OUTCOMES BEYOND PERFORMANCE

CORPORATE GOVERNANCE PRINCIPLES

United Kingdom

January 2018

For professional investors only

www.hermes-investment.com

HERMES EOS

COMPANY PURPOSE

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 all stakeholders, society and the environment. Given this relationship, our overriding expectation is that companies be run not only for shareholders but with a wider purpose that benefits society. In turn, this will support the long-term interests of the beneficiaries of their shareholders, namely the savers and pensioners who rely on sustainable returns within an economy and a society that is capable of providing them and their families with a secure future.

To succeed in the long run, companies will need to effectively manage relationships with stakeholders and have regard for the environment and society as a whole. Companies adhering to our overriding principle will not only create sustainable value for their shareholders but also benefit stakeholders, the wider economy and society.

ENDORSEMENT OF THE UK CORPORATE GOVERNANCE CODE

We endorse the principles and provisions of the UK Corporate Governance Code[1] (the Code), as well as its associated guidance. We encourage companies either to comply with the Code or to fully explain their reasons for non-compliance, while recognising that good governance cannot be guaranteed by strict 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

In order to drive best practice, we believe that smaller listed companies – those outside the FTSE 350 index – should comply with the Code in full or otherwise explain the reasons for non-compliance, except when the particular allowances for smaller companies[2] apply, as set out in the Code. The Quoted Companies Alliance's Corporate Governance Guidelines for Smaller Quoted Companies[3] provide good advice for companies outside the FTSE 350, including those on the AIM exchange, on how to develop and manage their governance arrangements in a manner appropriate to their stage of development.

In the following, we set out the key elements of corporate governance that guide our approach to responsible investment and stewardship in the UK.

BOARD COMPOSITION, INDEPENDENCE AND DIVERSITY

Boards should ensure that they comprise members with a diverse range of skills, knowledge and experience. These include leadership skills to move the company forward, good group dynamics, technical expertise to make informed decisions and sufficient independence and strength of character to challenge executive management and to hold it to account.

Independence

We support the Code's provision that for companies in the FTSE 350 at least half the board, excluding the chair, should be made up of independent non-executive directors in accordance with the definition provided by the Code. However, we generally permit some flexibility regarding the tenure of an independent director beyond nine years, provided this period is not fully concurrent with any executive director, and that the director's credentials, including his or her independence, are reviewed thoroughly by the board and explained to investors. A smaller company should have at least two independent non-executive directors.

Diversity

We believe that boards should seek diversity in its broadest sense, taking into account the company's long-term strategic direction, business model, employees, customers, suppliers and geographic footprint. We support the long-term aspiration that boards, together will all levels of management, should broadly reflect aspects of the diversity of society, including across race and gender. As members of the 30% Club, we believe that boards should already have achieved a minimum of 30% female representation and, if not at that level, should outline plans to reach the target of at least 33% by 2020 as set out in the report Women on Boards: 5 year summary by Lord Davies of Abersoch. We also support the findings of the Hampton-Alexander review[4], proposing that at least 33% of members of the executive team at FTSE 100 companies be women. We encourage companies to consider taking part in the Future Boards Scheme[5], by which women and other disadvantaged groups can be given shadowing roles on boards to assist in building the necessary skills and experience. We also support the recommendations of the Parker Review to improve ethnic diversity of boards.

Succession planning

We believe that good succession planning at the board and senior management level is essential to safeguard long-term value for any organisation. 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. Good succession planning should work to build a pipeline of suitable candidates from within the organisation to become senior managers and executive directors. We 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.

[1] https://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/UK-Corporate-Governance-Code-April-2016.pdf
[2] A smaller company is defined in the UK Corporate Governance Code as a company not included in the FTSE 350.
[3] http://www.theqca.com/
[4] https://www.gov.uk/government/news/ftse-100-executive-pipeline-needs-more-women-say-top-business-bosses
[5] https://30percentclub.org/press-releases/view/the-future-board-scheme.pdf

BOARD EFFECTIVENESS AND EVALUATION

We expect companies to continually assess the effectiveness of their boards to ensure they are operating optimally, with the right governance 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. Boards should demonstrate their commitment to effectiveness to shareowners by publishing the identity of the independent reviewer, who should be carefully chosen for his or her relevant skills and experience, and then reporting transparently and honestly on the main issues arising from the evaluation, its findings and 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, save for boards of two or fewer independent non-executive directors, and ought to comply with the expectations for composition set out below:

- The nomination committee must comprise a majority of independent non-executive directors. In the case of companies with a senior independent director (which should include all larger companies[6]), he or she should be a member.
- The remuneration committee should comprise only independent non-executive directors. However, the chair may be a member, provided he or she was independent at the time of appointment and does not chair the committee, as may a shareholder-appointed director.
- The audit committee should comprise at least three directors for larger companies or two directors for smaller companies and should comprise only independent non-executive directors, not including the chair. However, for smaller companies, the chair may be a member, provided he or she was independent at the time of appointment and does not chair the committee, as may a shareholder-appointed director. The chair should ensure that each director is not over-committed.

