PUBLIC ENGAGEMENT REPORT

A ticking time bomb – The overuse of antibiotics in animal farming

Q4 2017

HERMES
EOS

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This report contains a summary of the stewardship activities undertaken by Hermes EOS on behalf of its clients. It covers significant themes that have informed some of our intensive engagements with companies in Q4 2017.

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 shareholders.

Engagement by region

Over the last quarter we engaged with 236 companies on 506 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.

Global

We engaged with **236** companies over the last quarter.

- Environmental **15.2%**
- Social and ethical **28.3%**
- Governance **35.2%**
- Strategy, risk and communication **21.3%**

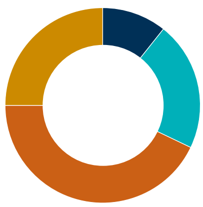
Australia and New Zealand

We engaged with **two** companies over the last quarter.

- Environmental **100.0%**

Developed Asia

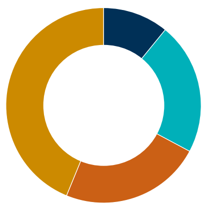
We engaged with **36** companies over the last quarter.



- Environmental **10.7%**
- Social and ethical **21.4%**
- Governance **42.9%**
- Strategy, risk and communication **25.0%**

Emerging and Frontier Markets

We engaged with **39** companies over the last quarter.



- Environmental **10.9%**
- Social and ethical **21.9%**
- Governance **23.4%**
- Strategy, risk and communication **43.8%**

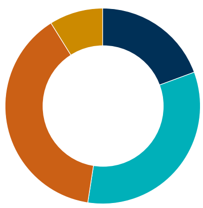
Europe

We engaged with **51** companies over the last quarter.

- Environmental **12.6%**
- Social and ethical **32.8%**
- Governance **30.3%**
- Strategy, risk and communication **24.4%**

North America

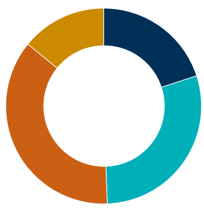
We engaged with **67** companies over the last quarter.



- Environmental **19.4%**
- Social and ethical **33.1%**
- Governance **38.7%**
- Strategy, risk and communication **8.9%**

United Kingdom

We engaged with **41** companies over the last quarter.



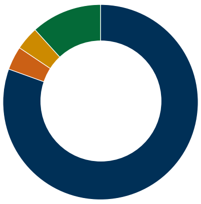
- Environmental **20.0%**
- Social and ethical **29.4%**
- Governance **36.5%**
- Strategy, risk and communication **14.1%**

Engagement by theme

A summary of the 506 issues and objectives on which we engaged with companies over the last quarter is shown below.

Environmental

Environmental topics featured in **15.2%** of our engagements over the last quarter.



- Climate change **80.5%**
- Forestry and land use **3.9%**
- Pollution and waste management **3.9%**
- Water **11.7%**

Social and ethical

Social topics featured in **28.3%** of our engagements over the last quarter.

- Bribery and corruption **3.5%**
- Conduct and culture **21.0%**
- Cyber security **7.7%**
- Diversity **2.8%**
- Human capital management **8.4%**
- Human rights **24.5%**
- Labour rights **11.9%**
- Supply chain management **11.2%**
- Tax **9.1%**

Governance

Governance topics featured in **35.2%** of our engagements over the last quarter.

- Board diversity, skills and experience **28.1%**
- Board independence **20.2%**
- Executive remuneration **29.2%**
- Shareholder protection and rights **11.8%**
- Succession planning **10.7%**

Strategy, risk and communication

Strategy and risk topics featured in **21.3%** of our engagements over the last quarter.

- Audit and accounting **16.7%**
- Business strategy **40.7%**
- Integrated reporting and other disclosure **17.6%**
- Risk management **25.0%**

Environmental

Tackling toxins – Cleaning up on pollution and waste management

We focus on the pollution and waste management of companies in a variety of sectors.

Setting the scene

As the planet becomes more industrialised, pollution continues to be a problem in developed countries and is worsening in many emerging markets. This includes increasingly harmful levels of air pollutants due to the diesel-powered vehicles on our roads and emissions from utilities, as well as the pollution of the world's oceans and lands through plastics and other waste. In addition, oil spills – from the Deepwater Horizon offshore rig in the Gulf of Mexico in 2010 to those from the Keystone and Dakota Access pipelines in 2017 – have highlighted how crucial it is for companies to have adequate risk management and incident response procedures in place.

The management of pollution and waste by companies is a big part of our engagement programme. While we can at times engage with one and the same company on several issues, we approach the topic from a variety of angles.

Methane

To curb the effects of climate change, we engage with companies on the reduction of their methane emissions. Over a 20-year time horizon, methane has far greater greenhouse gas effects than CO2 as it is at least 84 times more potent, according to the Climate and Clean Air Coalition's Oil and Gas Methane Partnership (OGMP). About 140 billion cubic metres of gas – mainly methane – per year are burned off by the oil industry in flares, states the World Bank, causing more than 300 million tonnes of CO2 to be emitted to the atmosphere. The OGMP estimates that average methane leakage rates in the US could be as high as 2%. A leakage rate of 2.8% is sufficient to eliminate the greenhouse gas benefits achieved through the switch from coal to gas-fired power generation over a 20-year period.

Cuts in methane emissions can thus lead to important and quick reductions in the rate of global warming. Methane is lost in upstream oil and gas production, as well as further downstream in pipelines and distribution, transmission, storage and processing. But it is estimated that at least half of all industry leaks can be eliminated at no net cost and the majority at low costs. Methane is after all the main constituent of natural gas and can be readily sold.

Systematic methane leak detection and repair programmes and improvements in project designs to minimise methane loss and flaring are therefore vital. We have urged companies in the oil and gas sector to measure, report and reduce methane leakage rates in accordance with industry best practice, as part of their wider greenhouse gas reduction strategies. We have welcomed various initiatives designed to reduce flaring, greenhouse gas and other atmospheric emissions, as well as to increase energy efficiency. We also encourage companies to endorse the World Bank's Zero Routine Flaring by 2030 initiative and join the OMGP and other industry initiatives.

In addition, we have led and participated in engagements with the Principles for Responsible Investment and US NGO the Environmental Defense Fund on the matter and contributed to the guide to engagement on methane in the oil and gas industry published by them.

Encouragingly, members of the Oil and Gas Climate Initiative are working together to improve detection and measurement techniques. Equally positive are the increasing efforts by companies with regard to co-generation, in other words powering their own operations with methane.

Spill management

Another focus of our engagement in the oil and gas sector has been the prevention and management of oil spills. In the wake of the 2010 Deepwater Horizon spill in the Gulf of Mexico, we intensified our engagement with companies in the sector, pressing for an oil spill prevention and management plan. We ask for as much preparation as possible for incidents and expect a good outline of post-incident management, including contact and dialogue with the affected stakeholders. In addition to policies and programmes to minimise the risk of accidents, companies must ensure their employees and contractors have the right training and skills, as well as access to the best technology.

The largest oil companies appear to have learned the lessons from Deepwater Horizon, while we believe that smaller ones, for example in the pipeline industry, still have room for improvement, as demonstrated by the leaks from the Keystone and Dakota Access Pipelines in 2017. In addition to in-house capabilities, upgrading and investing in safety measures to mitigate the risk of oil spills, many oil companies have joined the Oil Spill Response and Subsea Well Response projects and invested in intervention equipment that can be deployed globally. This includes four capping stacks – the equipment that ultimately stopped the spill in the Gulf of Mexico – three containment toolkits and a stock of dispersants. Brazilian oil and gas company Petroleo Brasileiro, for example, also has a 500-strong response team based in 25 cities, equipped with barriers and dispersants ready to be dispatched during any accidents and 40 oil spill response vessels to cover its offshore platforms.

We continue to regularly address spill management in our engagement with various companies, in particularly as the memories of Deepwater Horizon are beginning to fade.

We have also looked at the risk management of joint ventures, as there are dangers that none of the parties involved are sufficiently clear on their responsibilities. We have pushed companies to apply best practice to their joint venture operations and clearly assign responsibility for oversight and remediation in the case of any problems.

Toxic substance management

The pollution and waste management theme also includes the management of harmful substances, such as nitrogen dioxide, sulphur oxide, tailings, fly ash, as well as the discharge of antimicrobial pharmaceuticals [see pages 6-7].

