of the board as whole. For example, we are unlikely to be supportive of a board which includes a number of independent directors with more than nine years' tenure and lacks newer independent directors. Chairs should not remain in post for longer than nine years, although this may be extended for a short time if necessary for a smooth succession.

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

Diversity and inclusion

We believe that boards should seek diversity in its broadest sense – taking into account skills and experience, networks and demographics – to best serve the company's long-term strategic direction, business model, employees, customers, suppliers and geographic footprint.

We support the aspiration that board members, together with all levels of management, should broadly reflect the diversity of society, including in gender and ethnicity. As members of the 30% Club, we strongly support the initial goal of achieving at least 33% female representation on FTSE 350 boards by 2020, as set out in the report Women on boards: 5 year summary by Lord Davies of Abersoch, and the findings of the Hampton-Alexander review, proposing that at least 33% of members of the executive committee and their direct reports at FTSE 100 companies should be women, by 2020.

As the target year is approaching, we expect FTSE 350 companies to already have achieved a minimum of 30% female representation on boards and for FTSE 100 companies to have made clear progress in increasing female representation amongst their executive committees and their direct reports. If not, we expect companies to outline a credible plan for soon meeting these targets. In the absence of such plans, we may recommend a vote against:

- the re-election of the chair of the nominations committee of FTSE 100 companies where women comprise materially less than 30% of the board, or 25% at FTSE 250 companies;
- the re-election of the board chair or chair of the nominations committee of companies outside the FTSE 350 with no female board representation; and
- the re-election of the chair of a FTSE 100 company where there is no female representation on the executive committee.

We also support the recommendations of the Parker Review to improve ethnic diversity of boards, including the recommendations that FTSE 100 boards have at least one director from an ethnic minority background by 2021 and FTSE 250 boards have the same by 2024. We companies to disclose how they consider and promote ethnic diversity on the board and beyond.

Important though board and executive-level focus is in promoting diversity, companies should also focus on promoting a diverse and inclusive workforce. We expect to see clear disclosure of the company's policy on diversity and inclusion; its objectives, targets and progress in achieving them; and – for qualifying companies – the results of their gender pay gap analysis, related actions, targets and progress.

We welcome the change to the Code which broaden the focus of the nomination committee, including giving responsibility for overseeing the development of a diverse pipeline for succession to senior management. In support of this, we encourage companies to consider taking part in the Future Boards Scheme,[2] which provides shadowing roles on boards for women and other under-represented groups, to help them build the necessary skills and experience required to be a director.

Succession planning

We believe that good succession planning at board and senior management level is essential for safeguarding the long-term value of all companies. It should involve contingency planning for the sudden loss of key personnel, as well as planning for foreseeable change, for example impending retirement or other planned change. Effective planning for both the board and senior management should give consideration to ensuring the right mix of skills and experience and – within this context – promoting the diversity necessary to support the company's strategy, geographical footprint and demographic representation.

Overseen by the board, senior management should create a pipeline of suitable candidates from within the organisation to become senior managers and executive directors. We also encourage companies to make their senior management and executive directors available to serve as non-executive directors at other companies as part of their development. This helps to develop a deep pool of suitable talent for companies to draw from when selecting candidates for board positions.

BOARD EFFECTIVENESS AND EVALUATION

We expect boards to regularly assess their own effectiveness to ensure they are operating optimally, with the right governance practices and supporting structures. We endorse the Code's recommendation that boards should undertake a regular process of evaluation and, in particular, an independent evaluation at least every three years. The independent reviewer should be carefully chosen for his or her relevant skills and experience and should be enabled to interact fully with the board. Individual directors should play their full role in ensuring effective evaluations. The board should then report transparently on the main issues arising from the evaluation, as well as the steps that have been taken, and will need to be taken, to address them.

Board committees

Separate audit, nomination and remuneration committees should exist for all boards and should comply with the expectations on composition set out in the Code.

Director attendance and commitment

A board director should avoid being over-committed such that he or she is not able to fully discharge their duties. Whether a director may be over-committed depends on a range of factors beyond the number of other roles he or she has. These include the size and complexity of a company, travel requirements and any additional responsibilities, such as being a committee chair.