Director attendance and commitment

Each director should be able to allocate sufficient time to the company to discharge his or her duties, alongside other commitments, with attendance at board and committee meetings a requirement. The number of board, committee and other meetings attended by each director should be disclosed routinely in the annual report and accounts as a matter of best practice. Instances of less than full attendance should be explained. A board director should avoid being over-committed. Whether a director may be overcommitted 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 roles such as that of a committee chair. As a broad guideline, we tend to regard a director as overcommitted if he or she has more than five directorships, with a chair role equivalent to two directorships and an executive role equivalent to four directorships. We do not expect a chair of a listed company to also hold an executive role. A significant post in public life should be considered as equivalent to a directorship, whether an executive, a non-executive or a chair role.

REMUNERATION

Executive remuneration plays an important role in ensuring that the management of a company is incentivised to act in the best interests of the long-term owners of the business. We expect remuneration committees to ensure that remuneration structures and practices are relevant to their businesses and support the long-term success of the business. In 2016, following our increasing concern that the existing structures and practices concerning executive pay are not fit for purpose and that pay is too high, we published guidelines[7] clarifying our expectations for the UK market on remuneration, which can be summarised as follows:

- Shareholding: Executive management should make a material long-term investment in the company's shares.
- Alignment: Pay should be aligned to long-term success and the desired corporate culture.
- Simplicity: Pay schemes should be clear and understandable for investors as well as executives.
- Accountability: Remuneration committees should use discretion to ensure that awards properly reflect business performance.
- Stewardship: Companies and investors should regularly discuss strategy, long-term performance and the link to executive remuneration.

Alignment with long-term business success

- Pay structures should be much simpler and less leveraged than they are at present, for example through the use of a single incentive scheme and lower variable – but perhaps higher fixed – pay.
- Executives should be incentivised to deliver strategic goals, as opposed to total shareholder return, and to take account of the company's impact on key stakeholders.
- Pay awards should reflect the outcomes for long-term investors and take account of any erosion of the company's value.
- Pay packages should aim to enable executives to accrue wealth as ongoing owners and in support of the company's longer-term success.
- Pay schemes should recognise that the timeframes of executive tenure are commonly shorter than the timeframes of accountability for their decisions. Accordingly, minimum shareholding requirements for directors should remain in place for a period of time following departure to help to mitigate tail risk following a period in office.

Sustainable pay in accordance with fair pay principles

- Remuneration committees, taking account of the UK Corporate Governance Code's guidance to avoid paying more than is necessary, should take a more robust view on pay, using their judgement and being accountable for their decisions.
- The potential outcomes of a pay policy should be rigorously scenario-tested with a published cap on the total pay opportunity agreed in advance.

[6] A larger company is a company included in the FTSE 350 at any point in the prior 12 months.
[7] https://www.hermes-investment.com/wp-content/uploads/2017/09/Remuneration-Principles-Clarifying-Expectations.pdf

- Boards should be able to justify to the workforce and the public the rationale for pay awards to management. If they are not able to do so convincingly, directors should use their discretion to make adjustments.
- Engagement by investors coupled with and reinforced by voting is likely to be the most effective means of bringing about positive change.
- Investors should demonstrate that their policies can be evidenced through their voting. They should not be supportive of payouts which do not support the company's long-term success and should hold individual directors accountable for questionable pay policies or approving inappropriate outcomes.

Specific examples of structural approaches to remuneration which embody the above expectations are:

- Restricted share awards in lieu of longer-term variable pay awards, particularly for companies which appear to struggle to identify metrics suitable for long-term incentive plans of three to five years and rely on total shareholder return as their dominant long-term metric. This offers the potential to reduce average payout of packages by reducing variable pay with its associated discount factor and increasing fixed pay.
- Simplifying incentive structures, including consolidating variable pay around a single incentive scheme focused primarily on strategic goals (not total shareholder return) in place of a combination of an annual and long-term incentive plan.
- Higher minimum shareholding requirements of at least 300% of base salary for FTSE 100 companies and 200% for FTSE 250 companies, which last for at least two years beyond the tenure of the executive.