With mining companies, our focus has been on riverine tailings management. We were pleased about the progress in our engagement on the subject with Zijin Mining in relation to its Chinese operations. The company has set up an environmental and safety committee, a department of environmental preservation and safety, as well as a social responsibility department for significant wholly-owned projects operating in China, all with board level oversight, in line with our engagement on environmental risk management. Its 2016 Corporate Social Responsibility report, published in 2017, was vastly improved. To encourage better environmental performance management, incentive schemes and quantitative key performance indicators have been introduced, in line with our suggestions. The company also described, for example, how it has improved its management of tailings by using an online monitoring system with regular tailings storage checks, as a result of which it has been able to reduce its tailings by 12% over the year.

In the automotive sector, we have pressed car manufacturers to develop a sound roadmap for sustainable vehicle models, including zero-carbon drivetrain technologies. We want them to set out a strategy designed to reduce fleet emissions over the next 20 years and publicly back policies that support emissions reductions over time. Although petrol and diesel-powered vehicles will continue to exist for the foreseeable future, we will push for a growing percentage of the overall sales of car manufacturers to come from electric vehicles that can compete on specification and price with internal combustion engine-powered vehicles.

Elsewhere, we have engaged with utilities on their flood responses and management of excess water. In the wake of the severe flooding in the UK in 2015, we urged United Utilities to put in place a long-term flood response plan. We were pleased that the revised plan includes lessons from the 2015 floods and the emergency response to a bacterial infection incident in 2016. Our successful engagement on the prevention of water pollution through infrastructure upgrades with the company was confirmed by the UK's Environment Agency, which awarded the company a good ranking for the second year in a row against its Environmental Performance Assessment. Furthermore, we were able to complete our engagement objective with US-based power company Duke Energy on the management of hazardous waste after it successfully applied the lessons from the coal ash spill at one of its sites in 2014 to its operations in other US states.

Resource efficiency and the circular economy

We also seek to increasingly engage with companies on the efficiency of the resources they use and the circular economy. In a circular economy, the maximum value of products is extracted while in use before reusing, repairing or recycling them or the materials contained within them at the end of the life of each product. To embrace the circular economy, companies may need to seriously rethink their products and relationships with their suppliers and customers.

In our engagement, we push for more resource efficiency with regard to water and metals in the consumer, technology and automotive sectors, reduced use of other resources, such as packaging, and improved recycling rates. Encouragingly, some companies have made attempts at recycling rubber or cobalt, the mineral widely used in smartphones and the batteries of electric vehicles. We are also supportive of companies coming up with eco-friendly designs, reduced packaging and deposit schemes, for example on plastic bottles. At the 2017 AGM of US confectionery company Mondelez, we supported a shareholder proposal encouraging greater efforts to use recyclable packaging to supplement its existing programmes to reduce packaging in the first place.

In the retail sector, we have pushed for a formal waste production programme in supply chains and stores. We therefore welcome the publication of detailed data on food surpluses and waste by UK retailer Tesco. The company's CEO chairs a coalition called Champions 12.3, a group dedicated to achieving UN Sustainable Development Goal target 12.3, which seeks to halve global food waste at the retail and consumer level per capita and reduce food losses in production and supply chains by 2030. Tesco has set ambitious targets to halve the food waste in its own operations and supply chains, as well as to help halve the household food waste in its retail markets by 2030. To contribute to reducing waste at the consumer level, it is pursuing various initiatives such as innovative packaging and simplified use-by dates. An imperfect vegetables range launched in 2016 is helping to reduce waste at the farm level. In our engagement, we suggested it set intermediary targets to help track its progress and further improve its reporting.

In relation to best practice, we have participated in discussions with the International Council on Mining and Metals on the help of blockchain technology in waste and pollution management. We maintain links with many trade associations and NGOs such as the global oil and gas industry association for environmental and social issues IPIECA, the Environmental Defense Fund and many others to inform our work.

Green finance

We are also increasingly engaging on green finance with financial service institutions. In particular we want to know how banks and insurance companies take into account a company's environmental performance, including on pollution and waste management, and natural capital analysis in lending, financing and underwriting decisions.

We have urged, for example, China Construction Bank (CCB) and the Industrial and Commercial Bank of China (ICBC) to disclose how they ensure they lend responsibly when it comes to the financing of projects, including the undertaking of appropriate environmental and social impact assessments. Encouragingly, CCB and ICBC have green lending manuals that are used by their global offices to ensure a more consistent application of their standards.

Nuclear decommissioning

Nuclear policies and decommissioning tend to be determined by national governments, for example in Japan following the 2011 Fukushima nuclear disaster. However, we have engaged on nuclear decommissioning plans and the risk of contamination, for instance with Korea Electric Power and US energy company Exelon.

Across all of our engagements, we urge companies to provide as much disclosure as possible to inform investors and other stakeholders about their efforts. Our pressure to do so will only increase as pollution and waste management continues to be a focus of our engagements in 2018.

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Social

A ticking time bomb – The overuse of antibiotics in animal farming

We are ramping up our engagements with pharmaceutical and retail companies on the overuse of antibiotics in the food supply chain and beyond.

Setting the scene

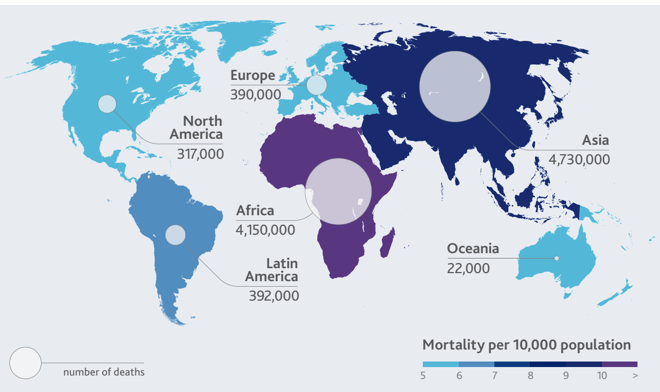
One of the biggest emerging threats to human health is the growing resistance to antibiotics, as it will increase the number of deaths from bacterial infections and limit the success chances of surgery and treatments for illnesses such as cancer and HIV. The UK government estimates that at least 700,000 deaths are attributable to antimicrobial resistance every year. With a continued rise in resistance, this is expected to lead to 10 million deaths annually by 2050. It will be accompanied by a reduction in GDP of 2-3.5%, costing the world up to $100 trillion.[1] Today, it is already estimated that antimicrobial resistance annually costs the EU €1.5 billion in healthcare costs and productivity losses alone.[2] The development of resistance is a result of the wide availability and – at times inappropriate – application of antibiotics. They are routinely overused in farm animals, thus ending up in our food chain. According to the Farm Animal Investment Risk & Return initiative, depending on region, between 45-75% of all antibiotics are used in cattle, pigs, poultry and aquaculture, including those that are critically important for human medicine, to promote growth and prevent the spread of disease.

Investors are increasingly becoming aware of the risk the growing resistance to antibiotics presents. They have begun to acknowledge that the non-therapeutic use of antibiotics represents a systemic risk to the pharmaceutical industry and has a direct impact on global productivity and growth and therefore the potential to impact investment risks and returns across asset classes.

Regulators and other bodies have already started to intervene on the topic. In November 2017, the World Health Organization developed guidelines that recommend that farmers and the food industry stop using antibiotics routinely to promote growth and prevent disease in healthy animals. Antimicrobial resistance has also been on the agenda of G7 and G20 summits, the UN General Assembly, the World Health Assembly and the World Economic Forum.

In January 2016, the Davos Declaration on Combating Antimicrobial Resistance was launched, calling on governments and the industry to work together in taking collective action against drug-resistant infections. Over 100 companies and industry associations have signed it to date.

Deaths attributable to antimicrobial resistance every year by 2050



Source: Review on Antimicrobial Resistance. Antimicrobial Resistance: Tackling a Crisis for the Health and Wealth of Nations. 2014.

Stewardship

While the severity of antimicrobial resistance may only be recognised in decades to come, action is needed now.

Stewardship on the topic also ensures that UN Sustainable Development Goal 3 on good health and well-being can be met. On a company level, managing the risk of antibiotic overuse or antimicrobial resistance prevents damage to the long-term financial and reputational standing of businesses by jeopardising the relevance of their products, as well as the threat of litigation.

