Public Engagement Report

AUTOMATIC FOR THE PEOPLE
How the financial services industry is embracing AI

Q1 2020

Federated Hermes
EOS

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For professional investors only

This report contains a summary of the stewardship activities undertaken by EOS on behalf of its clients. It covers significant themes that have informed some of our intensive engagements with companies in Q1 2020. The report also provides information on voting recommendations and the steps we have taken to promote global best practices, improvements in public policy and collaborative work with other long-term investors and their representatives.

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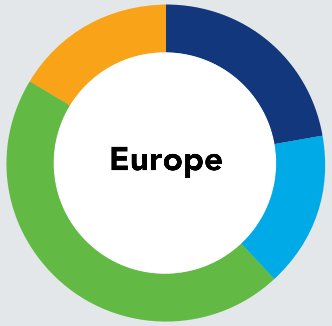
This report has been written and edited by Claire Milhench, Communications & Content Manager, EOS

Engagement by region

Over the last quarter we engaged with 471 companies on 1,221 environmental, social, governance and business strategy issues and objectives. Our holistic approach to engagement means that we typically engage with companies on more than one topic simultaneously.

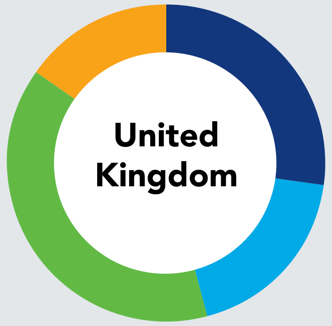
We engaged with 471 companies over the last quarter.

- Environmental **30.2%**
- Social and Ethical **17.5%**
- Governance **33.3%**
- Strategy, Risk and Communication **18.9%**



We engaged with 114 companies over the last quarter.

- Environmental **22.3%**
- Social and Ethical **15.9%**
- Governance **45.6%**
- Strategy, Risk and Communication **16.3%**



We engaged with 54 companies over the last quarter.

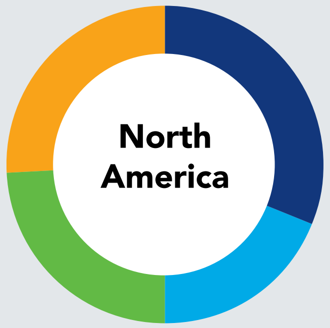
- Environmental **27.4%**
- Social and Ethical **18.5%**
- Governance **39.0%**
- Strategy, Risk and Communication **15.1%**

We engaged with 86 companies over the last quarter.

- Environmental **41.1%**
- Social and Ethical **12.6%**
- Governance **30.3%**
- Strategy, Risk and Communication **16.0%**

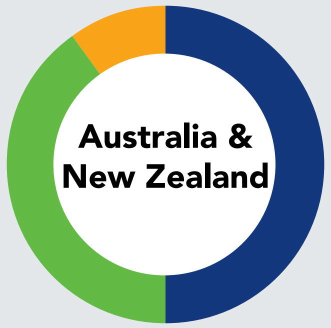
We engaged with 75 companies over the last quarter.

- Environmental **30.8%**
- Social and Ethical **21.7%**
- Governance **32.8%**
- Strategy, Risk and Communication **14.6%**



We engaged with 135 companies over the last quarter.

- Environmental **31.3%**
- Social and Ethical **18.8%**
- Governance **24.2%**
- Strategy, Risk and Communication **25.7%**

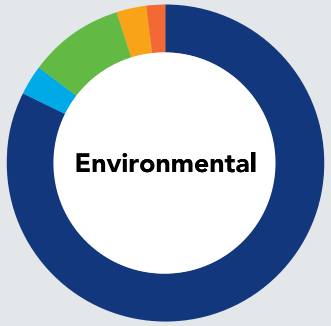


We engaged with 7 companies over the last quarter.

- Environmental **50.0%**
- Governance **40.0%**
- Strategy, Risk and Communication **10.0%**

Engagement by theme

A summary of the 1,221 issues and objectives on which we engaged with companies over the last quarter is shown below.



Environmental topics featured in 30% of our engagements over the last quarter.

- Climate Change **82.4%**
- Forestry and Land Use **3.0%**
- Pollution and Waste Management **9.8%**
- Supply Chain Management **3.0%**
- Water **1.9%**

Social and Ethical topics featured in 18% of our engagements over the last quarter.

- Bribery and Corruption **4.2%**
- Conduct and Culture **17.8%**
- Diversity **17.8%**
- Human Capital Management **20.6%**
- Human Rights **29.9%**
- Labour Rights **7.0%**
- Tax **2.8%**

Governance topics featured in 33% of our engagements over the last quarter.

- Board Diversity, Skills and Experience **26.3%**
- Board Independence **13.5%**
- Executive Remuneration **39.8%**
- Shareholder Protection and Rights **15.2%**
- Succession Planning **5.2%**

Strategy, Risk and Communication topics featured in 19% of our engagements over the last quarter.

- Audit and Accounting **5.2%**
- Business Strategy **41.1%**
- Cyber Security **6.1%**
- Integrated Reporting and Other Disclosure **27.7%**
- Risk Management **19.9%**

The chatbot will see you now

Banks, insurers and asset managers are eager to employ artificial intelligence (AI) to combat fraud, underwrite risk and deal with customers more efficiently through the use of automation or chatbots. But flaws in the data underpinning AI algorithms can lead to unintended bias, regulatory infringements or bad business decisions, exposing companies to financial and reputational risks. By Claire Milhench

Setting the scene

Artificial intelligence (AI) is already widely used in financial services – to generate alpha in asset management, to assess and underwrite risks in insurance, to detect fraud in banking, or to help customers via chatbots and virtual assistants. AI can improve efficiency and productivity through automation, reduce human error, and identify anomalies or longer-term trends that otherwise might be tricky to spot.

However, companies need to be aware of potential pitfalls, such as biases in the input data when profiling customers or credit scoring. Also, overly relying on third-party data could expose a company to risks it has failed to consider and manage, such as privacy breaches.

This article draws on our December 2019 white paper: *Artificial Intelligence Applications in Financial Services*, written in conjunction with Oliver Wyman, Marsh and Bryan Cave Leighton Paisner LLP[1].

This topic was a new engagement theme for us in 2019, and one on which we are engaging more actively in 2020.

In 2018, the UK's Financial Conduct Authority (FCA) levied one of its largest fines for a failure in an outsourcing relationship. Liberty Mutual Insurance Europe was fined £5.28m for its poor oversight of a third party that processed mobile phone insurance claims and handled complaints. The FCA said some customers had been unfairly denied cover for claims for loss or theft, or claims were not investigated adequately, due to an over-reliance on voice analytics software.[2]

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[1] https://www.hermes-investment.com/ukw/insight/strategy/ai-applications-financial-services/
[2] https://www.fca.org.uk/publication/final-notices/liberty-mutual-insurance-europe-se-2018.pdf

The case neatly underscores the dilemma for many financial services companies, which may lack the expertise to develop their own AI software and processes, or even the knowledge and understanding to carry out effective oversight of third parties. Without sufficient due diligence and/or back testing, companies may run the risk of fines, consumer backlashes, or bad business decisions, leading to higher-than-anticipated financial losses.

Regulators and policymakers around the globe are now calling for the ethical and responsible use of AI. In early 2020, the World Economic Forum released an AI oversight toolkit for boards of directors, offering guidance on how AI may impact a company's brand, operations and competitive strategy, among other elements. Singapore has also published a model AI governance framework for broader consultation, adoption and feedback.

Key risks and concerns

A debate around the implications of using data in financial services has resurfaced in recent years due to breakthroughs in "Big Data" analysis and related scandals in the tech sector. For insurers and banks, there are worries about the appropriateness of using Big Data in customer profiling and credit scoring. One of the concerns is that this could be discriminatory and breach an individual's right to privacy.

The EU's General Data Protection Regulation (GDPR) gives EU citizens a number of rights, among them the right to restrict the processing of their data, and the right to restrict profiling. However, it is unclear how easily individuals can opt out of the sharing of their data for customer profiling, and if opting out will impact their credit scoring, meaning they pay more for insurance or loans.

Also, because technology evolves rapidly and regulation moves slowly, companies should be prepared to demonstrate leadership by developing their own ethical AI policies and processes. This will build brand loyalty and makes business sense. If an insurer is able to detect and manage out unintended bias in an underwriting algorithm, for example, or if a bank can reduce the number of false positives in its AI anti-money laundering software, it can free up resources and build a better book of business.

Below, we look at the key challenges within each segment.

Asset management

Asset managers may use AI algorithms to generate alpha, improve operational efficiency and manage risk. But the suitability of Big Data and AI for alpha generation will vary according to the investment style and process. A sophisticated AI algorithm may be able to cut through the information overload that portfolio managers experience on a daily basis from trading screens, social media and research notes. Algorithms may be able to identify patterns or trends in all this white noise, helping fund managers sort the wheat from the chaff.

But what happens if the role of the AI algorithm moves from supporting decisions to decision-making itself? One client sued his wealth manager after a "supercomputer" named K1 lost over $20 million in a single day. The client alleged that the wealth manager had misrepresented K1's abilities[3,4]. The wealth manager sued for unpaid fees. The legal battle is the first known example of a court case over financial losses caused by an AI-driven trading system.

Yet AI can play a valuable role for long-term investors by helping to enhance their understanding of companies, which is an important part of their stewardship activities. For example, an increasing number of third-party providers are using AI to assess companies' exposure to ESG risks such as water stress. AI can be used to collect data and generate undisclosed or unmeasured data.

Sample questions boards should ask about AI in investment analysis

- Could the use of a large amount of momentum-driven corporate ESG news push a value-driven investment manager to adopt more of an event-driven style, without them intending to?
- Are there published and peer-reviewed papers on the methodology of the AI systems you use?
- How often do you change your data universe? What would trigger a review?
- Do you test the consistency of outputs? If so, how often?
- How does the company ensure that senior executives have sufficient technical ability and skills to understand the implications of AI deployment in investment analysis?

[3] https://www.bloomberg.com/news/articles/2019-05-06/who-to-sue-when-a-robot-loses-your-fortune
[4] http://disputeresolutionblog.practicallaw.com/ai-powered-investments-who-if-anyone-is-liable-when-it-goes-wrong-tyndaris-v-vwm/

Banking

Banking fraud is a growth industry. In the financial year 2018-2019, over 12,000 complaints about financial fraud were logged with the UK Financial Ombudsman Service, up 40% on the previous year. Fraudsters are becoming increasingly sophisticated, using spoof emails from real solicitors to extract large money transfers from people buying property, for example. The losses for individuals in so-called "push payment fraud" run into the tens of thousands of pounds in the UK alone.

Until relatively recently, UK banks could refuse to compensate defrauded customers, blaming them for the loss. However, most UK banks have now signed up to a voluntary industry code to compensate victims, with policymakers calling for this to be made compulsory.[5] Consequently, banks need to tighten up their fraud detection.

Traditional methods of fraud and money-laundering identification capture only a small percentage of cases and produce a high percentage of false positives. Banks invest time and resources in investigating what may turn out to be dead ends. AI is seen as a way to improve predictions and reduce false alarms, as it can analyse millions of data points to detect fraudulent transactions that might otherwise go unnoticed.

For example, in recent years, global bank HSBC has been investing in AI and machine learning solutions to enable it to analyse data at high speeds and with greater sophistication. The goal is to create value for its customers (for example, by helping to identify potential service issues), make banking safer, and detect and prevent financial crime.[6] However, there is a need for robust ethical frameworks to guide decision-making as AI technologies evolve.

Sample questions boards should ask to decide whether to employ AI in banking

On fraud and money laundering:

- How does the bank tackle false positives and false negatives in fraud protection?
- Where does the bank source biometric data? Are its processes for handling biometric data adequate?

On credit underwriting:

- How does the bank source or collect data?
- What due diligence process has the bank put in place to evaluate third-party data providers?
- Are there potential biases that require human intervention? What could be done to remove or reduce biases?
- Who is legally responsible in the case of bias?

On chatbots:

- What is the level of functionality of the chatbot? Does it make financial promotions or provide investment advice?
- How can the chatbot represent brand and value?