We incorporate these principles and guidelines into our discussions on remuneration with companies. We will support remuneration committees that look to innovate their incentive schemes, for which they are responsible, to position companies best for long-term success.

If a company has a remuneration framework that is materially out of step with our remuneration principles and appears to be consistently failing to respond to our engagement, we will consider recommending voting against the chair of the remuneration committee and other relevant directors, including remuneration committee members and the chair of the board.

Remuneration reporting

Despite legislation designed to improve reporting on remuneration, the reports of many companies can be difficult to comprehend. We therefore urge for clarity in the reporting of remuneration policies and their implementation. We endorse the guidance provided by the GC100 and Investor Group[8]. We expect companies to disclose targets under incentive schemes either in advance or within a year following the end of the relevant reporting period. In the case that a company deems that this is not appropriate 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 is vital to ensuring 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.

Audit committees

Audit committees play a critical role in overseeing the audit process and ensuring the quality of reporting to investors. They should describe to investors the key aspects of their work, including descriptions of the following:

- The significant issues considered and how they were addressed.
- How the audit committee assessed the effectiveness of the internal and external audit process and how it sought to remedy any concerns.
- The committee's approach to the appointment and reappointment of the auditor, including an explanation of how auditor objectivity and independence are safeguarded.

Viability statements

We support the Code's requirement for publication of a viability statement explaining the belief of directors that a company can continue in operation and meet its liabilities, taking account of its position and principal risks. We believe companies should set out viability statements corresponding to their long-term planning period, which for some companies will be three years but for others will be a longer period.

Auditor independence

Auditor independence is vital, which is why we support regular retendering of the role of auditor, noting that EU Audit Regulation 537/2014 requires retendering at least every 10 years combined with mandatory rotation at least every 20 years. We do not believe that audits should be compromised or perceived to be so because the audit firm has been paid significant non-audit fees. We do not support non-audit fees in excess of the audit fee unless they are clearly justified. We note the requirement of the EU Audit Regulation that non-audit fees are capped at 70% of audit fees over an average of three years.

PROTECTION OF SHAREHOLDER RIGHTS

We rigorously seek protection of shareholder rights on behalf of asset owners, including the right to access information, propose resolutions and vote at shareholder meetings. We support a single share class structure and generally oppose any measures to increase the complexity of shareholding structures. We require the unbundling of resolutions so that shareholders have the ability to vote distinctly on the general and enhanced authorities to issue shares as separate items on the agenda of shareholder meetings. We only approve requests for financial assistance on a case-by-case basis and do not approve any general requests to waive the requirement to seek shareholder approval prior to financial assistance.

[8] http://uk.practicallaw.com/groups/uk-gc100-investor-group

Share capital management

We support measures to protect the value of each share issued to shareholders, which include the following:

- Pre-emption rights: Pre-emption rights for existing shareholders provide vital protection from the risk of erosion of value or control through the dilution of their share support holdings without prior approval. We support the Investment Association's Share Capital Management Guidelines[9] and the Pre-Emption Group's statement of principles and associated guidelines 2015 on dilution[10].
- Share buy-backs: We support the Investment Association's Share Capital Management Guidelines.

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 reporting against the UK Corporate Governance Code, maintenance of pre-emption rights and class tests for major transactions. We support the exclusion from the FTSE indices of those companies maintaining secondary listings.

Shareholder resolutions

We support the selective use of shareholder resolutions as a potentially useful tool for communicating investor concerns and priorities or the assertion of shareholder rights. Shareholder resolutions can be a powerful tool for expressing clearly the views of long-term shareholders in the context of the many short-term pressures on a company's board and management. Their constructive use and dialogue around them can help long-term shareholders maintain confidence in the board.

COMMERCIAL TRANSACTIONS

When considering our voting recommendation on a commercial transaction, we will consider a range of factors including the following:

- Governance: The overall governance framework of the transaction, including the extent to which due process is followed and information is made available to shareholders.
- Consistency with strategy: Whether the transaction is consistent with the prior stated strategic aims of the company.
- Risks: The key risks to the business from the transaction and the extent to which these appear to have been managed. This is our assessment on the quality of the due diligence on the transaction, including an assessment of factors such as cultural fit and the post-merger integration plan, if applicable.
- 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 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 long-term shareholders have been made.
  - Whether the transaction erodes any shareholder rights, which may occur under a poison pill arrangement.
  - 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 applicable 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 their sustainability. They also ought to regularly disclose to shareholders how they identify and manage these material risks and provide evidence that the processes to do so are effective. Furthermore, companies should clearly define board and senior management responsibilities for environmental and social issues. Directors of companies should be accountable to shareholders for the management of material environmental and social risks, as, over the long term, these will affect value and the ability of companies to do business.