We are particularly concerned about the use of antibiotics in Asia and the US, where, unlike in the EU, the use of growth promoters – the use of antibiotics to make animals grow faster – has not been banned. The Farm Animal Investment Risk & Return initiative (FAIRR) predicts that Asia will increase its use of antibiotics by over 120% in chicken and pigs alone, using 51,000 tonnes of antibiotics by 2030.[3] In the US, a lack of regulation and limited pressure from consumer organisations to date has added to concerns.

Together with more than 70 investors with a combined $2.3 trillion in assets under management, we have signed FAIRR's Global Investor Statement on Antibiotic Stewardship,[4] which seeks to phase out the routine non-therapeutic use of antibiotics in livestock production. It also urges companies to introduce a best practice policy on antibiotics stewardship.[5]

FAIRR calls on retail and food companies to have in place a comprehensive policy to phase out the routine, non-therapeutic use of antibiotics across all livestock, seafood and poultry supply chains, with clear targets and timelines for implementation, as well as to increase transparency by reporting on its implementation, including on the mechanisms to measure and audit the use of antibiotics in supply chains.

We support FAIRR on this long-term issue and have created clear engagement objectives in relation to its antibiotics mission, as we are intensifying our engagement on the matter.

Retailers and food companies

According to FAIRR, the food industry continues to be the largest consumer of antibiotics globally, and we have been engaging with retailers, restaurants and food companies on the issue.

As antimicrobial resistance is still a relatively new concern for many companies, our dialogue initially focused on awareness raising, followed by requests from us to address the issue in the risk management of their direct operations and that of their supply chains. In our engagement, we have also pushed the companies to improve the disclosure on the use of antibiotics as part of their reporting.

We have had some pushback from companies, saying that they have only received limited signals on this topic from their customers but are continuing to press for standards in this area. Where companies do not have one in place already, we push for them to draft and publish a statement on antibiotics.

One encouraging example has been US fast food chain McDonald's. The company ended the use of all antibiotics critical to human health, except for one, in its US chicken supply chain in 2016. We have talked to the company to ensure that it follows this up with a similar ban on antibiotics that are critical to the human health in its European poultry supply chain, which it plans to complete in 2018, and that it is identifying what it needs to do for similar measures on a global basis. The company aims to have eliminated the highest priority critically important antibiotics in broiler chickens in 80% of all of its markets by the end of 2019. While this is not a commitment to eliminate all use of antibiotics, it is an important first step on which to build.

In addition, we have been engaging with the company on its progress towards removing antibiotics critical to human health from its beef and pork supply chains globally. We heard that the beef and pork supply chains are more difficult to control as the company does not buy whole carcasses. In addition, these supply chains are much more diffuse with far more suppliers, which stands in contrast to the more manageable number of large suppliers providing its chicken. Therefore the company's leverage over its pork and beef suppliers is not as strong and the traceability of the meat it buys is more difficult. However, we still pushed it for further progress on this.

Pharma companies

Crucially, the overuse of antibiotics cannot be tackled on the food chain end alone, which is why we have stepped up our engagement with pharmaceutical companies on this matter. This is in line with the EU's One Health[6] approach, which calls for a holistic approach across many different sectors to tackle this complex problem.

Antimicrobial resistance has become a critical issue for the pharma industry. The next generation of antibiotics has yet to be found to ensure that treatments for life-threatening diseases continue to work, meaning that the industry's viability is at stake.

Our dialogue with pharma companies in our engagement programme on the overuse of antibiotics is three-fold. In relation to the environment, we focus on the avoidance of water pollution, waste management and the management of the supply chain. We also concentrate on the stewardship of pharmaceutical products, including their marketing, availability, for example as in over-the-counter, their use, as well as the incentivisation of sales staff and their selling techniques. Furthermore, we have proceeded to identify the main publicly held sellers of antibiotics to the food producers and to challenge what, if any, preventative measures are in place to avoid antibiotics ending up in animal feed.

As part of our dialogue, we also push companies to report on their production and use of antibiotics in line with the roadmap to combat antimicrobial resistance.[7]

To supplement our engagement at the company level, we have been in dialogue with other industry bodies. We are, for example, a member off the Access to Medicine (ATM) Foundation, which will publish its first ever Antimicrobial Resistance Benchmark in 2018. The goal of the benchmark is to incentivise pharmaceutical companies to implement effective actions for tackling the problem of antimicrobial resistance. In addition, we support the ATM Foundation's Access to Vaccines Index, which was first published in March 2017, and is designed to prevent disease at scale instead of focusing on cure only.

Outlook

Antibiotic overuse represents only one of a number of risks – which include climate change and water pollution among others – that the agriculture sector, in particular the intensive rearing of animals, poses to investors, and at some point there may have to be a rethink of this business model.

In the meantime, we are ramping up our engagements on the routine use of antibiotics with companies in the retail, food and pharma sectors to push for a speedy phasing out of this practice.

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[1] https://amr-review.org/sites/default/files/AMR%20Review%20Paper%20-%20Tackling%20a%20crisis%20for%20the%20health%20and%20wealth%20of%20nations_1.pdf
[2] https://ec.europa.eu/health/amr/antimicrobial-resistance_en
[3] file://hermes/vhd_profiles/VDI_Home_VHD1/roehrbn/Downloads/FAIRR-Initiative_Factory-farming-in-Asia-assessing-investment-risks%20(1).pdf
[4] http://antibioticsstatement.fairr.org/
[5] http://antibioticsstatement.fairr.org/wp-content/uploads/2017/11/FAIRR-Template-Antibiotics-Policy-final.pdf
[6] https://ec.europa.eu/health/amr/antimicrobial-resistance_en
[7] https://www.ifpma.org/wp-content/uploads/2016/09/AMR-Roadmap-Press-Release_FINAL.pdf

Regulators and listing rules – Why the principle of one-share one-vote remains crucial

We continue to strongly support the principle of one-share one-vote in the wake of more stock exchanges seeking to allow listings of companies with multi-class share structures, as we believe it is a pre-requisite for effective stewardship.

Setting the scene

The last few years have seen increased competition between stock exchanges for initial public offerings (IPOs) globally. In 2014, the Hong Kong Stock Exchange, following an intervention of its regulator, rejected the listing of e-commerce company Alibaba whose structure gives a small founder-led team preferential rights over the appointment of board members, something that was a priority for the company. Alibaba subsequently listed on the New York Stock Exchange. Following the listings of technology services companies Alphabet and Facebook, the listing of their peer Snap in 2017 – which offered only shares without any voting rights to the public – took the trend among US companies to share structures with differential voting rights to a new extreme. Anxious to avoid losing more IPOs, several stock exchanges in Asia have been considering to allow the listing of companies with differential voting rights. In the UK meanwhile, the Financial Conduct Authority issued a consultation on a proposed new premium listing category for sovereign-controlled companies, which would result in investors in these companies losing the protection provided by related party and controlling shareholder rules.

Listing rules are set by local stock exchanges or their regulators. Their significance in shaping the domestic corporate governance framework and providing investor protection varies substantially between markets. In the UK, for example, the listing rules are the regulatory underpinning of the Corporate Governance Code and its comply-or-explain approach. They also provide other significant protections, for example with regard to major and related party transactions. Moreover, the rules applicable to companies with a primary premium listing require adherence to the principle of one-share one-vote, which ensures proportionality between equity ownership and voting powers and economic risk bearing.

It is our fundamental belief that the financial system and regulatory frameworks should operate in the interests of the ultimate owners, the beneficiaries. As fiduciaries of the ultimate owners, institutional investors should therefore ask stock exchanges, regulators and governments globally to focus on creating a framework that facilitates the long-term success of companies they invest in on behalf of the underlying beneficiaries and not the commercial success of a particular stock exchange or a market. In our view, this requires adequate shareholder rights, investor protection and management accountability, underpinned by the principle of one-share one-vote.

Drivers of differential voting rights

Many stock exchanges are commercial businesses and listed entities. The commercial interest in obtaining new listings drives stock exchanges and associated industries to provide companies or their early investors, often founders, with the flexibility they want with regard to their share structures. Advocates of multiple-class share structures claim that the one-share one-vote principle allows investors to exercise undue pressure that encourages short-term thinking and decision-making. Giving a founder more control through enhanced voting rights, they argue, allows companies to be run with a long-term view without undue interference in, for example, the use of resources and the role of key individuals.