We wrote to HSBC's chair in early February seeking the board's insights on the responsible use of AI across seven key areas. That same month, HSBC published its principles for the ethical use of Big Data and AI, having worked on these for some time. These cover privacy, legitimate purpose, and unfair bias and decision-making, among other elements. Also, in a response to our letter to the chair, HSBC acknowledged the potential ethical risks in the use of AI and the need for a robust framework.

CASE STUDY

Ping An Insurance Group Co of China

In early 2019, we presented to Ping An's chief innovation officer and chief strategist at the insurer's Shenzhen headquarters on the need for responsible AI practices that met investors' expectations.

In August 2019 Ping An became one of the first major financial institutions globally to publish a set of AI ethical principles. The document explained six key ethical issues of AI specific to the company's businesses, and the five key principles that guide AI applications. Ping An has referred to the Trustworthy AI Guidelines published by the European Commission, which we had previously shared, and other relevant documents from Japan, industry associations and peers. We subsequently provided four pages of detailed feedback on its principles.

Ping An's co-CEO also highlighted the positive impacts of its AI applications and the company's emphasis on information security and AI governance in its interim results announcement. Although an AI governance framework is in place with the sponsorship of the co-CEO, plus members of the management committee and research committee, we have recommended that the company considers appropriate board level oversight.

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[5] https://www.moneysavingexpert.com/news/2020/02/funding-to-refund-money-transfer-scam-victims-extended-to-the-en/
[6] https://www.ft.com/content/b9d7daa6-3983-11e8-8b98-2f31af407cc8

Banks may also use AI to assess credit risk and manage their loan books, improving productivity by automating some of the process and potentially enhancing risk control. But banks need to be careful there is no unintended or hidden bias in the software, due to biases in the underlying data, as this could lay them open to charges of discrimination and expose them to unmanaged risk.

AI can also help with intraday cash management – so banks have enough liquidity to meet daily withdrawals – or be used to serve customers better. For example, Wells Fargo offers users of its mobile banking app a predictive analytics tool that will provide customers with money-saving recommendations and an analysis of their spending habits.

Insurance

The insurance industry is using AI to identify fraudulent claims, handle retail sales and queries via chatbots, improve customer profiling, and process data in risk-rating models to help underwriters make decisions. The quality of this data is key – if it is corrupted or biased, it can lead to regulatory fines or financial losses. For example, insurers may use visual recognition software to identify cracks in buildings, but the AI may not be 100% accurate, so it is important to understand the margin of error and to factor this in when pricing the risk.

Sample questions boards should ask to decide whether to employ AI in insurance

- Does Big Data analysis for sales and pricing create the risk of an uninsured or uninsurable class of buyer? If so, what might be the reputational and regulatory response?
- Is the data set accurate and held securely? Is it being managed properly? Has the potential for bias in the data or the algorithms been fully understood, managed, and protected against?
- When using third-party providers, is the liability clearly understood, defined, and managed?

Traditional methods of fraud and money-laundering identification capture only a small percentage of cases and produce a high percentage of false positives.

CASE STUDY

The Asian insurer

We are engaging with an Asian insurer, which has launched a chatbot to assist customers with claims and policy premiums.

We have discussed its use of AI and technology, which is focused on areas such as automating operations and going paperless, and using digital technology to facilitate customer interaction.

In January 2020 we wrote a letter to the board chair to open a dialogue on the company's governance of artificial intelligence. In the letter, we introduced our second AI paper targeted at the financial services sector, published in December 2019.

We sought the board's insights in several areas including: the company's AI footprint; the board's oversight of the company's use of AI; the company's AI governance principles (if any) and their implementation; and the company's engagement with policymakers and other relevant stakeholders on AI governance.

In February, we met company representatives to discuss this topic further. We explained the background to our AI letter to the board chair, and highlighted legal cases related to chatbots and virtual assistants. This included Liberty Mutual's fine for its poor oversight of a third-party supplier, whose voice analytics software led to some claims being unfairly declined or not being investigated adequately. This could be relevant for Asian markets, as voice analytics might fail to recognise a local accent. The company was aware of the legal case and appreciated our explanation. It is internally collecting information about its AI footprint and data sources across the group.

Engagements for 2020

In 2020, we have started to engage with senior executives and the boards of key financial services companies globally on this topic. Boards must establish a reliable process with controls in place to meet investor and other stakeholder expectations of trustworthy AI governance, within the broader context of delivering business purpose ethically.

We will benchmark companies' preparedness based on the following:

- A clear action plan for the implementation of the company's policy on data ethics, security, and privacy issues. This should include disclosure of a company's ethical AI principles, informed by EOS's AI principles.
- Board oversight of data ethics, data governance, security and privacy, with access to sufficient, relevant and up-to-date technological expertise.
- Companies' engagement with key stakeholders on this topic.

Miners need to dig deep to allay investor concerns

Following the fatal collapse of Vale's tailings dam at a mine in Brazil in 2019, investors have stepped up their engagement with the mining industry on catastrophic risk management. Engager Andy Jones examines the work that is being done to ensure that lessons are learnt, and the risks associated with such facilities are managed effectively.

Setting the scene

Following the Brumadinho disaster, the Investor Mining and Tailings Safety Initiative was launched, led by the Church of England Pensions Board and the Council of Ethics of the Swedish National Pension (AP) Funds. This has pushed forward several important initiatives, including the development of a new international standard for tailings safety.

It has also co-ordinated a disclosure request to 726 extractive companies seeking greater disclosure on the management of tailings storage facilities. At the time of writing, nearly half had responded, representing over 84% of the total global mining industry market capitalisation[1], providing new transparency on hundreds of tailings storage facilities and the risks they pose.

EOS has actively supported the Initiative, co-signing the disclosure requests to companies and contributing to the discussions to define a new set of principles for all key stakeholders. Following the disaster, we also engaged directly with the companies in our programme with the most significant tailings facilities, to review and understand their oversight and risk management of these. We were pleased to see the efforts made across the industry to better understand the risks posed, and the actions taken to reduce these risks, where necessary.

For example, Arcelor Mittal temporarily evacuated the area around one of its facilities until it was satisfied that the risk was managed to a higher standard. The company has also said it will avoid developing any new wet tailings dams[2], thus removing a significant risk to the business.

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[1] https://www.churchofengland.org/investor-mining-tailings-safety-initiative
[2] https://corporate.arcelormittal.com/media/news-articles/2019-mar-13-ensuring-the-safety-of-our-tailings-storage-facilities

It's now over a year since the collapse of Vale's iron ore tailings dam at Brumadinho, Brazil, which claimed the lives of 270 people. The accident, which followed a similar dam failure at Vale and BHP's joint venture Samarco in 2015, was both a human tragedy and an environmental disaster. As well as the loss of life, local communities lost their homes, their livelihoods and their access to water. In the months since, investors and their representatives have pushed for improvements at Vale and across the extractives sector.

Mining, by its very nature, can have a high impact in terms of the number of human lives lost, and the catastrophic environmental damage that can be caused. This risk can stem from tailings storage facilities or spills, failures in the mine structure, and through the use of heavy machinery and explosives. If there is a serious accident, companies can take a significant financial and reputational hit, with fines, compensation pay outs and an increased cost of capital, as well as lost production.

Our approach to engaging with the sector focuses on the governance, risk framework and controls for environmental and social (E&S) risks. However we also focus on 'softer' elements, such as the underlying corporate culture and the pre-eminence of safety compared with the importance of meeting targets, which can make the difference between suffering a catastrophic event or not.

What are tailings dams?

Tailings storage dams or facilities are large compounds used to store mine waste. This waste often contains toxic substances. With each facility there is a risk of structural failure resulting in the contamination of land and water, plus injury or fatalities to workers or local communities. Factors such as the structural design, the water content, the geology and climate contribute to the level of risk.

Directors should visit a range of operational sites including those in higher-risk locations, during their induction and on a regular basis thereafter.

Governance

We look for a board with sufficient knowledge to oversee and challenge management on E&S risks, and with access to external experts to supplement the board's knowledge where necessary. E&S risks at a mining company should be a full board responsibility, but we do encourage the use of dedicated sustainability committees or their equivalents, to ensure a regular and focused discussion. Given the materiality of the risks to the sector, we believe these should be made up entirely of independent directors.

Directors should visit a range of operational sites including those in higher-risk locations, during their induction and on a regular basis thereafter. Directors should be able to speak directly to the independent reviewers that form part of the company's layers of risk control, and could accompany them on site visits. We engage directly with independent board members, particularly the chair of the board, on how they provide robust oversight of these risks. This interaction provides us with a view of the board's engagement on this topic, the nature of related board discussions, and the level of expertise and understanding at board level.

We read through corporate governance reports in detail, including the board and committee reports, to review the extent to which these risks are included in past actions and the future areas of focus for the board and relevant committees. We also review company policies to ensure they are comprehensive, that they refer to international standards and thoroughly address both risk prevention and incident response. We engage on any gaps and misalignments identified.