Environmental risks

Companies should ensure they are aware of and have appraised the risks and opportunities arising from the environmental impact of their own activities and those of others and are supportive of public policy efforts to help manage the key environmental impacts of their business. This should include specific policies and actions in the following areas:

- Climate change: Including the impact of the company's own operations (Scope 1, 2) and those related to its supply chain products and services (Scope 3) by reporting to the CDP initiative.
- Natural resource efficiency: Including the impact of water use in areas of water stress, together with the risks from intense weather events and flooding by reporting to the CDP, and opportunities to improve waste management and resource efficiency by reducing demand, re-using products, recycling materials or otherwise recovering value prior to safe disposal and explaining what steps the company is taking to help build a more circular economy.
- Pollution: Including pollution of the air, water and soil.

Financial Stability Board's Task Force on Climate-related Financial Disclosures

We welcome the recommendations of the Financial Stability Board's Task Force on Climate-related Financial Disclosures[11] (TCFD). As a representative of long-term shareholders, we expect companies to assess and report on possible future climate change risks, not just those that have already emerged.

For companies where the materiality of climate change and wider environmental risks is likely to be high – such as energy (including oil and gas and utilities), materials (including metals and mining), transportation (including airlines, automotive and logistics), together with financial services companies exposed to these sectors (including

[9] https://www.ivis.co.uk/media/12250/Share-Capital-Management-Guidelines-July-2016.pdf
[10] http://www.pre-emptiongroup.org.uk/
[11] https://www.fsb-tcfd.org/

banks and insurance) – we expect to see solid evidence, through company reporting, of good governance of the management of relevant environmental risks. This should include the implications for corporate strategy and targets and metrics used to monitor risk, and the evolving strategic implications, in line with the TCFD guidelines. Given the unprecedented nature of these risks, when considering the implications for strategy, it will be appropriate for companies to test the resilience of their strategy against a range of different climate change scenarios, including publicly available low-carbon scenarios such as those published by the International Energy Agency by which global warming as a result of climate change may be limited to 2°C or lower.

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:

- Human rights: Compliance with all legal requirements and the duty to respect all internationally recognised human rights, including the obligations of the Modern Slavery Act.[12]
- Conduct and culture: Seeking to develop and maintain the highest standards of conduct towards all stakeholders, including employees, customers, suppliers, government, regulators and the wider public across all markets, together with a culture that ensures the highest standards of integrity and a respect for others within and outside of the company. This includes development of an ethical culture and robust policy that recognises the corrosive impact of bribery and corruption for the company concerned and for wider society, as well as procedures which aim to prevent any such activity in compliance with the UK Bribery Act and associated guidance[13].
- Human capital management: Employees are a company's most valuable asset and 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 their human capital.
- Bribery and corruption: We expect companies to have best practice anti-bribery and corruption policies and processes in place and robust compliance mechanisms to enforce them. However, on their own, these are not enough. We expect boards to oversee the bribery and corruption controls and – as importantly – to set the tone from the top, as well as to outline the highest ethical standards and expectations and the values of the organisation. This is to ensure that the culture does not allow corruption to thrive and has the necessary organisational measures in place to provide the best possible defence against corruption. We seek to enter dialogue where we judge the culture and values of a company to be lacking or the effective oversight and management of or reporting on bribery and corruption, company values and ethics to be insufficient.

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.
- Disclose the taxes paid by or collected by them in each country.

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 encourage companies to report on how they support the SDGs and encourage them to engage with civil society on how best to respond to them.

Transparency and reporting

We believe that the quality of narrative reporting reflects how well the board thinks about its strategy, has line of sight into operations and 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 and how the company manages and mitigates them.

Effective engagement

We support the UK Stewardship Code, 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 in furtherance of a constructive relationship, rather than a procedure to be followed when things go wrong close to the AGM. It should involve debate between directors and investors on strategy, risk management and other key issues affecting the long-term health of the company and on how a company's specific governance arrangements are tailored to its needs.

[12] https://www.gov.uk/government/collections/modern-slavery
[13] https://www.justice.gov.uk/downloads/legislation/bribery-act-2010-guidance.pdf

HERMES INVESTMENT MANAGEMENT

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, and small and mid cap

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

Multi asset
Multi asset inflation

Stewardship
Active engagement, advocacy, intelligent voting and sustainable development

Offices

London | 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.

Contact information

Hermes EOS

Bruce Duguid +44 (0)20 7680 2110 bruce.duguid@hermes-investment.com

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

EOSxxxx 0002537 Global 01/18