The suggestion that pressure from the capital markets necessitates listings with differential voting rights is something institutional investors should take seriously and seek to address, as it is a concern not just for high-tech, founder-led companies but increasingly for established companies too. Institutional investors could put themselves in a much stronger position in the discussion about differential voting rights if the industry made more progress in addressing the issue of short-termism, for example, by lengthening typical performance measurement periods, focusing on absolute performance against agreed objectives and systematically integrating long-term factors within their decision-making processes and conversations with management. This would mean focusing on a significant part of the underlying problem instead of dealing with the symptoms by introducing ever more complicated share structures that disenfranchise investors and reduce accountability.

The stewardship case

The rationale behind stewardship codes and guidelines that have emerged globally, including in the US, suggests that appropriate shareholder rights and accountability mechanisms should be a key concern for regulators and governments. The dilution of such rights and mechanisms through the proliferation of listed companies that have share classes with differential voting rights at a time when investors are encouraged to become more active owners amounts to regulatory inconsistency.

While it is impossible to make an empirical case for adherence to the one-share one-vote principle across the various life stages of companies and sectors, it is equally uncertain that differential voting rights guarantee better long-term decision-making and outcomes. However, our experience suggests that at some point in the life of a company things will go wrong and at companies, such as US technology company Snap, investors will have no means to intervene and address problems.

An alignment between the economic interests of an investor and control rights through the one-share one-vote principle thus seems the best structure to ensure management accountability. If listing rules allow companies to list with differential voting rights, these should therefore be time-bound through sunset provisions and provide adequate safeguards for investors.[8]

Companies that aim for inclusion in indices, for example through a premium listing, should however be required to adhere to the one-share one-vote principle because these listings provide access to highly liquid and low-cost pools of capital. If an issuance is going to result in forced buyers of shares, then the forced buyers should in turn be granted adequate rights. In response to such reasoning, some index providers have already announced changes to their policies regarding companies with multiple-class share structures.

Regulators and stock exchanges

We have been seeking to address various minority shareholder rights and protection aspects with the regulators and stock exchanges concerned.

In response to the new board consultation by the Hong Kong Stock Exchange, for example, on listing opportunities for companies with weighted voting rights structures, we strongly advised against the proposed non-standard governance structure in a one-track or dual-track listed regime. We explained that we do not consider the needs of new economy and early stage enterprises to be valid enough reasons for non-standard governance structures to be introduced, especially when these structures have a defining role in shaping the continued power dynamics in the boardroom and across wider corporate culture. Unfortunately, the exchange has since announced the creation of two additional chapters in its listing regulations for pre-profit/pre-revenue biotechnology firms and companies with weighted voting rights structures, subject to additional disclosure and safeguards, and has commenced the drafting of the proposed amendments to the listing rules to put the proposals into effect.[9]

In our feedback to a consultation by the Singapore Exchange (SGX), we again made it clear that we are not supportive of the introduction of a dual-class share framework in the city state. Nevertheless, we acknowledged the thorough consideration the SGX has given this matter and the steps it has suggested to address the risks of a dual-class share structure, which, if implemented correctly, could be effective in mitigating much of the risk of abuse by owner managers of listed companies.

We also formally responded to the consultation by the UK's Financial Conduct Authority proposing a new premium listing category for sovereign-controlled companies, which would exempt them from some of the rules that provide their shareholders with additional protection. We contended that while the listing of sovereign-controlled companies in London under the new regime would be attractive from a short-term commercial perspective, in particular for the stock exchange, investment bankers, lawyers and other advisers, it is questionable whether their listing is beneficial to the underlying beneficiaries, whose money will ultimately be invested in these companies in the long term. We do not support the dilution of the protection the premium segment listing rules provide, in particular where a standard listing is already available to sovereign-controlled companies and where index inclusion is not an objective of the listing. We made clear that we believe that protecting the reputation and the value of a primary London listing, which is based on comprehensive shareholder rights and protection and can mean a lower cost of capital, should be at the top of the regulator's agenda when considering amendments to the listing rules.

Engagement with companies

We also continuously engage with companies with dual-class share structures, such as e-commerce company Alibaba, in an attempt to enhance the rights of minority shareholders, increase transparency and push for effective boards and investor dialogue. We have taken a stance through our voting recommendations at the AGMs of companies, for example, by opposing the election of the chair of the governance committee at US media company Twenty-First Century Fox or co-filing shareholder proposals requesting the elimination of dual-class share structures at News Corp, which garnered strong support particularly from non-affiliated investors.

Laudably, due to the country's experience with poor shareholder rights, dual-class share structures and the treatment of minority shareholders, companies in Brazil have been moving into a different direction from their peers in Asia and the US. Some have begun to convert their non-voting shares into voting ones, seeking to reduce the governance discount, as well as to increase their shareholder base and the share liquidity through the adoption of a single share class.

As part of this process, we supported the proposals submitted to the AGMs of mining company Vale and paper and pulp company Suzano Papel e Celulose to convert their non-voting into voting shares and to amend their articles of association to incorporate the requirements of the Novo Mercado, the B3 stock exchange segment with higher corporate governance standards.

In the case of Vale, the adoption of the one-share one-vote principle and the dissolution of the controlling shareholders agreement, which has been in place since its privatisation in 1997, will result in a dispersed ownership structure and an equitable treatment of all shareholders, which we welcome.

Advocacy

In our view, adherence to the principle of one-share one-vote is a prerequisite for stewardship. We are therefore concerned about the seemingly regulatory inconsistency described above that is undermining the effectiveness of stewardship.

As an advocate of shareholder rights and stewardship codes, we will continue to promote adequate shareholder rights, investor protection and management accountability through legal frameworks and listing rules.

For further information, please contact:

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8 https://corpgov.law.harvard.edu/2017/04/24/the-untenable-case-for-perpetual-dual-class-stock/

9 http://www.hkex.com.hk/News/News-Release/2017/171215news?sc_lang=en

Strategy

The rise of sustainability – China's journey to stewardship

We have been witnessing a change in attitude by Chinese companies to sustainability and stewardship.

Setting the scene

Rapid industrial development and economic growth in the world's most populous country have been accompanied by hazardous levels of water and air pollutants. The latter have been attributed to emissions from industries such as power generation, in particular from coal-fired plants, and metal processing. Carbon dioxide emissions have been constantly increasing in China, which is why its government has introduced specific emissions reduction targets. In addition, it has introduced an import ban on plastic waste. As a result of these pressing environmental issues, sustainability has been rising up the agenda of companies in the country.

State influence

Over the past 20 years, the progress made by domestic capital markets in Mainland China has reflected the country's economic development. The reform of share ownership in Chinese companies aimed at bringing in private sector investment has encouraged competition and more business-oriented behaviours among state-controlled companies, and a domestic institutional investment community has emerged. Private enterprises meanwhile have grown significantly.

But despite the country opening up to private – including foreign investment – the state remains highly influential over business activities. In addition, if the Chinese government decides to take action on, for example environmental, social or governance-related initiatives, it will ensure their implementation.

We are pleased that companies in Mainland China and Hong Kong are increasingly becoming aware of the importance of environmental, social and governance (ESG) factors and begun to open up to dialogue with long-term institutional investors and their representatives, such as ourselves. This was reflected in the invite from the state-directed Asset Management Association of China for us to speak at the first ever Responsible Investor Forum in China in 2017. It was also a clear signal that the Chinese regulator supports the development of responsible investment in China.

Access

In addition, we have witnessed a trend towards more open dialogue between investors and Chinese company boards. We have started to engage with family-controlled conglomerates, such as CK Hutchison and Jardine Matheson, and were successful in gaining access to their board directors, something that was difficult to achieve in the past.

However, other cultural issues – such as a reluctance to say anything at all if something is not perfect – are more difficult to address. This applies in particular to disclosures, for example to the CDP initiatives on water and carbon emissions.

Environmental issues

Due to the impact of pollution on its citizens, China's government and regulator now strongly focus on environmental issues. In particular, the Chinese government has begun to address carbon emissions by taking measures to reduce these, particularly in the extractives sectors, which is beginning to have an impact.