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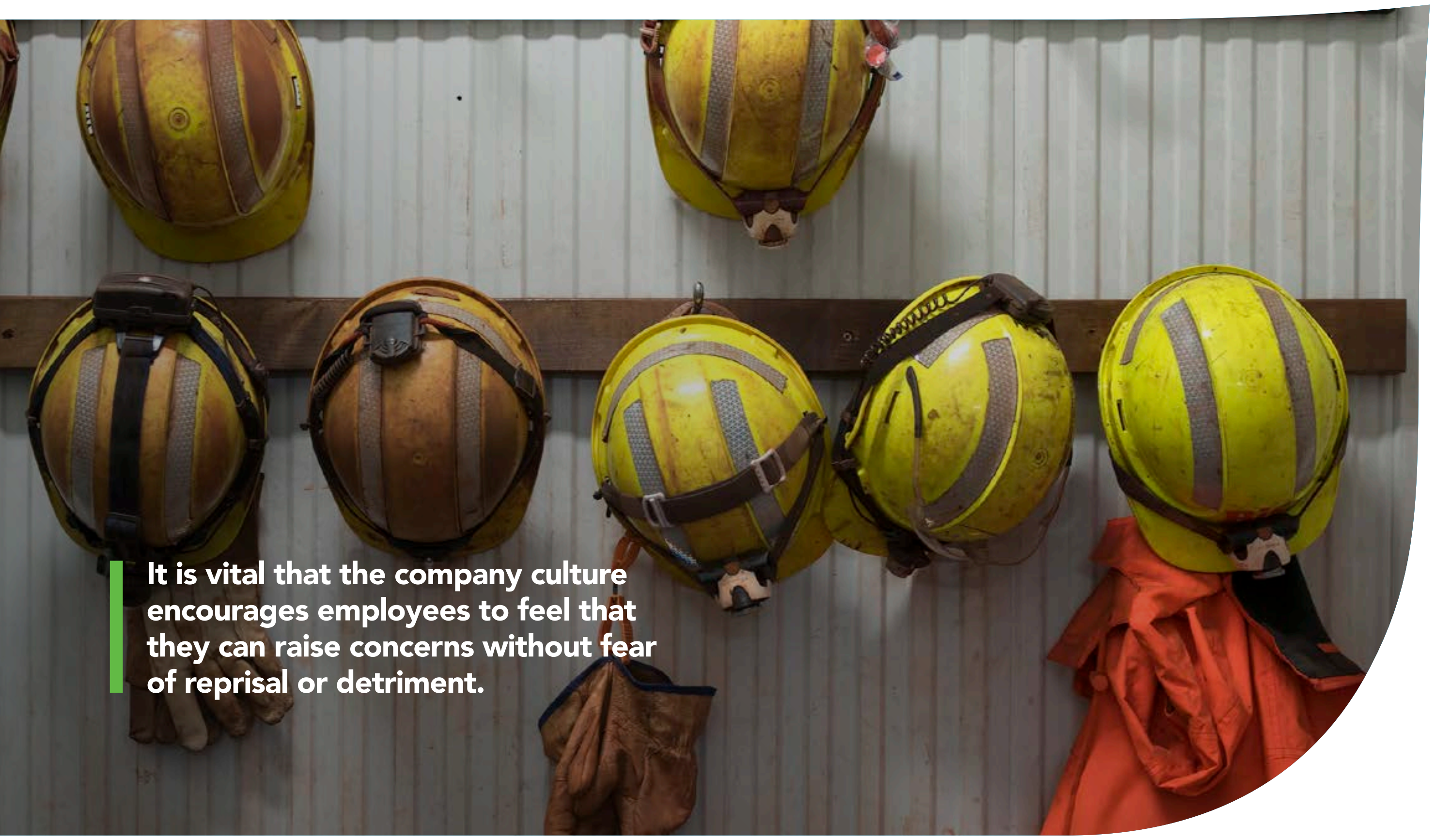
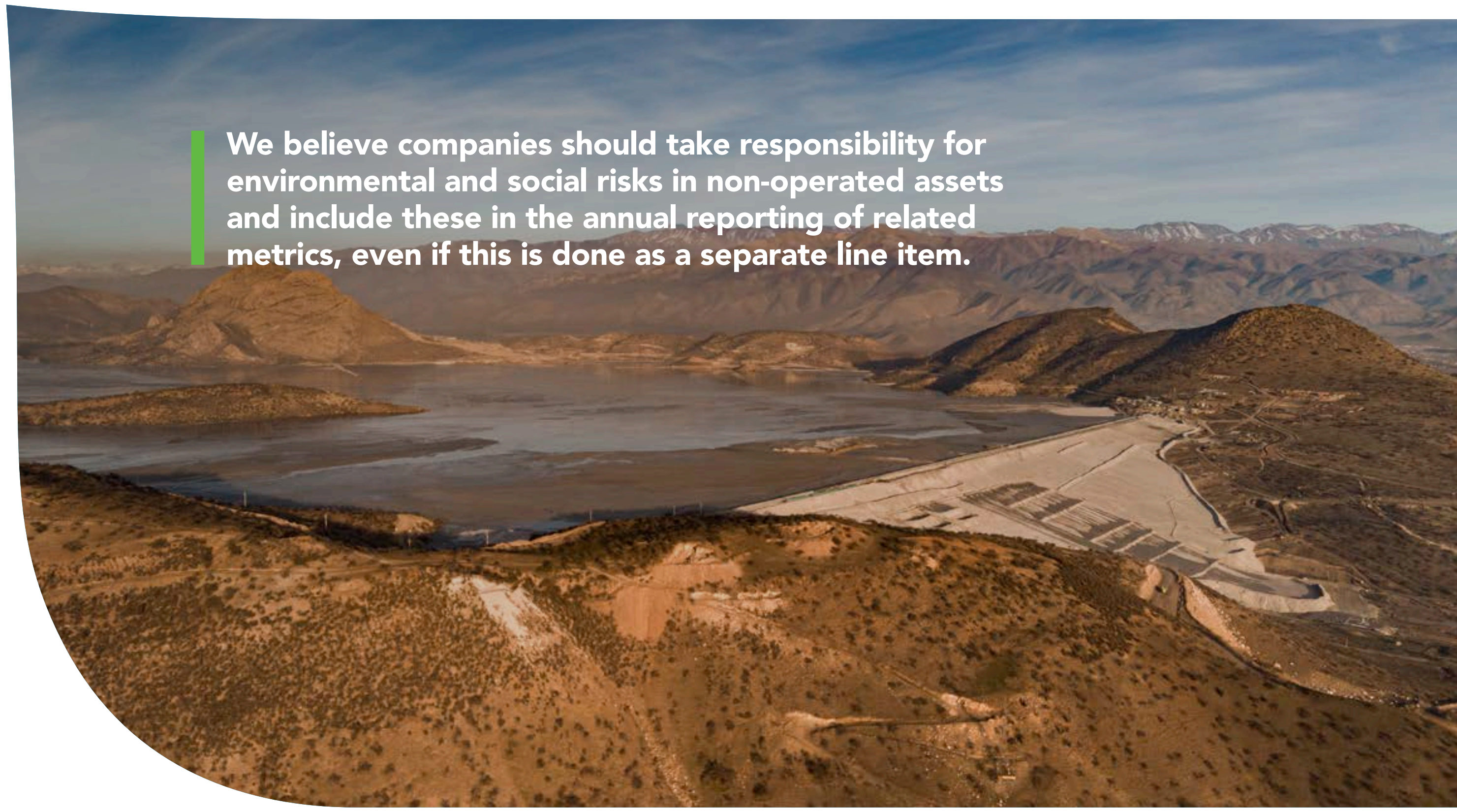
Culture

We also engage on the harder-to-assess area of culture, as this - in particular the failure to implement set policies and procedures - is a common root cause of E&S incidents across all sectors, including mining. We look for a culture of safety first and continuous improvement driven from the top of the organisation. It is vital that the company culture encourages employees to feel that they can raise concerns without fear of reprisal or detriment. We believe the targets set for management play a role in influencing a company's culture and should appropriately balance safety with financial performance. This forms part of our assessment of executive remuneration policies and reports, and related engagements. We also encourage companies to capture, record and investigate 'near miss' incidents.





Risk monitoring and controls

We look for a multi-layered monitoring approach that includes a mix of both human and non-human systems, and the latest technology such as automation, satellite imagery and drones. We expect companies to not only understand the current profiles of risks, but also how these may change over the life of the mine, particularly in terms of its vulnerability to physical climate change impacts.

Critically, we engage with companies to understand the strength of their risk management lines of defence. Typically, we look for three lines of defence on the most significant risks, including an engineer of record, an independent consultant, and an independent review panel. For example, in an engagement with BHP Group we investigated its dam safety governance and its use of Dam Stewardship Boards.

Critically, we engage with companies to understand the strength of their risk management lines of defence.

We also look for regular reviews of a company's compliance with risk management policies and procedures, including compliance with the three lines of defence, and the role of internal audit. We are engaging on the implementation of enhanced environmental and social risk management systems, or specific interventions such as improved procedures or training. We will continue to engage on and push for these enhanced systems until we see sustained reductions in incidents evidenced in annual reporting. In 2020 we wrote to the board of Rio Tinto congratulating the company on achieving its first fatality-free year in its 147-year history[3].

Finally, we look for risk reviews of non-operated joint ventures. Following the failure of a Brazilian tailings dam operated by BHP and Vale's joint venture Samarco in November 2015, BHP Group centralised its oversight of non-operated joint ventures. We sought assurance from the chair that the board was sufficiently engaged with the centralised function and was comfortable with the strength of oversight provided by the new model.

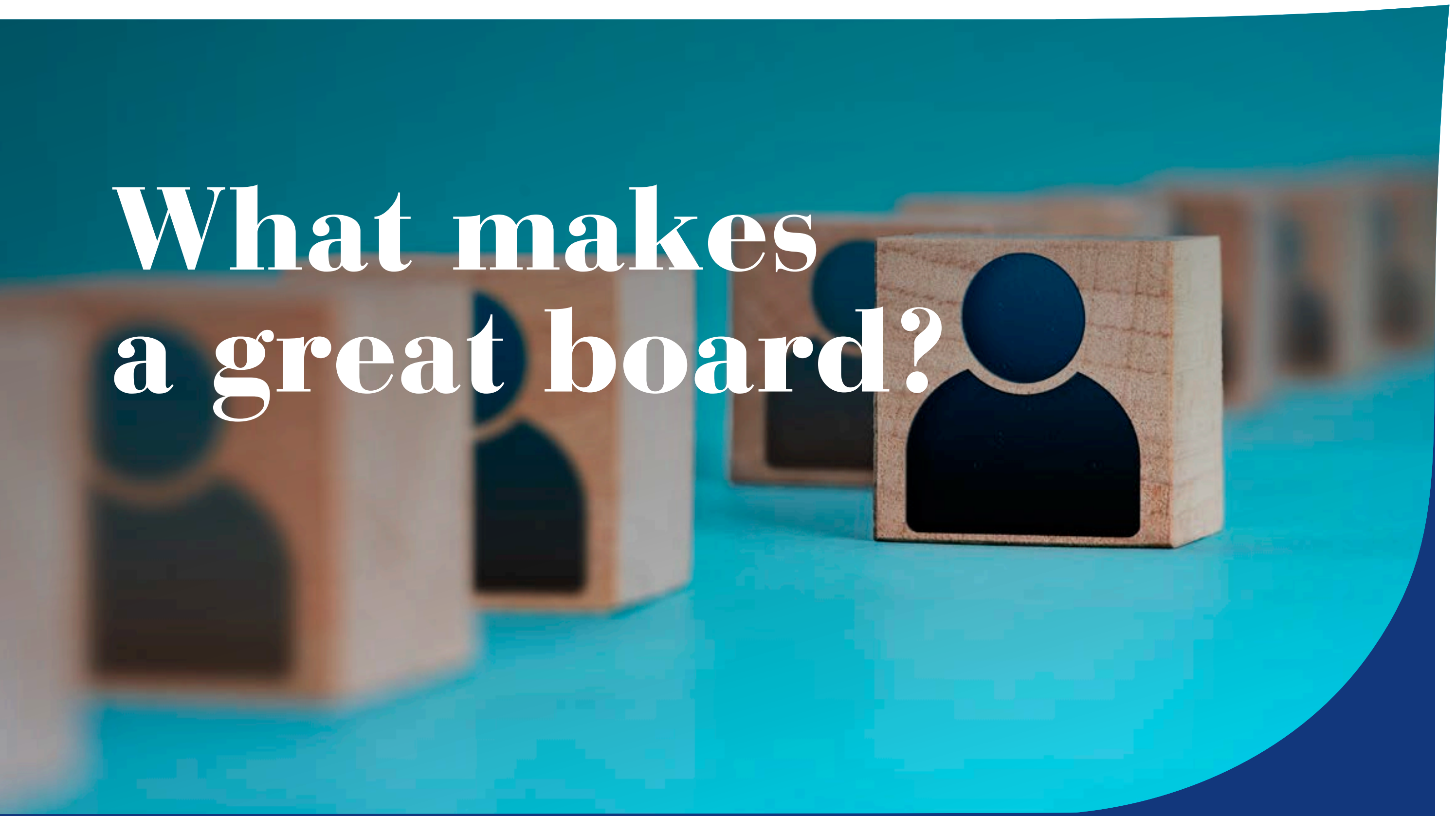
Also, in an engagement with Anglo American we investigated its oversight of non-operated joint ventures, where it uses a three-year rotating review of such facilities. We believe companies should take responsibility for environmental and social risks in non-operated assets and include these in the annual reporting of related metrics, even if this is done as a separate line item. We continue to engage for this across the sector.

Key takeaways

Companies in the mining sector have a long history of environmental and social risk management, and their policies, standards, training and procedures are, in general, well established. It is the 'softer' elements of risk management, that can now make the difference between success and failure. These go beyond the technical standards of procedures, equipment and engineering, and include governance and oversight, a company's culture, and active risk management controls. These can be indicated through corporate reporting and the trajectory of incident data, but it is engagement that can deepen the appraisal of this key aspect of risk management, shedding much needed light on the likely level of incidents going forward.

[3] https://www.riotinto.com/en/news/releases/Annual-Results-2019

What makes a great board?



A well-functioning board helps secure a company's long-term success as material risks and opportunities are more likely to be properly managed. A major crisis, such as the current coronavirus pandemic, underscores the need for an effective and efficient board. But how can investors assess the effectiveness of a board's culture, dynamics and behaviour? Engager Sonya Likhtman explores.

Setting the scene

Company disclosure of board size, age, composition and tenure is improving in some markets, but this provides a limited picture of a board's functionality. Ticking all the "good governance" boxes does not guarantee good governance, as demonstrated by large-scale corporate failures. In our recent white paper, we outlined five principles that we consider to be most important for board effectiveness. Instead of looking at the quantitative characteristics of a board, which are easy to assess, we examined the more intangible qualitative aspects. These areas are best explored through dedicated engagement between investors and board directors.

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A board that works well during "business as usual" is also likely to weather challenging times more successfully. The coronavirus pandemic is currently testing companies and supply chains around the globe, putting some under extreme pressure. Boards should be ready to take a proactive role in crisis management, ensuring that companies keep in touch with key stakeholders, prioritise human capital management to support their employees, and document learnings to enhance future crisis resilience. In effective boards, social and environmental risks are generally better managed, contributing to strengthened company performance in the long term.

However, it is difficult to assess how well a board is functioning from the outside. Governance metrics and company disclosures say very little about the qualitative aspects of board effectiveness. Board culture, dynamics and behaviours are critical, but difficult to quantify and less well understood. These softer aspects of board effectiveness are best assessed through engagement between investors and board directors.