As a guideline, we regard a director as probably over-committed if he or she has more than five directorships of public companies. We consider a chair role equivalent to two directorships and an executive role as equivalent to four directorships. We may not support a chair holding another chair role, depending on our view of the complexity and necessary time commitment, and will not support a chair with two or more additional chair roles. Any executive should only have one non-executive role at another public company and should not serve as chair.

[2] https://30percentclub.org/assets/uploads/UK/Future_boards/30__Club_The_Future_board_Scheme.pdf

When appointing directors, the company should disclose clearly to shareholders the director's other commitments. Directors must obtain prior approval before undertaking additional external appointments, with the company providing the reasons for permitting significant appointments in the annual report.

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 aligning properly with the core long-term objectives of companies. Therefore we continue to hold many discussions on reforming pay with remuneration committee members and other stakeholders around the world. We are often encouraged by their response to our views. However, pay practice within companies rarely reflects our discussions on our *Remuneration Principles*.[3] 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 with 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 at least two years following departure from the company.

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.

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.

Remuneration reporting

Despite legislation designed to improve reporting on remuneration, company reports can be difficult to comprehend. We therefore urge companies to be clear when reporting remuneration policies and their implementation. We endorse the principles and provisions of the Code and the guidance provided by the GC100 and Investor Group[4]. We expect companies to disclose targets within incentive schemes either in advance or within a year of the end of the relevant reporting period. If a company deems this to be difficult for reasons of commercial confidentiality, we expect a full explanation in respect of each metric for which targets are not published.

AUDIT

The audit process should help to ensure the integrity of company reporting on essential matters, such as the solvency of the company, its prospects for longer-term viability and its financial health more broadly. We expect audit committees to comply with the expectations of the Code and provide meaningful reporting for shareholders on the key aspects of their work.

We support the Financial Reporting Council's guidance on the publication of viability statements, as set out in its Guidance on Board Effectiveness.[5] In these statements, directors explain why they believe that the company can continue to operate and meet its liabilities, taking account of its financial position and principal risks. Many companies have settled on reporting against a three year time period. We believe that companies should report against their long-term planning period, which should be longer for most large, complex organisations.

Auditor independence is vital, which is why we support, as a minimum standard, the EU regulations on auditor re-tendering and rotation, and the capping of non-audit fees at 70% of audit fees over an average of three years. We remain concerned about the audit market and audit quality. We will hold the audit committee responsible for the quality of each company's audit.

PROTECTION OF SHAREHOLDER RIGHTS

We rigorously defend shareholder rights on behalf of institutional investors, including the right to receive good quality corporate reporting and material information on a timely basis, propose shareholder resolutions and vote at shareholder meetings. We support a single share class structure with one share one vote, and oppose any measures that deviate from this.

[3] https://www.hermes-investment.com/wp-content/uploads/2017/09/Remuneration-Principles-Clarifying-Expectations.pdf
[4] https://uk.practicallaw.thomsonreuters.com/w-017-9790?navId=4D0BA3947AADCE38D3B2FAA65903C5A2&comp=pluk&transitionType=Default&contextData=(sc.Default)
[5] https://www.frc.org.uk/getattachment/61232f60-a338-471b-ba5a-bfed25219147/2018-Guidance-on-Board-Effectiveness-FINAL.PDF

Premium listings

We expect companies listed on the main market of the London Stock Exchange to obtain and maintain premium listings, as these listings ensure that important investor rights are protected, including through governance arrangements disclosed against the Code; limitation of dilution within strict limits, unless authorised by shareholder vote; and class tests for major transactions. We support the exclusion from the FTSE indices of those companies maintaining standard listings.

Shareholder resolutions

We support the selective use of shareholder resolutions as a useful tool for communicating investor concerns and priorities or the assertion of shareholder rights, as a supplement to or escalation of direct engagement with companies. Shareholder resolutions can be a powerful tool for clearly expressing the views of long-term shareholders in the context of the many short-term pressures on a company's board and management. We expect boards to engage constructively when shareholder resolutions are filed.