We were encouraged, for example, to see the attendance at a CDP training seminar in China increase from two in 2016 to over 20 company representatives in 2017, which was also a result of our connections with companies. At the event, we were pleased to see that in particular companies from the energy, chemicals, consumer and financial services sectors have increased their resources to improve the disclosure of their environmental performance and set objectives in line with global best practice. However, we also pointed out that in addition to senior or board commitments to disclosure, vertical integration and an alignment of disclosure responsibilities are required to ensure sustainability is embedded throughout the company. Furthermore, we highlighted the importance of participation in policy discussions and global climate change-related initiatives to shape the environment in which the companies operate in and show their intention to integrate with the global business community on ESG issues.

IT company Baidu, for example, became the first Chinese member to sign up to EV100 initiative, which aims to accelerate the transition to electric vehicles (EVs) and make electric transport the new normal by 2030. Electric transport is able to cut millions of tonnes of greenhouse gas emissions per year, as well as curb transport-related air and noise pollution.

As part of the government's environmental efforts, attention has also shifted to green financing. We were pleased to see the China Institute of Finance and Capital Markets, a think tank affiliated with the China Securities Regulatory Commission, advocating green finance, in other words the lending to low-carbon economy projects and businesses by financial institutions, accompanied by restrictions on lending to high-risk sectors that may lead to environmental degradation and pollution.

We have been increasingly engaging with banks in China on climate change and are getting more traction with them [see page 5]. Following our encouragement and the technical training by the CDP initiative, the 2016 CDP climate change survey of the Industrial and Commercial Bank of China for the first time reached a standard that could be scored. This was a major milestone as it shows that the company has set aside dedicated resources to improve the disclosure of its climate change performance. The bank also responded well to our questions on how it balances the priorities of the Communist Party of China and its business and was able to provide positive examples, including with regard to lending policies linked to the country's One Belt One Road initiative.

While philanthropic corporate social responsibility reports are mandatory in Mainland China, they are not comparable to ESG or sustainability reports that link material sustainability issues to potentially financial impacts in core business activities although there may be some overlap in the topics covered. We urge companies to improve their disclosure by collaborating with standard-setting initiatives such as the CDP, thus improving overall standards of environmental performance management among Chinese companies.

We were therefore pleased about the significant improvements made to the disclosures of the majority state-owned telecommunications company China Mobile in its sustainability report, as well as on its website. The company is the first Mainland Chinese company to attain an A ranking in CDP's climate change survey. It also published a policy and corresponding due diligence guide for responsible supply chain management in 2016.

We also encourage Mainland Chinese and Hong Kong-listed companies to adopt the recommendations of the Financial Stability Board's Task Force on Climate-related Financial Disclosures (TCFD). We would like to see them provide the relevant disclosures in their annual financial filings, including the determination of materiality of other information. If companies do not fully report against the TCFD recommendations, they should explain their reasons for not doing so.

Social matters

In particular in view of the commercial success of many Chinese technology businesses, we encourage companies to provide evidence of a culture of risk awareness and management in relation to cyber security, including data privacy, information security, business continuity plans and the prevention of frauds and crimes.

Other social issues we have been engaging on with Chinese companies include health and safety, particularly in the extractive sectors, human capital and supply chain management, as well as bribery and corruption.

We, for example, began our engagement with China Mobile in 2012 following a number of serious bribery and corruption allegations concerning its senior executives. We encouraged the company to locate and rectify the apparent weaknesses in its policies and systems and pressed it to learn from individual cases to improve its internal controls and risk management. We sought evidence of a change in culture and staff behaviour, which we believed to be core to addressing the root causes of the problems. In addition, we encouraged improved disclosure on a range of ESG issues.

We therefore welcomed the demonstrable efforts by China Mobile to tackle bribery and corruption by analysing all the corruption cases it had identified since 2011. To show its commitment to cultural change, it held educational seminars on the topic for its employees. We commended its open admission of the bribery issues identified, its demonstrable commitment to change and setting a positive example for other companies. The company verified all whistleblowing reports and set up a coordination mechanism encompassing material verification, external investigation support and special case coordination. It also required the family of management staff to sign an anti-bribery and corruption pledge. The improvements made by the company are in line with the bribery and corruption assessment by the Central Commission for Discipline Inspection, the central government's branch for compliance.

Governance

In contrast to the positive momentum to improve environmental and social standards in Mainland China and in Hong Kong, governance does not appear to have the same priority at the moment. The governance structure of Chinese companies in some sectors, such as telecommunications, e-commerce and other sensitive businesses, is complicated as they have an extra layer through the creation of variable interest entity structures, which allow foreign investors, who are not allowed to directly invest in these Chinese companies, to do so through specially created vehicles.

However, we firmly believe that corporate governance in China can be enhanced through engagement from foreign institutional investors. In particular, we believe that the quality and diversity of boards, the protection of minority shareholders and the disclosure of related party transactions need to improve further at Chinese companies.

The access of minority shareholders to the board outside of AGMs is a distinguishing feature of companies with better governance standards. It is particularly important when a company has a dominant or controlling shareholder. We therefore recommend companies appoint a lead independent director, who could act as a contact point, especially if it is family- or state-dominated or where the role of chair and CEO are combined. The lead independent director should act as a counterweight to the board chair, lead the group of independent directors and function as a link between them and the executive directors, as well as play a key role in board evaluation and shareholder engagement.

As Chinese companies expand their customer base and operations overseas, we expect them to explain how they take into account the different dimensions of diversity, such as gender, ethnicity, nationality, skill sets and experience, on their board and in their management to improve the long-term performance of their business. As members of the 30% Club, we support the 30% Club Hong Kong campaign to increase the percentage of women directors on company boards to 20% by 2020, working towards a long-term goal of 30% for all companies in the Hang Seng Index. We consider voting against the nomination committee chair at companies with no female board members unless a credible plan to introduce women directors is available or the nomination chair can provide a solid explanation for the circumstances.

Due to capital account restrictions, many Chinese companies have set up subsidiaries outside of China to hold and manage foreign currencies required for business transaction purposes. We therefore expect related party transactions, especially finance-related transactions to be accompanied by detailed disclosure on the rationale of the use of the connected party, the terms of the agreement and the audit and assurance mechanisms put in place to ensure that the transaction is conducted in a fair and transparent manner over the agreement period, not only during the initial phase. We expect a thorough review mechanism to be in place should any irregular activities be noted by the auditor.

We will continue our engagement with Chinese companies across all sectors to make sure that they maintain the momentum on environmental and social concerns, enhance their governance standards as outlined in our regional Corporate Governance Principles[10] and continue to improve in line with global best practice.

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[10] https://www.hermes-investment.com/ukw/wp-content/uploads/sites/80/2017/12/china-cg-principles-2017-dec-2017.pdf

Strategy

Engagement on strategy

Many of our most successful engagements include discussions on business strategy and structural governance issues.

Overview

We adopt a holistic approach to engagement, combining discussions on business strategy and risk management, including social, environmental and ethical risks, with structural governance issues. We challenge and support corporate management in their approach to the long-term future of the businesses they run, often when there is minimal outside pressure for change. We are generally most successful when we engage from a business perspective and present environmental, social and governance issues as risks to the company's strategic positioning. Companies may benefit from new perspectives on the board and from promoting fresh thinking at the head of the company. An independent chair or change of CEO is frequently the key to improving performance and creating long-term value for shareholders.

Examples of recent engagements

Board composition

Lead engager: Michael Viehs

We obtained reassurances on the skill sets and experiences of the proposed new board members of a European company. In an unusual meeting with the outgoing and incoming chairs of its supervisory board, we discussed the company's governance and strategic challenges. To ensure that only suitable candidates for the supervisory board are put up for election, the chairs had interviewed a number of shortlisted candidates. While we were generally content with the four selected candidates, we questioned the additional perspective that the candidate without industry experience could bring to the board. The chairs outlined to us how her experience in governmental relations is crucial for developing the company and its strategy further. We were also satisfied with how the board has dealt with the overboarding of one candidate who, as a result, will step down from board positions at two large companies.

Nevertheless, we challenged the chairs on the multiple board positions several of the board members occupy. They reassured us that during normal times, the board is not too busy to properly monitor the company's executive team. We also learned that the incoming chair is supportive of the company's strategy but believes that a more flexible structure is required to adequately respond to new industry challenges.