> **Metrics such as a director's age, tenure and number of board meetings attended per year do not necessarily inform how well a board functions.**

Assessing board effectiveness

In many markets, boards are expected to disclose how often directors attend meetings, their skills and their compensation. But assessing board effectiveness remains difficult. Metrics such as a director's age, tenure and number of board meetings attended per year do not necessarily inform how well a board functions. Even disclosure of diversity and independence does not guarantee that the directors in these categories will bring a diversity of thought or a level of independent thinking to the board. In some cases, there is a tendency for boards to "tick boxes" when it comes to governance, rather than appoint directors who will lead to improved board effectiveness. Overall, the governance metrics that are available in public disclosures provide a limited picture.

The answer is not more disclosure. The answer is dedicated engagement between investors and board directors. Shareholders elect directors and can expect to have an opportunity to meet them to discuss a company's performance, challenges and other strategic matters. Engagement offers a way for individual directors and the board to remain accountable to shareholders. When based on trust, engagement enables a deeper dive into board dynamics and culture.

Below, we outline five principles that we consider to be important for board effectiveness, all of which we seek to discuss with directors during engagements

Five principles for board effectiveness

Principle 1: Genuine independence, diversity and inclusion

Being labelled as an independent director does not necessarily mean that an individual has the psychological capabilities, emotional intelligence and experience to conduct their role effectively. We expect independent directors to raise difficult questions, challenge long-held assumptions and actively mitigate the risk of groupthink. Boards function best when composed of a strong core of independent directors, preferably led by a senior independent director.

The rationale for having a diverse group of directors on a board is to improve idea generation, debate and decision-making. Numerous studies have shown the positive correlation between diversity on a board and company performance. Like independence, it is not enough to tick the diversity box. Rather, diversity of thought must be encouraged by the chair and accompanied by a strong culture of inclusion.

A board's skillset must also be diverse. It should reflect the company's strategic priorities, which are likely to change over time. What's more, we expect directors to take personal responsibility for continuous learning and development.

> **We expect independent directors to raise difficult questions, challenge long-held assumptions and actively mitigate the risk of groupthink.**

Differences in board structures

There are regional and company-specific differences in board structures and ownership structures. Widely-dispersed ownership and concentrated ownership, whether through control by the founder, family, government, or corporation, offer different opportunities for boards and their approach to governance. The application of these five principles may differ for each company, but we believe that the principles themselves hold true for a well-functioning board regardless of the context.

CASE STUDY

Novartis: Board diversity and board evaluation

We have engaged with Novartis at the board and executive level over several years and many of our conversations have focused on board effectiveness. In October 2019, we reiterated the concerns that we had raised in previous years about the insufficient number of women on the board. We also shared our expectations regarding the disclosure for board evaluations, which did not exist at Novartis.

We spoke at the AGM in 2020, asking the board to start planning for a rotation of the audit firm. During the speech, we welcomed the January 2020 commitment to increase board gender diversity and the additional information provided in the annual report about the board self-evaluation. The reporting now features a description of the self-evaluation process and some identified areas for improvement. We look forward to reviewing the outcomes of the external board evaluation, which is planned for 2020.

Pauline Lecoursonnois
Sector lead: Consumer Goods

Principle 2: The role of the chair

The chair plays a unique role on the board, co-ordinating the directors to come to collective decisions. The chair and CEO roles should be separated because of the inherent conflict of interest in combining the roles, and because the role requirements differ substantially. While the CEO leads the company, the chair leads the board. We believe that an independent chair is best placed to create the overall conditions for board effectiveness.

The chair plays a critical role in setting and enforcing the expectations for a board culture that is based on mutual respect, openness and trust. During a crisis, such as the current coronavirus pandemic, the chair plays a crucial role in co-ordinating a strong response from the board. The environment must also allow for disagreement and lively debate amongst board directors. An effective chair is able to give each director an equal voice, drawing out diverse perspectives. Ultimately, we are looking for the chair to facilitate a healthy tension, rather than constant agreement, between board directors.

> **We believe that an independent chair is best placed to create the overall conditions for board effectiveness.**

Principle 3: How the board allocates its time

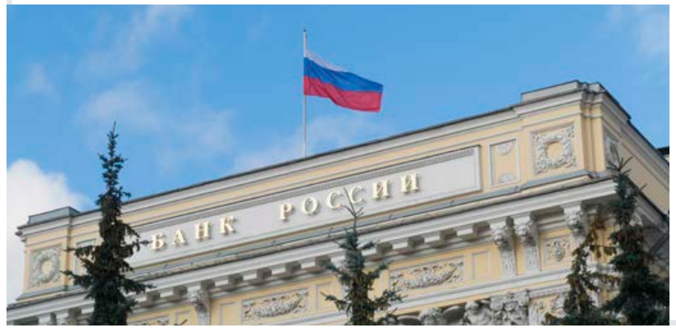
Given the competition for a board's time, a board must establish priorities and stick to them. Effective boards find ways to address matters that are important, though not necessarily urgent. The topics that fall into this category are generally forward-looking, such as human capital management, company culture and succession planning. Developing a company purpose and carefully scrutinising the strategy proposed by management to ensure alignment with this must be a continuous activity. Boards will also have to address urgent issues sometimes, as we are seeing with the coronavirus. However, boards that have spent time addressing forward-looking risks and opportunities are likely to be in a better position to address urgent issues when they arise.

We are also interested in how directors spend their time between board meetings. Committee work is valuable for taking a deeper dive into key strategic issues, so we encourage boards to set up committees according to their needs. Site visits and engagement with stakeholders, including customers, suppliers, and investors, are also important.

CASE STUDY

Board effectiveness at a Russian bank

We have been engaging with this bank on board effectiveness for several years. In a meeting with the senior independent director in 2016, we challenged the company on the role of the independent directors and the diversity of skills on the board. We also questioned the quality of the board evaluation and sought to gain an understanding of the main actions taken as a result of the evaluation findings.



We continued to have in-depth discussions on board effectiveness with different company representatives in regular meetings. Over the years, we have encouraged the board to add climate change to its agenda, emphasising the need for the board to provide a tone from the top on this. In 2019, we met with an independent director and focused on the board dynamics. The director provided helpful details about each aspect of board effectiveness, in a fruitful and informative discussion. We continue to discuss the role of the board in initiating greater action on climate change throughout the company. Recently, we were pleased to hear that climate change and other ESG issues now feature much more regularly in board discussions.

Jaime Gornsztejn
Sector lead: Industrials & Capital Goods

CASE STUDY

An independent chair at a US manufacturer

In our engagement with the company, which has intensified since 2018, we have repeatedly pushed for splitting the CEO and chair roles. We believe the chair should manage the board and the CEO should manage the business.

Combining these functions can confuse these distinct roles and responsibilities, which require different attributes. It also overly concentrates power in one person, creating problems with oversight, accountability and succession. It is especially important to protect the rigour of oversight where product safety is essential.

Our request to the company was that the roles be split by appointing a new board chair or otherwise, at the time of the next CEO change. In a conversation with the general counsel in June 2019, we heard that the board would revisit the question of splitting the CEO and chair roles during its upcoming self-assessment process. We reiterated our concerns in a meeting with the general counsel team in early October. Soon after this meeting, the company decided to split the chair and CEO roles. We welcome this decision but continue to encourage the company to amend its governance guidelines so that an independent chair is an instituted requirement.

> **Our request to the company was that the roles be split by appointing a new board chair or otherwise, at the time of the next CEO change.**

Andy Jones
Team lead: Europe
Sector lead: Mining & Materials

Principle 4: The board's relationship with the CEO

It is difficult to assess how constructive or problematic the relationship between a chair and CEO is, although sometimes engaging with both individuals in the same room can provide some insights. Ideally, the relationship should be transparent and trusting, with clear responsibilities and boundaries between the two roles, and the board actively supporting, challenging, and holding the CEO to account.

> **We recognise that disclosing the findings of a board evaluation is sensitive, especially when it relates to the performance of individual directors.**

Principle 5: Commitment to continuous improvement

Board evaluations can be valuable tools that enable a board to pause, reflect and improve performance. However, they are only effective when board directors are genuinely committed to the process, rather than rushing through evaluations as a compliance exercise. When a board commits to a board evaluation, it sends a clear signal to investors about the board's openness to continuous improvement.

We recognise that disclosing the findings of a board evaluation is sensitive, especially when it relates to the performance of individual directors. However, we expect disclosures to provide reassurance that the board evaluation has been meaningful.

CASE STUDY

Hyundai Motor: Director skills and internal board evaluation

We have been engaging with Hyundai Motor on governance issues since 2008. Given the continuous influence of the founding family, we have focused on ensuring that the board is composed of diverse directors and a wide range of skills to position the board to protect minority shareholder interests.

The company's non-executive directors have traditionally come from academic, legal or accounting backgrounds, so the board could have benefited from more strategic and business skills.

In 2016, we encouraged the board to conduct an external board evaluation to identify potential areas of weakness and ultimately lead to a board refreshment. We proposed an internal evaluation as an interim step, to which the board committed in 2018.

In early 2019, we were pleased to see a team of five external governance specialists review a range of candidates suggested by the board for the role of an independent director responsible for shareholder rights protection. The exercise highlighted several areas of weakness, including international expertise, an understanding of shareholder interests, and knowledge of governance. The subsequent election at the AGM led to a notably improved mix of skills and experience. We continue to press the company to appoint its first female independent director and to conduct an external board evaluation.

Sachi Suzuki
Sector lead: Transportation

Our engagement approach

These five principles are intricately connected. We meet with chairs, independent directors and CEOs to improve our understanding of board dynamics and culture. We challenge companies on how board composition can be improved to enhance the quality of debate and decision-making. We question how boards are spending their valuable time and encourage them to conduct board evaluations.

It is only possible to assess board effectiveness through engagement with directors, and this is a critical way to maintain accountability. The outcomes of discussions about board dynamics, culture and behaviour are more difficult to measure than for some other engagement issues. However, we recognise that asking the right questions and outlining our expectations of board effectiveness are valuable engagements in themselves, even if they are more difficult to track.

Shareholder engagement and its effects on target companies

The award-winning study *ESG shareholder engagement and downside risk*[1], which uses engagement data from EOS at Federated Hermes, reveals that companies that are successfully engaged by EOS exhibit a lower risk profile, particularly when environmental issues are tackled.

Setting the scene

In recent years academic studies have looked at institutional investors engaging with companies through private, behind-the-scenes dialogues and other means.[2] However, scepticism remains amongst practitioners as to the financial benefits that may accrue from dedicating significant resources to stewardship.

A few years ago, EOS at Federated Hermes shared its engagement data with an international team[3] around Professor Andreas Hoepner from University College Dublin. The authors formulated a very simple – in this case paraphrased – research question: What effect do engagements by EOS have on the riskiness of targeted companies? Their findings won the 2019 PRI award for the best research in responsible investment.

Dr Michael Viehs
ESG Integration, Federated Hermes International

Shareholder engagement, when conducted effectively and targeting the most financially material ESG issues to which a company is exposed, should reduce that company's level of risk. Companies with better ESG credentials have on average a lower chance of going bankrupt, more stable cash flows, and are more resilient to external ESG shocks, such as tightened regulation on pollution and climate change[4]. The financial benefits of better ESG practices for bond investors have also been proven.[5]

The approach taken by the academics has similarities with medical research. For example, to test the effectiveness of a new drug, researchers typically investigate two different groups of patients. There is a 'treatment group' of patients, all of whom receive the new drug, and a 'control group' who receive a placebo but are otherwise exposed to the same medical and personal conditions, such as age, weight and so on. In other words, the two groups generally only differ regarding one characteristic – whether they receive the drug or not.

[1] https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2874252

[2] See, for example, McCahery, Sautner and Starks (2016): "Behind the Scenes: The Corporate Governance Preferences of Institutional Investors", Journal of Finance, 71(6), 2905-2932.; Krueger, Sautner and Starks, (2019): "The Importance of Climate Risks for Institutional Investors", ECGI Working Paper; Dimson, Karakas, and Li, (2016): "Active Ownership", The Review of Financial Studies, 28(12), 3255-3268; Becht, Franks and Wagner, (2019), "Corporate Governance Through Voice and Exit", ECGI Working Paper.