COMMERCIAL TRANSACTIONS

Most merger and acquisition transactions are not as successful as the acquiring party expects. When considering our voting recommendation on a commercial transaction, we will consider a range of factors in the context of seeking to protect and promote long-term, sustainable value. The underlying expectation is that due process is followed, with information made available to shareholders. Considerations include:

- Consistency with strategy: whether the transaction is consistent with the prior stated strategic aims of the company or whether any change in strategy appears coherent and sensible.
- Risks and opportunities: the key risks and opportunities to the business from the transaction and the extent to which these appear to have been managed. This is our assessment of the quality of the due diligence on the transaction, including factors such as cultural fit, human capital management implications and the post-transaction integration plan.
- Conflicts of interest: any conflicts of interest which may affect the alignment of the interests of directors or particular shareholders with those of long-term outside or minority shareholders, including the following:
  - Whether the proposal is a related party transaction and, if so, whether appropriate disclosures or other steps to protect the interests of other shareholders have been made.
  - Whether the transaction erodes any shareholder rights.
  - Any potential conflict of interest concerning the directors' duty to act in the interests of shareholders, in particular as these may arise from either existing or newly revised remuneration arrangements.

MANAGEMENT OF ENVIRONMENTAL AND SOCIAL RISKS AND OPPORTUNITIES

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.

Ethical leadership

We expect companies to have best practice anti-corruption and anti-bribery policies and processes in place. They should also have robust compliance mechanisms to enforce them, in compliance with the UK Bribery Act and associated guidance.[6] However, these mechanisms 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, and 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

Due to the systemic risk that climate change poses 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 climate change is covered in board meetings at least annually. Boards and senior management should 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 views on climate change that differ 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 in order to encourage effective action on climate change, in-line with the Paris Agreement. Where a company and a third party 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.

[6] https://www.justice.gov.uk/downloads/legislation/bribery-act-2010-guidance.pdf

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 that 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 should report how they will help 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 incorporate material goals into their business models and strategies. We urge companies to report on how they are responding to the SDGs and encourage them to engage with civil society on how best to support them.

Social risks

Companies should ensure that, to the extent relevant to their business and operations, including their suppliers and potential product uses, they are aware of and take effective measures in the following areas:

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 reputational factors, including companies' performance on human rights. We expect companies to comply with all legal requirements and the duty to respect all internationally recognised human rights, including the obligations of the Modern Slavery Act.[7] 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.

Human capital management

Employees are a company's most valuable asset. Businesses should therefore develop human capital management strategies and accompanying objectives that seek to develop the potential of their employees in support of maximising long-term value through a positively engaged, committed and talented workforce. We encourage companies to provide qualitative contextual information describing their approach, as well as annual disclosure of the key performance indicators they use to manage human capital.

Transparency and reporting

We believe that the quality of narrative reporting reflects the board's strategic thinking, its line of sight into operations and how well it oversees the company. Boards must report openly and transparently on the performance of the company and their stewardship of it over the year, acknowledging the challenges, as well as the achievements, the state of the market and the competitive landscape. It is also fundamental that each company reports in a way that allows investors to understand the main risks that the board has identified for the business, along with how the company manages and mitigates them.

Effective engagement

We support the UK Stewardship Code,[8] which, through its 'comply-or-explain' mechanism, encourages investors to engage with investee companies, with the aim of enhancing and protecting value. While the Stewardship Code makes clear that stewardship does not entail interfering in the day-to-day management of a business, it requires investors to take an active interest in the oversight of companies and to intervene if necessary. To be effective, we believe stewardship must be seen by companies and investors as an ongoing process. Engagement should ensure a constructive relationship, rather than a procedure to be followed. It should involve debate between directors, management and investors on strategy, risk management and other key issues affecting the long-term health of the company, including how a company's specific governance arrangements meet its needs.

[7] https://www.gov.uk/government/collections/modern-slavery
[8] https://www.frc.org.uk/investors/uk-stewardship-code

OUTCOMES BEYOND PERFORMANCE

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:

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