Carbon price

Lead engager: Natacha Dimitrijevic

We welcomed the sustainability plan of a European company, which was presented by its CEO and a number of key executives, including the CFO, at its first ever sustainability day. The key pillars of the plan are resource management – including in relation to water and energy efficiency – safety, ethics, human rights and diversity, as well as the use of new technologies. We particularly commended that from 2018 the company will start using a $10/tonne internal carbon price, rising to $40/tonne by 2025, which we had it encouraged to do for a number years. In a subsequent meeting with its CEO, we sought to understand the impact of the introduction of the carbon price on exploration and downstream activities. In addition, we pushed for the publication of a dedicated report on climate change and were pleased that the CEO agreed to consider this for 2018. The company also set new environmental targets, which are part of its employee incentive schemes. However, we challenged the company's assumptions and scenarios in relation to climate change, as it is investing in public charging points for electric vehicles but overall remains cautious on renewable energies.

Climate change strategy

Lead engager: Christine Chow

A conversation with a financial services company in which we highlighted the importance of the recommendations of the Task Force on Climate-related Financial Disclosures (TCFD) appears to have had a positive impact because, following our meeting, it decided to fill in a survey on the risks and opportunities it faces as a result of climate change. The greenhouse gas emissions disclosures provided by the company to the CDP initiative included data from its head office and all its branches in the capital, which shows that initial steps in data collection have been taken. Encouragingly, one of the big four consulting firms is assuring the company's latest CSR report.

We subsequently welcomed the commitment by the company to implement the TCFD recommendations. To meet the expectations, it will build on its low-carbon, green finance strategic plan, and to improve the disclosure, it plans to disclose the Scope 1 and 2 emissions of an additional 37 subsidiaries in 2018. We encouraged the company to reduce the financing of coal-powered plants, and it described to us how it would cut its funding of high-emissions sectors. In addition, the company seeks to grow its low-carbon and green finance portfolio. We suggested that the company include policy, market and technology developments in its critical factors and following a scenario analysis in line with the TCFD recommendations, come up with early warning indicators to better manage the risks and opportunities of climate change. We also called for adequate disclosure to demonstrate its strategic commitment and will continue to monitor the bank's greenhouse gas emissions in absolute terms, as well as relative to associated sectors.

Environmental and social risk management

Lead engager: Jaime Gornsztejn

Encouragingly, an emerging markets company has taken initial steps to address the concerns we raised with its senior independent director about the lack of a group-wide policy regulating how it identifies, assesses, mitigates and monitors environmental and social risks in its operations. A sustainability committee has been established at the board level and a senior executive responsible for sustainability will be appointed in the first quarter of 2018.

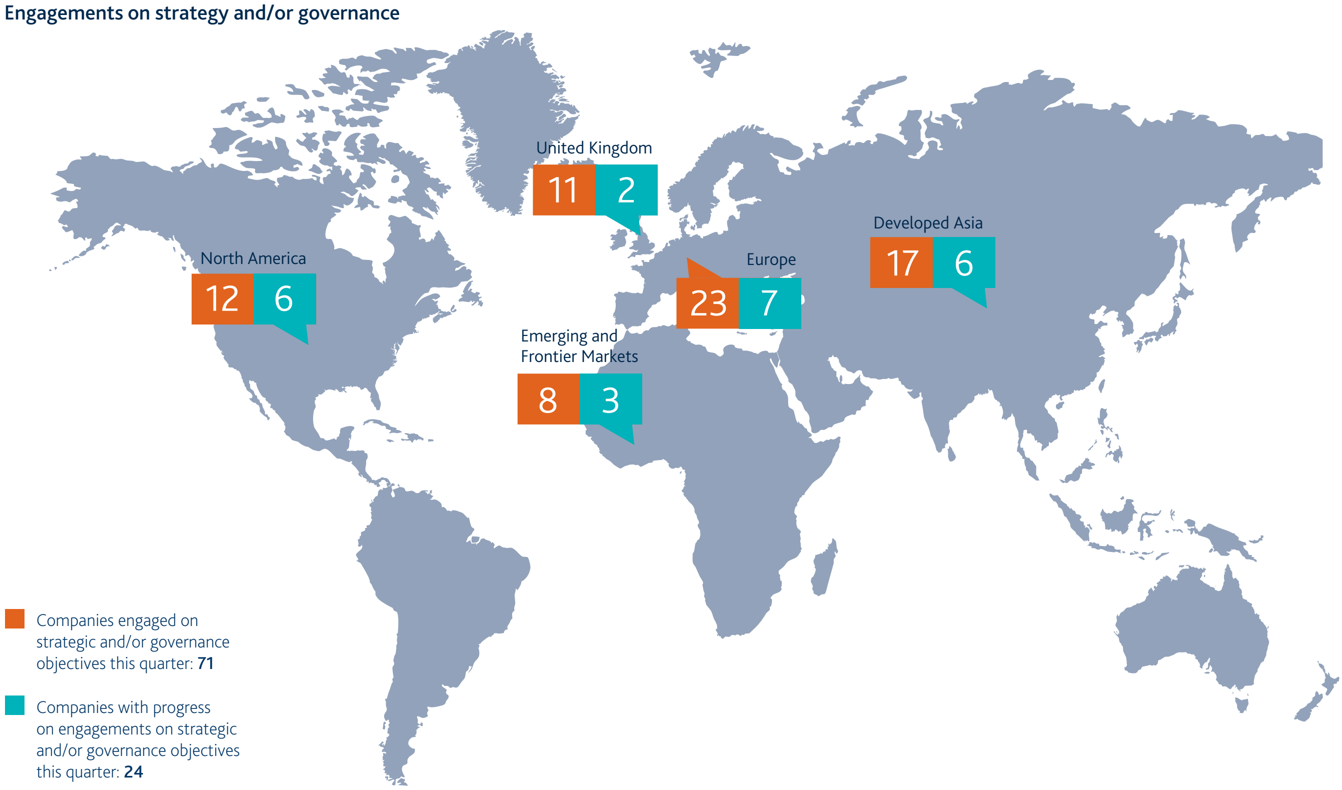
The company has also undertaken a benchmarking exercise with some European and US peers on their practices in this area. In our engagement, we suggested that the benchmarking be extended to include emerging market peers. We provided examples of environmental and social risk management policies developed by its Brazilian peers and offered to make introductions so that the company can discuss best practice and the challenges involved in adopting them. The company accepted our offer.

Sustainability strategy

Lead engager: Roland Bosch

In meetings with the chair and deputy head of corporate sustainability earlier in 2017, we had requested a UK company to be more explicit in disclosing its exposure to the risks from climate change, set long-term sustainable finance objectives and update its sustainability risk policies. In addition, we had urged it to lead best practice by reporting in line with the recommendations of the Task Force on Climate-related Financial Disclosures (TCFD). The company subsequently updated its sustainability strategy with five new commitments to support the transition to a low-carbon economy, which we commended. It has made a commitment to intensify its support for clean energy and low-carbon technologies and projects that support the implementation of the UN Sustainable Development Goals. The company plans to adopt the recommendations of the TCFD – with the first disclosures to be reported in its 2017 annual report – while continuing to shape the debate around sustainable finance and investment. Earlier in the quarter, we had contributed to the review of its energy policy.

Engagements on strategy and/or governance



Public policy and best practice

Hermes EOS contributes to the development of policy and best practice on corporate governance, sustainability and shareholder rights to protect and enhance the value of the shareholdings of its clients 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 in value for shareholders, and developing codes of best practice for governance, 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. Hermes 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 whose interests may be markedly different – particularly companies, lawyers and accounting firms, which tend to be more active than investors in these debates.

Highlights

Climate Change 100+

Lead engager: Bruce Duguid

We identified the goals and priorities of the Climate Action 100+ initiative with other core members of the corporate engagement group of the Institutional Investors Group on Climate Change. Climate Action 100+ is a globally coordinated engagement initiative focused on the top 100 most strategically important greenhouse gas emitters. The target list is based on the emissions of companies in their operations and in their products, which is why it includes fossil fuel suppliers such as oil and gas companies, as well as automotive manufacturers. We pushed for the initiative's engagements to identify clear and feasible objectives. We explained that requesting oil and gas companies to reduce the supply of profitable oil and gas is unlikely to be feasible but that a focus on the risks of exploration activities could help companies set an appropriate cost of capital and reduce supply in return. In addition, we volunteered to lead the dialogue with several high carbon-emitting companies in Russia and other parts of the world, as well as to help with the engagements at some Asian companies.