[3] The research team also includes: Ioannis Oikonomou (Henley Business School), Zacharias Sautner (Frankfurt School of Finance and Management), Laura Starks (University of Texas at Austin), and Xiao Zhou (University of Oxford).

Putting this example into the context of engagement, the study's authors constructed a treatment group of companies – those that had been targeted by EOS – and a control group – those that had not been targeted by EOS. In all other characteristics, such as size, industry and profitability, the companies in the control group were the same as, or very similar to, those in the treatment group. As in the medical example, there is only one distinguishing feature in the two samples – the presence of EOS's engagement. This allowed the researchers to draw strong conclusions about the effect of engagement by EOS on target companies.

The authors used two measures as proxies for company risk. The first was a risk-weighted probability of a negative stock return occurring on any given day in a given month, and the second was the value at risk (VaR) – that is, the worst daily returns during a given month. As in medical studies, which test the efficacy of drugs pre- and post-treatment, the authors then tested the riskiness of companies pre- and post-engagement.

The results from this exercise showed that the companies targeted by EOS experienced a significant decline in their riskiness after the engagement versus before, all relative to a control group of companies that had not been targeted for engagement.

The more successful engagements often involved an interpersonal communication with a chair or senior executives.

Putting this result into the context of the EOS milestone system, which tracks engagement progress, the authors were able to document that the risk reduction effect from engagement is largest when the engagement is more successful – that is, the engagement stands at milestone 3 or 4 – and when environmental topics are addressed.

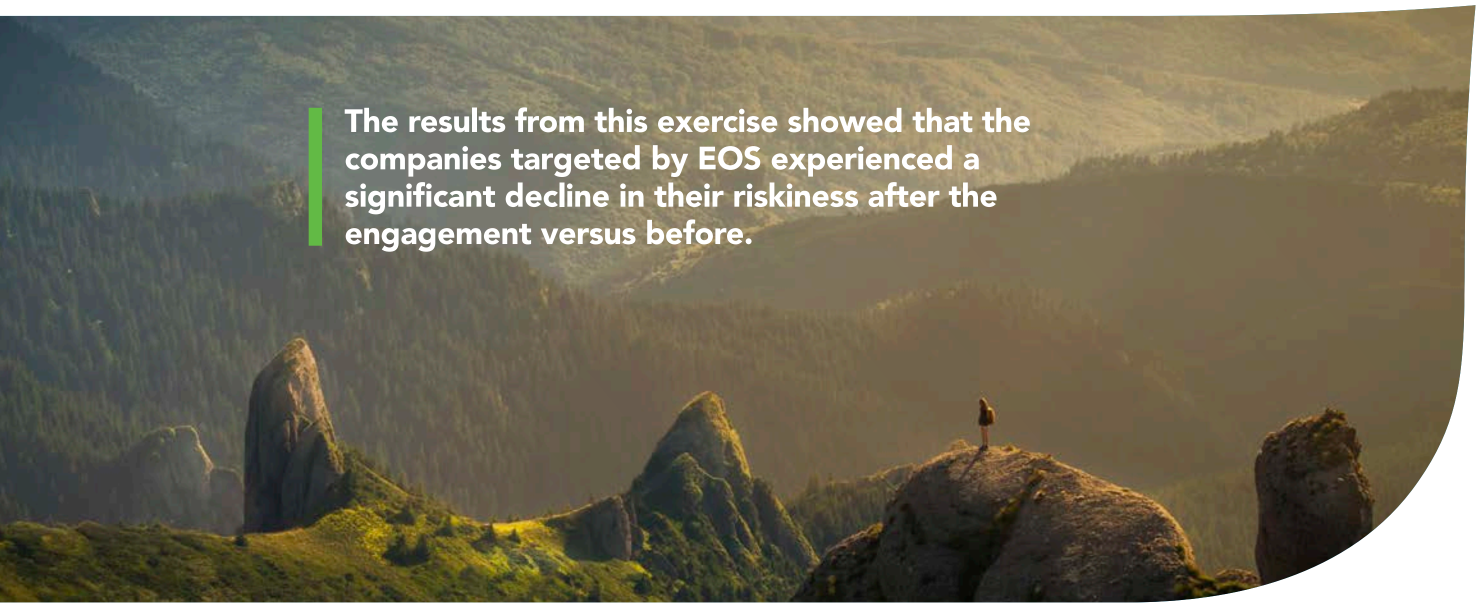
A constructive dialogue requires resources, knowledge, seniority and a multi-skilled team.

The authors of the paper also found that the vast majority of interactions by the EOS team took place in the form of a personal meeting, be it with a company chair, a senior executive or middle management. The more successful engagements often involved an interpersonal communication with a chair or senior executives.

This finding reinforces the conclusions made by the research team around Professor Wolff who documented this relationship in 2017, identifying a link between the engagement success of EOS and interpersonal communication. In the independent study *Talk is not cheap*[6], he and his research team demonstrated that EOS's interaction with chairs and executives was the most important factor when seeking to promote change at companies.

Overall, the research carried out with EOS engagement data provides evidence that stewardship can result in material financial outcomes for companies and their investors. However, it is important to understand that several prerequisites must be met in order to achieve change.

A constructive dialogue with companies at a senior level is most effective in promoting change and financial benefits. Equally important to note is that such a dialogue requires resources, knowledge, seniority, and a multi-skilled team. To promote long-term value, effective stewardship must be more than just a letter-writing exercise.



The results from this exercise showed that the companies targeted by EOS experienced a significant decline in their riskiness after the engagement versus before.

[4] See, for example, Clark, Feiner, and Viehs, (2015): "From the Stockholder to the Stakeholder", Working Paper, as well as Friede, Bassen, and Busch, (2015): "ESG and financial performance: aggregated evidence from more than 2000 empirical studies", Journal of Sustainable Finance and Investment, 5(4), 210-233.

[5] An example in the academic literature serves Chava (2014): "Environmental Externalities and Cost of Capital", Management Science, 60(9), 2111-2380. Further practitioner examples are the research studies by Hermes Investment Management: "Pricing ESG risks in credit markets" and "Pricing ESG risk in sovereign credit" which are available at www.hermes-investment.com.

[6] https://www.hermes-investment.com/ukw/press-centre/stewardship/new-research-shows-importance-board-level-contact-impactful-engagement/

Engagement on strategy

Business strategy and structural governance issues are at the heart of many of our most successful engagements.

Overview

Our approach to engagement is holistic and wide-ranging. Discussions range across many key areas, including business strategy and risk management, which covers environmental, social and ethical risks. Structural governance issues are a priority too. We challenge and support management on the running of the company and management's approach to ensuring the company's long-term future. In many cases, there is minimal external pressure on the business to change. Much of our work, therefore, is focused on encouraging management to make necessary improvements.

The majority of our successes stem from our ability to see things from the perspective of the business with which we are engaging. Presenting environmental, social and governance issues as risks to the company's strategic positioning puts things solidly into context for management. The issues may also present opportunities. For instance, businesses may benefit from fresh thinking at board level. Similarly, a change of chief executive can be the catalyst for enhanced business performance and the creation of long-term value for shareholders.

Examples of recent engagements

Diversity and TCFD disclosure

Lead engager: Diana Glassman

We had a frank discussion in which we stated our dissatisfaction with this US software company's general lack of responsiveness to long-term shareholders. We laid out our expectations for greater access to the company, plus enhanced diversity including UK-style global gender pay gap disclosure, Scope 3 and TCFD scenario planning, and AI leadership. The company acknowledged that its weak board structure, which features a rotating lead independent director, and complex executive compensation structure are unique. Its board is open to simplifying the compensation structure when the current scheme concludes in two and a half years.

The company is in litigation with the US Department of Labor and unlikely to release gender pay gap data but may release more diversity data in future. We encouraged it to consider the reputational risks of dealing with potential business partners and expressed our hope that it would become an AI governance leader. It stated it had brought on a new, non-independent director with AI expertise. The company agreed it needs to do more to help customers reduce emissions. We asked to speak with the heads of diversity and inclusion, sustainability and an independent director.

Remuneration reform

Lead engager: Amy Wilson

We met with the remuneration committee chair to discuss the pay proposals for this global consumer goods company. We expressed a number of concerns, primarily the continued use of options and a variable pay opportunity in excess of our guidelines. The shareholding guidelines are high, which we welcomed, but we pushed for strengthened post-cessation guidelines. We also challenged the actions taken on alignment of executive pensions, stressing that we expect to see a commitment to align incumbent directors as soon as possible and no later than 2023. We contributed our views on improvements to malus and clawback provisions and discussed which ESG metrics the company may include in its schemes. It is considering this in parallel with the development of its 2030 sustainability strategy. We will continue our engagement with the executive responsible for sustainability to discuss this plan and, specifically, regenerative agriculture and biodiversity.

Product governance and drug pricing

Lead engager: Katie Frame

During a call with this US retailer we asked how it is taking the lessons it has learned from opioids and applying them holistically to its approach to product governance. We particularly raised this in relation to the responsible sale of antibiotics. The company compared its approach to opioids with tobacco, but it was unable to answer specific questions about antibiotics and anti-microbial resistance, which we will follow up on. When we questioned the company's long-term view on its exposure to US healthcare reform, it appeared confident that it could pivot to different contracting models for its business, and that it would improve transparency on drug pricing if legislation required it to do so. We encouraged it to continue to improve pricing transparency regardless of legislation, given the significant social and reputational impact it could have. We also urged it to improve disclosure around service fees, and to support consumer education on using health savings accounts.

We will continue our engagement with the executive responsible for sustainability to discuss this plan and, specifically, regenerative agriculture and biodiversity.

Whilst the company was confident it had already established its business purpose and was living by this, we said this could be better articulated in a standalone document, owned by the board. We agreed to follow up by sharing further guidance on this and asked for a meeting with the CEO or a board director to discuss it.

We pressed the company to keep a lead independent director especially if the current chair/CEO becomes chair for a transition period.

Separation of chair and CEO roles

Lead engager: Claire Gavini

In a call with the general counsel and head of legal of this European construction company, we engaged on governance matters ahead of the annual general meeting. We were pleased by the overall increase in the level of disclosure, especially on the results of the external board evaluation, for which we had pushed. While the changes on the board will be minimal this year, several mandates will end in 2022 including that of the chair/CEO. We asked about succession planning and pushed for a separation of the roles when the chair/CEO retires, most likely at the end of his mandate. We also explained that we do not support the former chair/CEO becoming chair, unless this is for a set period of time. We pressed the company to keep a lead independent director especially if the current chair/CEO becomes chair for a transition period. We also pushed for ending the split between vice-chair and lead independent director, which in our view undermines the lead independent director role.

We were pleased to see the first woman appointed to the executive committee earlier this year, and pressed for further gender balance. On remuneration, we pushed for enhanced disclosure of the underlying metrics of the qualitative part of the bonus and challenged the use of the CDP score in the long-term incentive plan, which in our view could be completed by an internal climate target.

Gender diversity and employee safety

Lead engager: Lisa Lange

In a call with this European beverages company, we asked for an update on the evolving Covid-19 pandemic. The company said it was prioritising the safety of its employees and had formed a crisis committee when the outbreak started to co-ordinate its response.

We praised the improved level of gender diversity on the board and in the executive team and asked how the company was working towards better gender diversity throughout the organisation. The company said the CEO had stressed that diversity was a key focus. It has launched a global diversity and inclusion policy, and implemented company-wide unconscious bias training. It uses algorithms to check annual performance reviews against bias and has launched a four-month global parental leave benefit.

We raised concerns about the level of independence on the board. The company will send us information on which directors it considers to be independent.

The company provided us with an in-depth update on the 2025 sustainability goals it launched in 2018, focused on smart agriculture, water stewardship, circular packaging and climate action. Overall, we commended the company for focusing on issues material to its operations and taking an impact-oriented approach. The company is working on impact metrics to track performance over time and we encouraged this.

The company said the CEO had stressed that diversity was a key focus. It has launched a global diversity and inclusion policy, and implemented company-wide unconscious bias training.