Executive remuneration in Germany

Lead engager: Hans-Christoph Hirt

We outlined concerns about executive remuneration practices and set out our expectations about future policies and pay packages at a conference for senior company representatives in Germany. We addressed the complexity and leverage of many pay packages and questioned whether long-term incentive plans work, given the risk aversion and excessive discounting of the executives benefitting from these plans. We also presented evidence on the poor alignment between company performance and executive remuneration. Our proposal to radically simplify remuneration by significantly increasing fixed pay and using share ownership beyond tenure to create alignment was well received. However, it was agreed that at present it would be impossible to substantially reform executive remuneration as investors have significantly different views and expectations on pay. We welcomed the work the German Corporate Governance Commission is undertaking on executive pay and mentioned our engagement with individual companies and the development of remuneration guidelines we are about to start.

Fiduciary duty

Lead engager: Will Pomroy

We participated in a roundtable, which was coordinated by the Centre for the Understanding of Sustainable Prosperity, to inform the subsequent deliberations of the European Commission's High-Level Expert Group on Sustainable Finance (HLEG) on fiduciary duty. The HLEG has been tasked by the president of the European Commission with proposing the necessary changes to legislation in order to reframe and clarify the fiduciary duties of financial institutions across the EU. The roundtable discussed the quality of advice provided to trustees, the need to be more explicit that the duty extends to stewardship and the merit of promoting the interests of beneficiaries irrespective of their expressed preferences, such as for example tackling climate change. We encouraged the participants to think practically and focus on removing existing impediments to the ability of investors to fulfil their fiduciary duty, such as the market practice of measuring and reporting short-term relative investment returns and poor governance standards across the asset owner and management industry.

Stewardship Code in Russia

Lead engager: Jaime Gornsztejn

In a presentation to senior staff at the Central Bank of Russia (CBR), we called for the development of a stewardship code in the country and shared examples of best practice from other emerging markets. We had been invited by the CBR to give a presentation on the role of institutional investors in promoting good corporate governance at their investee companies. As the capital markets regulator, the CBR had published the country's comply-or-explain corporate governance code in 2014 and is responsible for its enforcement. Similarly to other emerging markets, there has been little stewardship activity to date by institutional investors in Russia. We highlighted the fiduciary duty of asset owners and managers to be responsible investors in order to preserve and enhance the long-term value of their investments. We outlined our approach to stewardship, including on engagement and voting, and described the developments in emerging markets such as South Africa, Malaysia, Hong Kong and Brazil. Encouragingly, the CBR said that Russia plans to develop a stewardship culture too and asked us to deliver a second presentation as it builds its internal capacity, which we agreed to do.

Other work in this quarter included

Promoting best practice

- We discussed the allegations of misconduct in its South African business in relation to the **corruption scandal** involving the Gupta family with representatives of KPMG UK and South Africa. We pressed for a plan to effectively identify and address the governance and cultural issues in the South African unit and for a review of the processes in place to ensure that all affiliates are implementing the values which KPMG International promotes.
- We spoke at the Westminster Business Forum about board diversity, the voice of customers and the representation of workers. In advocating gender, ethnic and different forms of **diversity**, we highlighted the importance of cognitive diversity and the expectations from investors when company boards explain how they identify skills gaps among their directors. We encouraged companies to be specific and transparent about the skills they need based on their own stakeholder models and materiality assessments.
- At the steering committee meeting of the **Diversity Project**, we presented a best practice guidance framework for companies to submit their case studies, which covers the challenges faced, the lessons learned and the actions to be taken to improve diversity at the recruitment level. Our suggestions were received positively.
- We pushed for independent external board evaluations and promoted some of our ideas to reform **executive remuneration** at a high level corporate governance roundtable in Germany. During sessions on board composition and effectiveness, we highlighted the importance of investor dialogue with board members, in particular non-executive directors, in assessing the quality of the board. We also pointed out the importance of simplicity in executive pay packages.
- We accepted the invitation by NGO First Peoples Worldwide to participate in the **First Peoples Investor Engagement Project** study into the costs of the failure of the developers and financiers of the Dakota Access Pipeline to engage meaningfully with the Standing Rock Sioux Tribe to obtain free, prior and informed consent for the project.
- As a member of the advisory committee of the Handbook for Lawyers on Business and Human Rights initiative, we provided suggestions on the training materials for lawyers on **human rights** to the International Bar Association. We recommended the inclusion of the UN Guiding Principles Reporting Framework and Assurance Guide to give lawyers additional reference to put human rights considerations into practice. A pilot training session is set to take place in a face-to-face meeting in Australia in the first quarter of 2018. This is part two of the same initiative following the launch of the Handbook for Lawyers on Business and Human Rights, to which we had contributed.
- At a roundtable on the **living wage**, we spoke about the approach of long-term investors to the payment of the living wage by companies to their employees. We highlighted the business benefits, including the human capital advantages this can bring through increased retention, higher productivity and reduced reputational risk.
- We spoke at the conference of the **Responsible Minerals Initiative**, which focused on the conflict-free sourcing of raw materials in the supply chain of the electronics and other sectors. We argued that respecting the salient human rights of those within the supply chains of companies is not only the right thing to do ethically but is also good for business, as it reduces reputational and legal risks while enhancing the resilience of businesses.
- We welcomed the report submitted by the corporate governance committee of the **Securities and Exchange Board of India** with recommendations on corporate governance changes aimed at the better protection of shareholders and long-term value creation. The recommendations reflect our suggestions, such as the importance of separating the CEO and board chair. The report's recommendation to have one independent female director on a company board is also in line with our Corporate Governance Principles for India.
- In a meeting with the deputy CEO of the **Shanghai Stock Exchange**, we outlined best practice in relation to board refreshments, director nominations and stakeholder engagements. We criticised the lack of coherent standards and meaningful content in the ESG reports of A-share companies and encouraged them to provide reports in English.
- As the only representative from the investor community, we discussed the next phase of **supply chain audit** approaches at a conference hosted by the International Council on Mining and Metals. Since the conference of members of the Electronic Industry Citizenship Coalition in January 2017, we have been pushing decentralised ledgers that could potentially increase the efficiency and transparency of the conflict minerals supply chain and were therefore pleased about the progressive discussions.

Public policy

- The US Securities and Exchange Commission (SEC) gave final approval to the **auditor's report regulation**, as proposed by the Public Company Accounting Oversight Board (PCAOB) in 2016. In our consultation response to the PCAOB, we had advocated for significant changes to the existing auditor's report, including the communication of critical audit matters arising from the audit and new elements relating to auditor independence and tenure. Overall, the approved changes will enhance the form and content of the auditor's report by making it more relevant and informative to investors and other users of financial statements.
- We responded to the consultation on the review of the **Corporate Governance Code and related listing rules by the Hong Kong Stock Exchange**. We recommended that the stock exchange take concrete actions to enhance the transparency and accountability of the nomination and election process of independent non-executive directors. We also raised the overboarding of directors as a long-standing concern, recommending no more than five directorships for each director, and encouraged more guidance on the quality of disclosures to avoid boilerplate policy statements. Furthermore, we suggested that companies report on board committee actions and progress during the year. We pointed out that we expect companies to provide credible plans to improve their board diversity and recommended companies consider appointing a lead independent director, especially if they have a combined chair and CEO and one or more dominant shareholders.
- The Investor Working Group of the Sustainable Stock Exchanges initiative, of which we are a member, drafted a letter addressed to the chair of the International Organization of Securities Commissions (IOSCO) in support of the review of ESG issues that is taking place in its Committee 1 and Growth and Emerging Markets Committee. The group seeks to encourage IOSCO to issue global **ESG reporting guidance** following the review.
- In a meeting with the Financial Reporting Council, we encouraged the regulator to think outside the box when reviewing the **UK Stewardship Code**. We argued that now is the time to identify best practice in voting and engagement and encourage investors to consider undertaking stewardship activities that are demonstrably effective. The live preliminary consultation on the direction of the UK Stewardship Code will be followed by a more substantive one later in 2018.

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

In most cases of 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.

Hermes EOS makes voting recommendations at companies all over the world, wherever its clients own shares.

Overview

Over the last quarter we made voting recommendations at 1,128 meetings (7,952 resolutions). At 532 of those meetings we recommended opposing one or more resolutions. We recommended voting with management by exception at one meeting and abstaining at 10 meetings. We supported management on all resolutions at the remaining 585 meetings.

Global

We made voting recommendations at **1,128** meetings (**7,952** resolutions) over the last quarter.

- Total meetings in favour **51.9%**
- Meetings against (or against AND abstain) **47.2%**
- Meetings abstained **0.9%**
- Meetings with management by exception **0.1%**

Australia and New Zealand

We made voting recommendations at **214** meetings (**1,118** resolutions) over the last quarter.

- Total meetings in favour **54.7%**
- Meetings against (or against AND abstain) **45.3%**

Developed Asia

We made voting recommendations at **95** meetings (**541** resolutions) over the last quarter.

- Total meetings in favour **60.0%**
- Meetings against (or against AND abstain) **40.0%**

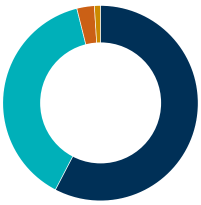
Emerging and Frontier Markets

We made voting recommendations at **459** meetings (**3,111** resolutions) over the last quarter.

- Total meetings in favour **52.3%**
- Meetings against (or against AND abstain) **46.6%**
- Meetings abstained **1.1%**

Europe

We made voting recommendations at **104** meetings (**873** resolutions) over the last quarter.



- Total meetings in favour **57.7%**
- Meetings against (or against AND abstain) **38.5%**
- Meetings abstained **2.9%**
- Meetings with management by exception **1.0%**

North America

We made voting recommendations at **175** meetings (**1,428** resolutions) over the last quarter.

- Total meetings in favour **41.1%**
- Meetings against (or against AND abstain) **58.3%**
- Meetings abstained **0.6%**

United Kingdom

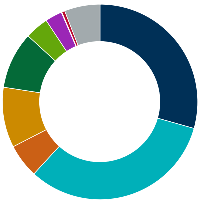
We made voting recommendations at **81** meetings (**881** resolutions) over the last quarter.

- Total meetings in favour **48.1%**
- Meetings against (or against AND abstain) **50.6%**
- Meetings abstained **1.2%**

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

Global

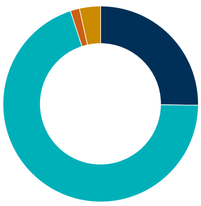
We recommended voting against or abstaining on **1,296** resolutions over the last quarter.



- Board structure **29.4%**
- Remuneration **32.5%**
- Shareholder resolution **5.6%**
- Capital structure and dividends **10.0%**
- Amendment of articles **9.4%**
- Audit and accounts **3.9%**
- Governance **2.8%**
- Investment/M&A **0.1%**
- Poison pill/Anti-takeover device **0.5%**
- Other **5.9%**

Australia and New Zealand

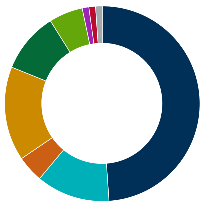
We recommended voting against or abstaining on **202** resolutions over the last quarter.



- Board structure **25.2%**
- Remuneration **69.8%**
- Shareholder resolution **1.5%**
- Capital structure and dividends **3.5%**

Developed Asia

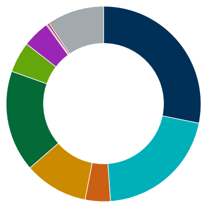
We recommended voting against or abstaining on **90** resolutions over the last quarter.



- Board structure **48.9%**
- Remuneration **12.2%**
- Shareholder resolution **4.4%**
- Capital structure and dividends **15.6%**
- Amendment of articles **10.0%**
- Audit and accounts **5.6%**
- Governance **1.1%**
- Poison pill/Anti-takeover device **1.1%**
- Other **1.1%**

Emerging and Frontier Markets

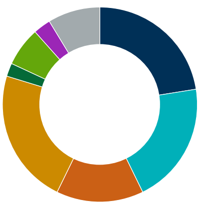
We recommended voting against or abstaining on **624** resolutions over the last quarter.



- Board structure **28.2%**
- Remuneration **20.7%**
- Shareholder resolution **4.2%**
- Capital structure and dividends **10.6%**
- Amendment of articles **16.8%**
- Audit and accounts **5.1%**
- Governance **4.5%**
- Investment/M&A **0.2%**
- Poison pill/Anti-takeover device **0.3%**
- Other **9.5%**

Europe

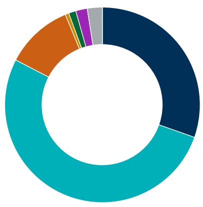
We recommended voting against or abstaining on **138** resolutions over the last quarter.



- Board structure **22.5%**
- Remuneration **20.3%**
- Shareholder resolution **14.5%**
- Capital structure and dividends **22.5%**
- Amendment of articles **2.2%**
- Audit and accounts **6.5%**
- Governance **2.9%**
- Other **8.7%**

North America

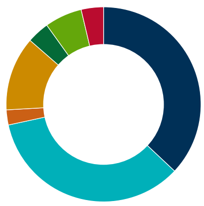
We recommended voting against or abstaining on **161** resolutions over the last quarter.



- Board structure **30.4%**
- Remuneration **52.2%**
- Shareholder resolution **11.2%**
- Capital structure and dividends **0.6%**
- Amendment of articles **1.2%**
- Governance **1.9%**
- Other **2.5%**

United Kingdom

We recommended voting against or abstaining on **81** resolutions over the last quarter.



- Board structure **37.0%**
- Remuneration **34.6%**
- Shareholder resolution **2.5%**
- Capital structure and dividends **12.3%**
- Amendment of articles **3.7%**
- Audit and accounts **6.2%**
- Poison pill/Anti-takeover device **3.7%**

What is Hermes EOS?

Hermes EOS helps long-term institutional investors around the world to meet their fiduciary responsibilities and become active owners of public companies. Our team of engagement and voting specialists monitors the investments of our clients in companies and intervenes where necessary with the aim of improving their performance and sustainability. Our activities are based on the premise that companies with informed and involved shareholders are more likely to achieve superior long-term performance than those without.

Pooling the resources of other like-minded funds creates a strong and representative shareholder voice and makes our company engagements more effective. We currently act on behalf of 42 clients and £336.2/€378.7/$454.7 billion* in assets under advice.

Hermes has one of the largest stewardship resources of any fund manager in the world. Our 26-person team includes industry executives, senior strategists, corporate governance and climate change experts, accountants, ex-fund managers, former bankers and lawyers.

The depth and breadth of this resource reflects our philosophy that stewardship activities require an integrated and skilled approach.

Intervention at senior management and board director level should be carried out by individuals with the right skills, experience and credibility. Making realistic and realisable demands of companies, informed by significant hands-on experience of business management and strategy-setting is critical to the success of our engagements.

We have extensive experience of implementing the Principles for Responsible Investment (PRI) and various stewardship codes. Our former CEO led the committee that drew up the original principles, and we are engaged in a variety of workstreams through the PRI Collaboration Platform. This insight enables us to help signatories in meeting the challenges of effective PRI implementation.

How does Hermes EOS work?

Our company, public policy and best practice engagement programmes aim to enhance and protect the value of the investments of our clients and safeguard their reputation. We measure and monitor progress on all engagements, setting clear objectives and specific milestones for our most intensive engagements. In selecting companies for engagement, we take account of their environmental, social and governance risks, their ability to create long-term shareholder value and the prospects for engagement success.

The Hermes Responsible Ownership Principles[1] set out our fundamental expectations of companies in which our clients invest. These cover business strategy, communications, financial structure, governance and management of social, ethical and environmental risks. The engagement programme we have agreed with our clients, as well as the Principles and their regional iterations, guide our intervention with companies throughout the world. Our approach is pragmatic, as well as company- and market-specific, taking into account the circumstances of each company.

We escalate the intensity of our engagement with companies over time, depending on the nature of the challenges they face and the attitude of the board towards our dialogue. Some engagements involve one or two meetings over a period of months, others are more complex and entail multiple meetings with different board members over several years.

At any one time around 400 companies are included in our core engagement programme. All of our engagements are undertaken 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 acts as a 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.

We would be delighted to discuss Hermes EOS with you in greater detail.

For further information, please contact:

Head of EOS Dr Hans-Christoph Hirt on +44(0)207 680 2826

* as of 31 December 2017

[11] https://www.hermes-investment.com/ukw/stewardship/eos-literature/

Hermes EOS team

Engagement

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Head of EOS

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Bruce Duguid
Sector lead: Utilities

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Dr Michael Viehs
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Client Relations

Rochelle Giugni
Client Relations

Alice Musto
Client Relations

Report written and produced by Nina Röhrbein

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

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