CASE STUDY

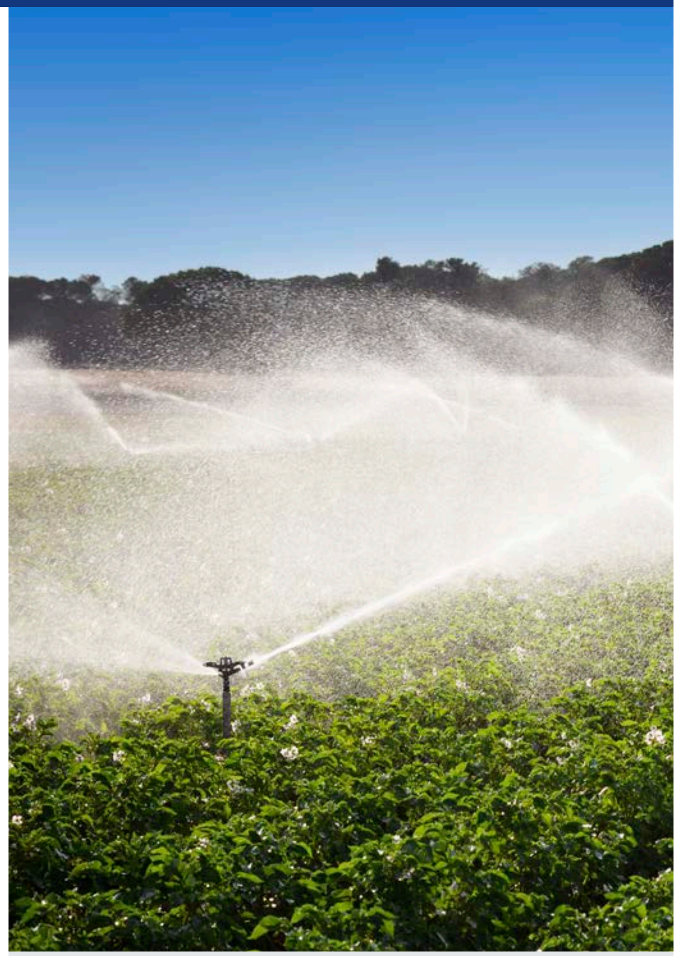
Imperial Brands: Implementing water management systems

In 2012, we began engaging with Imperial Brands, the multinational tobacco and tobacco alternatives company, on its use of water. We encouraged the company to implement water management systems and targets at its sites.

In 2015 our engagement established that although the company had conducted an analysis of water risks in its supply chain, it had not set targets for water management beyond its own operations. Over subsequent years, we sought regular updates from the heads of sustainability on how the company was monitoring water use and progress against site-specific reduction targets. These were achieved in 2018, ahead of the 2020 target year. Given the early completion, we pressed the company on whether the 2020 targets had been sufficiently stretching. It confirmed there were opportunities to set more stretching targets in certain areas of the business.

In a meeting with the head of sustainability in 2019, we heard that the company intended to develop context-based water targets for water-stressed sites in its supply chain. We welcomed the company's move to take greater responsibility for its supply chain, which is also reflected in its approach to carbon, where it has extended its science-based carbon reduction targets to its Scope 1, 2 and 3 emissions.

We will continue our engagement on how the company adopts a robust approach to water stewardship across its supply chain.



Read our engagement case study in full at
https://www.hermes-investment.com/ukw/eos-insight/eos/imperial-brands-case-study/

Amy Wilson
Sector lead: Retail

BLOG SPOTLIGHT

The coronavirus and crisis management

In our latest EOS Insights posts, we looked at the coronavirus pandemic from a crisis management perspective, and what it means for supply chain risk and employees.

Public health crises can be exceptionally fast-moving, and their severity is unpredictable. How can companies mitigate the worst impacts?

First, we recommend that board members take a proactive role in crisis management. A good crisis response should swiftly address what has gone wrong and what management can do about it, while learning lessons for the future. It is also about communication and engagement - with customers, suppliers, staff, regulators and the public using social media and other communication methods.

The board should also have an alert system in place to identify when crisis management should take effect, at which point the company should follow its established Business Continuity Plan (BCP). This may need to be updated with regard to public health scenarios, taking into consideration global supply chains, international operations with staff travelling worldwide, and customer needs in time of crisis.

Amidst the coronavirus outbreak, prices of some healthcare products have rocketed, prompting questions about business ethics. With this in mind, we also highlight the importance of companies issuing a statement of business purpose to ensure better, more transparent and more socially responsible corporate governance.

Two of the areas likely to be most impacted by the virus are supply chains and employees. We recommend that companies improve global supply chain risk management by conducting an impact assessment. For example, steel production and logistics challenges persist after extended travel restrictions were implemented in Wuhan, the epicentre of the coronavirus outbreak in China. This could impact leading car manufacturers around the globe, as well as auto parts suppliers and consumer electronics.

It is also vital that businesses look beyond physical assets to support their workforce. Companies that have already implemented best practice flexible or agile working arrangements may find that the impact of the coronavirus on productivity is reduced. Employees who are already familiar with working from home will be better adapted to getting on with their roles. However, there needs to be a commitment from individuals and teams to maintain productivity levels and standards, regardless of working arrangements.

We hope that by being open and transparent about addressing a public health crisis through the lens of ESG, we can support companies in being better prepared to create long-term value for all stakeholders.

Read our EOS Insights posts in full at

https://www.hermes-investment.com/ukw/eos-insight/eos/the-coronavirus-and-crisis-management/

https://www.hermes-investment.com/ukw/eos-insight/eos/supply-chain-risk-employees-and-the-coronavirus/

Companies engaged on strategic and/or governance objectives and issues this quarter:

Global	353
United Kingdom	49
North America	97
Developed Asia	58
Emerging Markets	50
Europe	94
Australia and New Zealand	5

CASE STUDY

Target setting to reduce carbon emissions

Since 2010, EOS has been engaging with Centrica, a UK-based provider of energy to households and businesses, on its response to climate change.

We stepped up our engagement in 2016 when we spoke at Centrica's annual shareholder meeting. We asked the company to set ambitious carbon reduction targets for customer emissions and seek to regain its coveted 'A' grade under the CDP rating system.

After the 2016 shareholder meeting, we met the group head of environment, head of corporate affairs and company secretary to discuss the development of a published target for the reduction of emissions associated with Centrica's customers, as well as improved reporting. We would go on to request further action and disclosure on climate change at the company's 2017, 2018 and 2019 shareholder meetings.

In 2018, EOS was appointed lead co-ordinator of investors for Centrica as part of the Climate Action 100+ collaborative engagement initiative. We co-ordinated a meeting between investor representatives and the company's CEO and other executives in Q3 2018. At this

In 2018, EOS was appointed lead co-ordinator of investors for Centrica as part of the Climate Action 100+ collaborative engagement initiative.

we requested that the company raise its ambition to set a pathway to decarbonise its business in line with the goals of the Paris Agreement, and also report on the resilience of the company to low-carbon scenarios in line with the guidelines of the Task Force on Climate-related Financial Disclosures (TCFD).

In its 2018 Annual Report, the company confirmed its commitment to report in increasing alignment with the TCFD guidelines. In January 2019 the company gained an A grade in the CDP ranking and a Level 4 rating under the Transition Pathway Initiative. In April 2019 it published its 2030 Responsible Business Ambitions, which included a target to enable the reduction of its customers' emissions by 25% below 2015 levels for the first time. In July 2019 the company explicitly integrated the low-carbon transition into its corporate purpose.

We continue to engage with the company on achieving net-zero emissions, in line with the goals of the Paris Agreement, as well as the role Centrica can play in the transition.

Read our engagement case studies in full at

https://www.hermes-investment.com/ukw/eos-insight/eos/centrica/

Andy Jones
Team lead: Europe
Sector lead: Mining & Materials

Public policy and best practice

EOS contributes to the development of policy and best practice on corporate governance, sustainability and shareholder rights to protect and enhance the value of its clients' investments over the long term.

Overview

We participate in debates on public policy matters to protect and enhance value for our clients by improving shareholder rights and boosting protection for minority shareholders.

This work extends across company law, which in many markets sets a basic foundation for shareholder rights; securities laws, which frame the operation of the markets and ensure that value creation is reflected for shareholders; and codes of best practice for governance and the management of key risks, as well as disclosure.

In addition to this work on a country specific basis, we address regulations with a global remit. Investment institutions are typically absent from public policy debates, even though they can have a profound impact on shareholder value. EOS seeks to fill this gap.

By playing a full role in shaping these standards, we can ensure that they work in the interests of shareholders instead of being moulded to the narrow interests of other market participants, which may differ markedly – particularly those of companies, lawyers and accounting firms, which tend to be more active than investors in these debates.

FAIRR sustainable proteins letter

Lead engager: Marija Rompani

In collaboration with investors and the Farm Animal Investment Risk and Return (FAIRR) Initiative, we signed a letter to 25 companies in the restaurant and food sector calling on them to demonstrate a comprehensive approach to protein diversification. The Intergovernmental Panel on Climate Change's August 2019 report, *Climate Change and Land*, stated that current land use and global food systems are exacerbating climate change, land degradation, biodiversity loss and other environmental threats.

> **We are encouraging companies to take a proactive approach to addressing the impacts of their animal protein sourcing.**

It is crucial for companies to adopt a comprehensive global evidence-based approach to diversifying protein offerings to mitigate supply chain risks and capitalise on opportunities. We are encouraging companies to take a proactive approach to addressing the impacts of their animal protein sourcing, and to clearly articulate their strategy to expand their offering of plant-based food and alternative proteins. We are asking companies to disclose information on their intentions to transition their protein portfolios in line with climate science and the answers will be used to assess their progress against FAIRR's evaluation framework.

Consultation response on Japan's Stewardship Code

Lead engager: Sachi Suzuki

We responded to a public consultation on the proposed revisions to Japan's Stewardship Code. We largely welcomed the proposals, particularly the additional note on the consideration of sustainability and ESG issues and the inclusion of asset classes other than equities, but highlighted some concerns. We suggested extending the application of the code to companies that invest in others through strategic or cross-shareholdings. We also raised concerns about the idea that investors should consider sustainability 'corresponding to their investment management'. The problem is that this may be interpreted as investors not needing to consider sustainability if it does not correspond to their investment strategies.

We also said the requirement for proxy advisers to have a business establishment in Japan seemed overly prescriptive and potentially demanding. While welcoming the use of the word 'collaborative' in place of 'collective' engagement, we expressed our disappointment that there was no stronger encouragement for collaborative engagement. Given the level of anxiety among investors about working collaboratively due to the 5% rule, we asked for more explicit encouragement.

> **We shared examples of how we leverage national policies when engaging with companies on their strategy alignment and implementation.**

Department for Business, Energy and Industrial Strategy (BEIS) meeting on UK heat decarbonisation

Lead engager: Andy Jones

We met with the heat decarbonisation team of the UK government's BEIS, along with other UK utility Climate Action 100+ (CA100+) participants. The UK's heat decarbonisation roadmap will be published this summer. It will set out the key questions that need to be answered and how this will be done, with the aim of getting the necessary policy in place by the mid-2020s. We agreed to hold a set of meetings to create greater dialogue between CA100+ and the BEIS team over this important year for heat decarbonisation.

Access to Medicine Index methodology training

Lead engager: Katie Frame

Together with the Access to Medicine Foundation, we hosted the first Access to Medicine Index methodology training event for US companies. We re-emphasised the importance of access to medicines to the attendees, who were from the US pharmaceuticals sector. We highlighted that this is a material issue for investors in terms of ensuring that developing markets have access to products, and for a company's social licence to operate.

> **It is crucial for companies to adopt a comprehensive global evidence-based approach to diversifying protein offerings to mitigate supply chain risks and capitalise on opportunities.**

In our opening remarks we encouraged companies to participate in the index, recognising that it is the best tool for investors to gain understanding of a company's efforts to improve access, as it brings together information in a structured format. We recognise the flaws in the index methodology and company reporting fatigue concerns, and encouraged attendees to use the event to voice these concerns directly with the Foundation.

Sustainable Finance roundtable with ASEAN regulators

Lead engager: Janet Wong

We shared our views on sustainable finance and ESG at the ASEAN Sustainable Finance roundtable in London, which was attended by regulators and policymakers from Indonesia, Malaysia, Myanmar, the Philippines, Thailand and Vietnam. We commended the efforts made by the working committee on capital market development to formulate sustainable finance strategies. We shared examples of how we leverage national policies when engaging with companies on their strategy alignment and implementation. We said that inadequate ESG disclosure is one of the key obstacles to encouraging capital flows into the region. Companies often treat ESG disclosure as a box-ticking exercise instead of a tool to drive long-term value. We argued for the principles of materiality and forward-thinking in ESG disclosure.

Some regulators asked if they should make the Task Force on Climate-related Financial Disclosures (TCFD) framework mandatory for corporate reporting. We said that explicit endorsements from regulators and policymakers would be helpful, and that some, such as the Securities and Futures Commission of Hong Kong, had already endorsed the TCFD recommendations, with the support of stock exchanges. We also recognise that regulators do not want to be too prescriptive in mandating which framework to adopt and that international standards evolve over time.

We suggested that regulators endorse the key pillars of frameworks on a "comply-or-explain" basis as a start and work closely with stock exchanges and other stakeholders. We also encouraged the harmonisation of taxonomies across regions, and highlighted that the EU taxonomy includes social minimum safeguards, with reference to the OECD Guidelines for Multinational Enterprises and the UN Guiding Principles on Business and Human Rights.

We shared examples of how we leverage national policies when engaging with companies on their strategy alignment and implementation.

Review of PRI's cybersecurity report

Lead engager: Roland Bosch

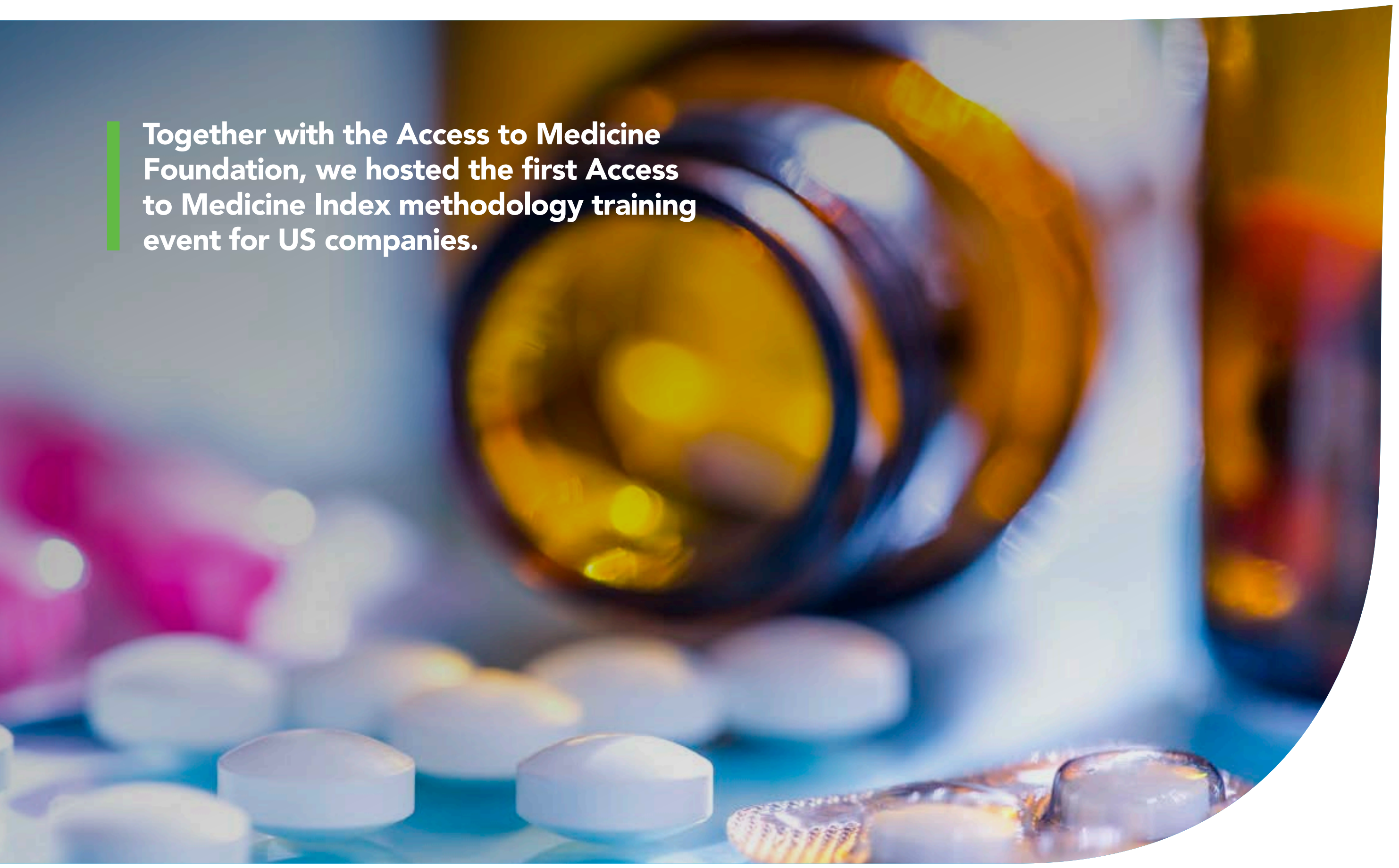
We reviewed the final draft of a PRI report on cybersecurity. This report provides insights from a collaborative engagement that sheds light on how cyber risks are being perceived and addressed by companies from diverse sectors. In addition, it gives a set of minimum standards on cybersecurity-related disclosures that investors can use to guide dialogue with portfolio companies.

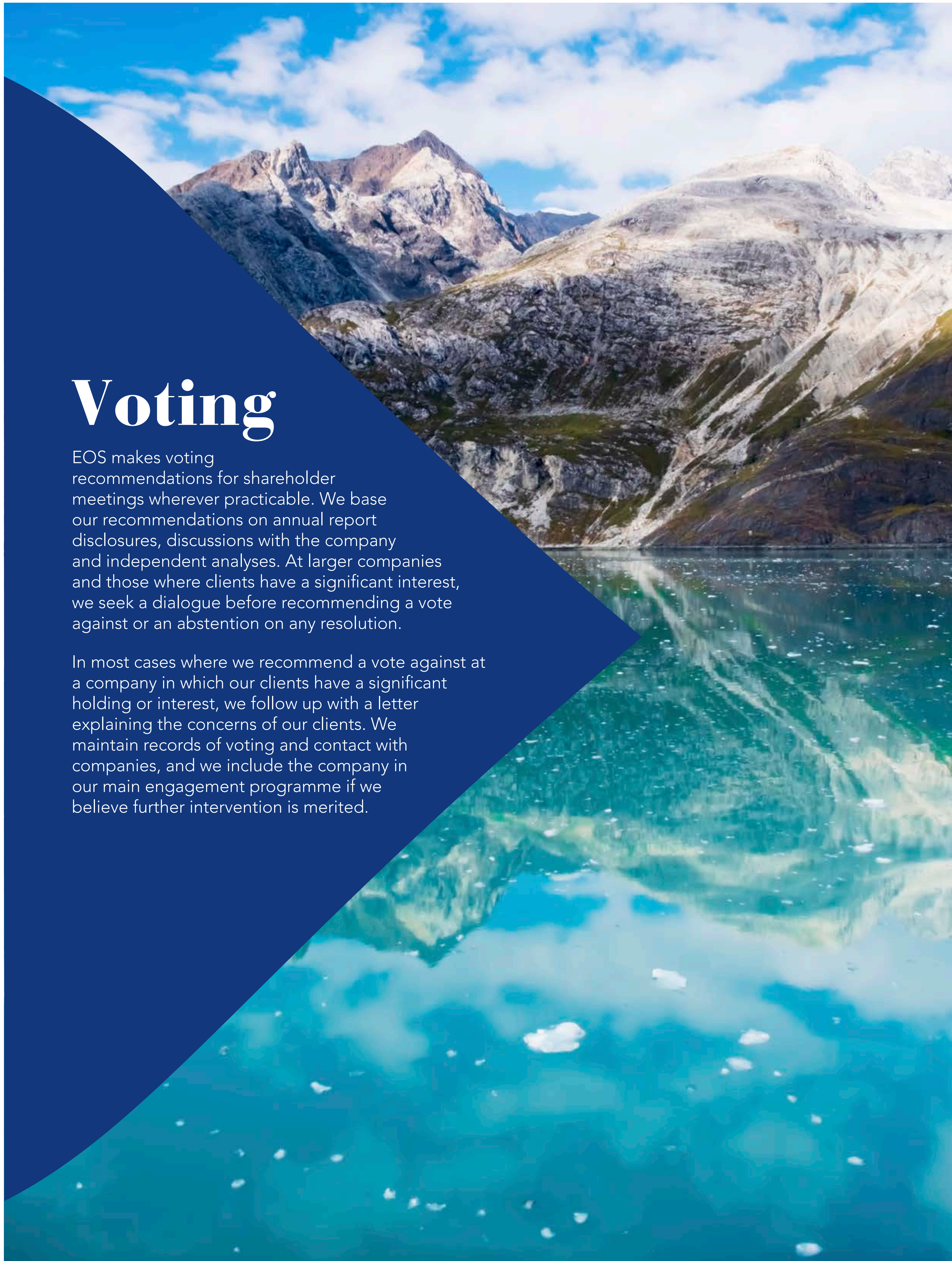
Meeting with Transparency International on its new workstream

Lead engager: Tim Goodman

Following our critique of its draft white paper in 2019, Transparency International asked for our comments on a two-year workstream. This will focus on how to measure the effectiveness of different anti-bribery and corruption programmes. It will then identify best leading practice, including values-based leadership and programmes. This is a distinct shift from our previous discussions, when it believed anti-bribery and corruption could be best improved by boilerplate disclosure. We will support this new project.

Together with the Access to Medicine Foundation, we hosted the first Access to Medicine Index methodology training event for US companies.





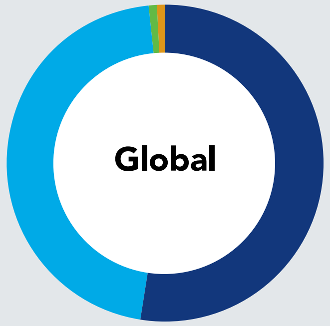
Voting

EOS makes voting recommendations for shareholder meetings wherever practicable. We base our recommendations on annual report disclosures, discussions with the company and independent analyses. At larger companies and those where clients have a significant interest, we seek a dialogue before recommending a vote against or an abstention on any resolution.

In most cases where we recommend a vote against at a company in which our clients have a significant holding or interest, we follow up with a letter explaining the concerns of our clients. We maintain records of voting and contact with companies, and we include the company in our main engagement programme if we believe further intervention is merited.

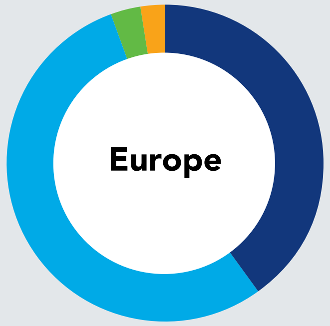
Voting overview

Over the last quarter we made voting recommendations at 1,673 meetings (14,574 resolutions). At 771 meetings we recommended opposing one or more resolutions. We recommended voting with management by exception at 11 meetings and abstaining at 11 meetings. We supported management on all resolutions at the remaining 880 meetings.



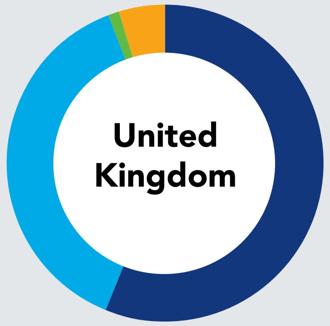
We made voting recommendations at **1,673** meetings (**14,574** resolutions) over the last quarter.

- Total meetings in favour **52.6%**
- Meetings against (or against AND abstain) **46.1%**
- Meetings abstained **0.7%**
- Meetings with management by exception **0.7%**



We made voting recommendations at **219** meetings (**3,211** resolutions) over the last quarter.

- Total meetings in favour **40.2%**
- Meetings against (or against AND abstain) **54.3%**
- Meetings abstained **3.2%**
- Meetings with management by exception **2.3%**

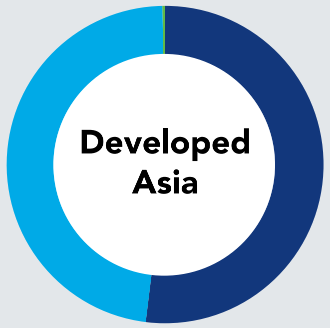


We made voting recommendations at **87** meetings (**1,122** resolutions) over the last quarter.

- Total meetings in favour **56.3%**
- Meetings against (or against AND abstain) **37.9%**
- Meetings abstained **1.1%**
- Meetings with management by exception **4.6%**

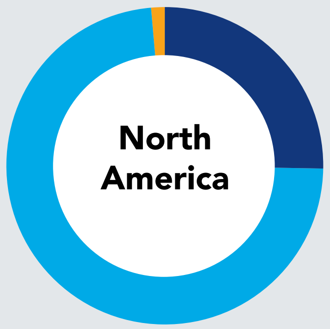
We made voting recommendations at **685** meetings (**4,961** resolutions) over the last quarter.

- Total meetings in favour **63.4%**
- Meetings against (or against AND abstain) **36.4%**
- Meetings abstained **0.3%**



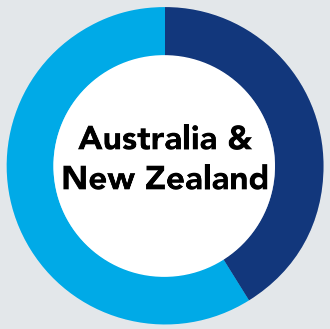
We made voting recommendations at **496** meetings (**3,734** resolutions) over the last quarter.

- Total meetings in favour **52.2%**
- Meetings against (or against AND abstain) **47.6%**
- Meetings abstained **0.2%**



We made voting recommendations at **169** meetings (**1,484** resolutions) over the last quarter.

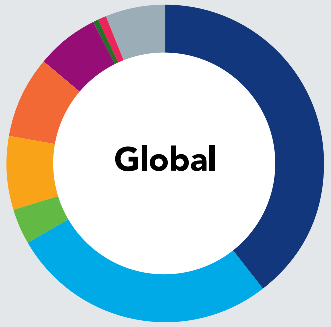
- Total meetings in favour **25.4%**
- Meetings against (or against AND abstain) **73.4%**
- Meetings with management by exception **1.2%**



We made voting recommendations at **17** meetings (**62** resolutions) over the last quarter.

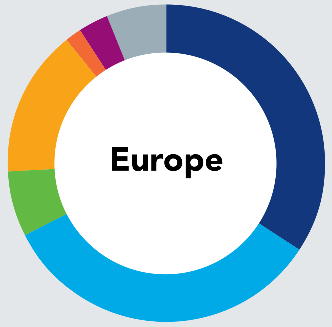
- Total meetings in favour **41.2%**
- Meetings against (or against AND abstain) **58.8%**

The issues on which we recommended voting against management or abstaining on resolutions are shown below.



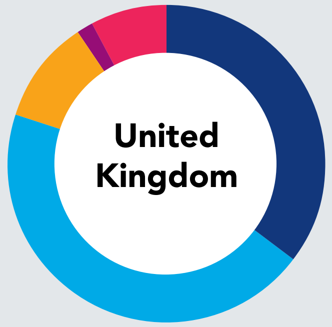
We recommended voting against or abstaining on **1,933** resolutions over the last quarter.

- Board structure **39.6%**
- Remuneration **27.2%**
- Shareholder resolution **3.8%**
- Capital structure and dividends **7.4%**
- Amend Articles **8.2%**
- Audit and Accounts **6.6%**
- Investment/MandA **0.6%**
- Poison Pill/Anti-Takeover Device **0.7%**
- Other **6.0%**



We recommended voting against or abstaining on **362** resolutions over the last quarter.

- Board structure **34.3%**
- Remuneration **33.4%**
- Shareholder resolution **6.6%**
- Capital structure and dividends **14.9%**
- Amend Articles **1.9%**
- Audit and Accounts **2.8%**
- Other **6.1%**

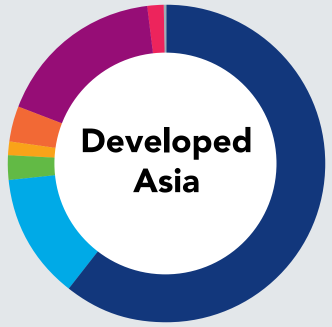


We recommended voting against or abstaining on **65** resolutions over the last quarter.

- Board structure **35.4%**
- Remuneration **44.6%**
- Capital structure and dividends **10.8%**
- Audit and Accounts **1.5%**
- Poison Pill/Anti-Takeover Device **7.7%**

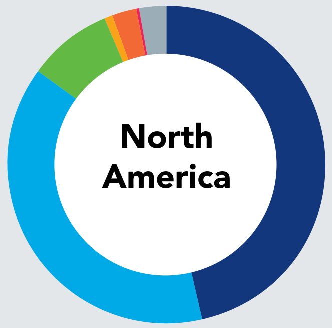
We recommended voting against or abstaining on **788** resolutions over the last quarter.

- Board structure **29.1%**
- Remuneration **26.9%**
- Shareholder resolution **1.9%**
- Capital structure and dividends **7.7%**
- Amend Articles **16.2%**
- Audit and Accounts **5.6%**
- Investment/MandA **1.5%**
- Poison Pill/Anti-Takeover Device **0.1%**
- Other **10.9%**



We recommended voting against or abstaining on **424** resolutions over the last quarter.

- Board structure **60.8%**
- Remuneration **12.7%**
- Shareholder resolution **2.4%**
- Capital structure and dividends **1.4%**
- Amend Articles **3.8%**
- Audit and Accounts **17.0%**
- Poison Pill/Anti-Takeover Device **1.7%**
- Other **0.2%**



We recommended voting against or abstaining on **275** resolutions over the last quarter.

- Board structure **46.5%**
- Remuneration **38.5%**
- Shareholder resolution **8.7%**
- Capital structure and dividends **0.7%**
- Amend Articles **2.5%**
- Poison Pill/Anti-Takeover Device **0.4%**
- Other **2.5%**

We recommended voting against or abstaining on **19** resolutions over the last quarter.

- Board structure **15.8%**
- Remuneration **15.8%**
- Capital structure and dividends **68.4%**

About EOS

EOS at Federated Hermes is a leading stewardship service provider. Our engagement activities enable long-term institutional investors to be more active owners of their assets, through dialogue with companies on environmental, social and governance issues.

We believe this is essential to build a global financial system that delivers improved long-term returns for investors, as well as better, more sustainable outcomes for society.

Engagement

We engage with companies that form part of the public equity and corporate fixed income holdings of our clients to seek positive change for our clients, the companies and the societies in which they operate.

Public policy

Engaging with legislators, regulators, industry bodies and other standard-setters to shape capital markets and the environment in which companies and investors can operate more sustainably.

Voting

We make recommendations that are, where practicable, engagement-led and involve communicating with company management and boards around the vote. This ensures that our rationale is understood by the company and that the recommendations are well-informed and lead to change where necessary.

Screening

We help our clients to fulfil their stewardship obligations by monitoring their portfolios to regularly identify companies that are in breach of, or near to breaching, international norms and conventions.

Advisory

We work with our clients to develop their responsible ownership policies, drawing on our extensive experience and expertise to advance their stewardship strategies.

The EOS advantage

- **Relationships and access** – Companies understand that EOS is working on behalf of pension funds and other large institutional investors, so it has significant leverage – representing assets under advice of US$877 billion as of 31 December 2019. The team's skills, experience, languages, connections and cultural understanding equip them with the gravitas and credibility to access and maintain constructive relationships with company boards.
- **Client focus** – EOS pools the priorities of like-minded investors, and through consultation and feedback, determines the priorities of its Engagement Plan.
- **Tailored engagement** – EOS develops engagement strategies specific to each company, informed by its deep understanding across sectors, themes and markets. It seeks to address the most material ESG risks and opportunities, through a long-term, constructive, objectives-driven and continuous dialogue at the board and senior executive level, which has proven to be effective over time.

Engagements in this report

All of our engagements are subject to a rigorous initial assessment and ongoing review process to ensure that we focus our efforts where they can add most value for our clients. While we can be robust in our dealings with companies, the aim is to deliver value for clients, not to seek headlines through campaigns which could undermine the trust that would otherwise exist between a company and its owners. We are honest and open with companies about the nature of our discussions and aim to keep these private.

Not only has this proven to be the most effective way to bring about change, it also provides protection to our clients so that their positions will not be misrepresented in the media.

For these reasons, this public report contains few specific details of our interactions with companies. Instead, it explains some of the most important issues relevant to responsible owners and outlines our activities in these areas.

EOS team

Engagement


Dr Hans-Christoph Hirt
Executive Director,
Head of EOS


Dr Emma Berntman
Sectors: Retail,
Pharmaceuticals
& Healthcare


Roland Bosch
Sector lead: Financial
Services


Hanah Chang
Themes: Climate Change,
Natural Resource
Stewardship


Dr Christine Chow
Team lead:
Asia & Emerging Markets
Sector lead: Technology


George Clark
Voting and Engagement
Support


Bruce Duguid
Director, Head of
Stewardship, EOS


Katie Frame
Sectors: Retail,
Pharmaceuticals &
Healthcare,
Technology Software


Claire Gavini
Sector: Retail


Diana Glassman
Sectors: Chemicals,
Financial Services, Oil &
Gas, Technology


Tim Goodman
Sector lead:
Oil & Gas


Jaime Gornsztejn
Sector lead: Industrials
& Capital Goods


Bram Houtenbos
Voting and Engagement
Support


Andy Jones
Team lead: Europe
Sector lead: Mining &
Materials


Lisa Lange
Sectors: Transportation,
Financial Services,
Consumer Goods


Pauline Lecoursonnois
Sector lead: Consumer
Goods


Kimberley Lewis
Sector lead:
Pharmaceuticals
& Healthcare


Sonya Likhtman
Sectors: Retail, Mining &
Materials, Pharmaceuticals
& Healthcare


Claire Milhench
Communications
& Content


Ian Munroe
Voting and Engagement
Support


James O'Halloran
Director of Business
Management, EOS


Marija Rompani
Sector lead: Chemicals


Hannah Shoesmith
Sectors: Transportation,
Retail, Financial Services,
Technology


Nick Spooner
Sector lead:
Utilities


Sachi Suzuki
Sector lead:
Transportation


Velika Talyarkhan
Sectors: Consumer Goods,
Retail, Industrial & Capital
Goods, Technology
Hardware, Utilities


Marcus Wilert
Sectors: Transportation,
Retail, Financial Services,
Technology

Amy Wilson
Sector lead: Retail

Janet Wong
Sectors: Financial Services, Technology

Haonan Wu
Themes: Conduct, Culture & Ethics, Human Rights

Tim Youmans
Team lead: North America
Sectors: Financial Services, Industrials & Capital Goods, Technology

Client Service and Business Development

Amy D'Eugenio
Director, Head of Client Service and Business Development, EOS

Marwa Curran
Client Service

Alexandra Danielsson
Client Service

Rochelle Giugni
Client Service and Business Development

Charlotte Judge
Communications & Marketing

Alice Musto
Client Service

Federated Hermes

EOS

Federated Hermes

Federated Hermes is a global leader in active, responsible investing.

Guided by our conviction that responsible investing is the best way to create long-term wealth, we provide specialised capabilities across equity, fixed income and private markets, multi-asset and liquidity management strategies, and world-leading stewardship.

Our goals are to help people invest and retire better, to help clients achieve better risk-adjusted returns, and to contribute to positive outcomes that benefit the wider world.

All activities previously carried out by Hermes now form the international business of Federated Hermes. Our brand has evolved, but we still offer the same distinct investment propositions and pioneering responsible investment and stewardship services for which we are renowned – in addition to important new strategies from the entire group.

Our investment and stewardship capabilities:

- **Active equities:** global and regional
- **Fixed income:** across regions, sectors and the yield curve
- **Liquidity:** solutions driven by four decades of experience
- **Private markets:** real estate, infrastructure, private equity and debt
- **Stewardship:** corporate engagement, proxy voting, policy advocacy

Why EOS?

EOS enables institutional shareholders around the world to meet their fiduciary responsibilities and become active owners of public companies. 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: