

Dear Sir/Madam

EOS at Federated Hermes engages with companies around the world on behalf of global institutional investors, representing assets of €1.5tn (30 September 2021). We aim to deliver sustainable wealth creation that enriches investors, benefits society and preserves the environment – for current generations and those to come. This aim informs our expectations of the companies in which we and our clients are invested.

It is our strong belief that companies can only create and preserve long-term, good quality returns for investors if they provide goods and services that sustainably solve societal needs, guided by a clear purpose that serves not only shareholders, but also other stakeholders, society and the environment. Doing this effectively requires robust governance and a healthy culture, with leadership that sets the right tone from the top and emphasizes ethical values across the organization.

### German Corporate Governance Principles

Our expectations are set out in more detail in our 2022 German Corporate Governance Principles, which are enclosed. We would like to highlight the following expectations for Germany-listed companies in 2022:

- **Climate change:** Earlier this year, the international business of Federated Hermes signed up to the Net Zero Asset Managers initiative (NZAM). This initiative now has the support of 220 signatory managers with \$57 trillion of assets under management<sup>1</sup> (55% of global AUM). Signatories to NZAM have committed to “implement a stewardship and engagement strategy, with a clear escalation and voting policy, that is consistent with [the] ambition for all assets under management to achieve net zero emissions by 2050 or sooner.” In 2022, we will continue to hold management boards accountable through our voting against the discharge where we believe companies’ actions are materially misaligned with the goals of the Paris Agreement, where company disclosures or responsiveness are insufficient. We assess companies using a range of frameworks and benchmarks, including the Transition Pathway Initiative (TPI),<sup>2</sup> the Climate Action 100+ benchmark,<sup>3</sup> Forest 500<sup>4</sup> and others. In principle, we support the emergence of so-called ‘Vote on Transition’ or ‘Say on Climate’ resolutions and will support those plans aligned to the goals of the Paris Agreement, as indicated by short, medium and long-term science-based greenhouse gas reduction targets and a clear and credible strategy to achieve these.
- **Diversity, equity and inclusion:** Many companies continue to fall short of reflecting the diversity of society on their boards, in senior management and throughout the workforce. We strongly advocate for supervisory and management boards of diverse composition, in its broadest sense, and for the execution of meaningful workforce-level diversity, equity and inclusion strategies. In 2022, we will expand our policy to recommend voting against resolutions at companies that we judge to be making insufficient progress on diversity, including:

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<sup>1</sup> [Net Zero Asset Managers Initiative - Home](#)

<sup>2</sup> <http://www.lse.ac.uk/GranthamInstitute/tpi/the-toolkit/>

<sup>3</sup> <https://www.climateaction100.org/progress/net-zero-company-benchmark/>

<sup>4</sup> <https://forest500.org/>

- We expect at least 30% representation of each gender on the supervisory board, in line with legal requirements, and will generally recommend voting against the election of shareholder representatives and/or the discharge of the chair of the supervisory board where this is not the case.
- We expect companies to work towards 30% representation of each gender on the management board and make robust plans to develop a pipeline of strong female candidates. We will generally recommend voting against the discharge of the supervisory board for DAX40 and MDAX companies that have no female directors on the management board.
- **Human and labour rights:** How a company manages its human rights strategy is of critical importance to its license to operate, its impact on people's lives and ultimately its ability to create and preserve long-term holistic value. Starting in 2022, we will consider recommending votes against relevant proposals, including the election of directors or their discharge, where a company is in clear breach of its applicable regulatory responsibilities or those outlined in the UN Guiding Principles on Business and Human Rights, and/or if there is sufficient evidence that a company has caused or contributed to egregious, adverse human rights impacts or controversies and has failed to provide appropriate remedy.
- **Executive pay:** We continue to make the case for simpler pay schemes aligned to long-term strategy and the desired culture in the organization, with an emphasis on long-term share ownership for executives. We seek to understand how executive remuneration decisions are made with consideration to a company's broader stakeholders and expect the board to intervene and apply appropriate discretion where pay outcomes do not align with these expectations. In our 2022 voting guidelines for Germany, consistent with previous years, when a remuneration system does not show sufficient progress towards our expectations, we will recommend voting against the policy and under certain circumstances escalate to voting against the discharge of the chair of the supervisory board. Insufficient progress could, for instance, be demonstrated by a lack of shareholding guidelines for the management board, misalignment of pay and performance, over-reliance on financial as opposed to strategic metrics in the long-term incentive plan or an absence of absolute caps for total remuneration.

We welcome any comments and observations on our 2022 Corporate Governance Principles and would be glad to answer any queries or concerns that may arise.

Yours sincerely,



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# Corporate Governance Principles

**Germany**

Our expectations of  
German-listed companies

**EOS at Federated Hermes  
2022**

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## Corporate Governance Principles: Our expectations of publicly-listed companies in Germany

2022

### INTRODUCTION

EOS at Federated Hermes is a stewardship service provider representing a broad range of long-term institutional investors. EOS clients seek to be active stewards of their beneficiaries' assets by being active owners of shares or debt of the companies in which they invest. EOS engages with our clients' investee companies around the world to promote long-term, sustainable returns to investors, their beneficiaries, and other stakeholders.

These Principles express our expectations of board directors and companies across a number of important strategic and governance topics, focusing on areas which will inform the policies which guide our voting recommendations for 2022.

This document is not exhaustive. More detail on our expectations, particularly on environmental and social topics, can be found in our Public Engagement Plan,<sup>1</sup> which is updated annually.

### COMPANY PURPOSE, CULTURE AND ETHICAL LEADERSHIP

The supervisory and management boards must set and find effective ways to oversee the values of the organisation, that must be founded on ethical integrity. Ethical considerations must underpin every decision made by the board. For example, the supervisory board must ensure that the CEO of the company has the highest ethical standards and must not accept any lapses in that expectation during the CEO's time in office or beforehand, performing sufficient due diligence and having strong contractual provisions to enable the board to take sufficient action, including clawing back pay and dismissal for cause, should unethical behaviour come to light.

The supervisory and management boards must ensure that a system exists to take multiple different soundings of the culture and micro-cultures in different parts of the organisation and guarantee that both the management board take action to improve the culture where it is not aligned with the supervisory board's expectations. This should include robust and accessible whistleblowing systems together with a demonstrable commitment to protect those that use such systems.

It is our strong belief that companies can only create and preserve long-term, good quality returns for investors if they provide goods and services that sustainably solve societal needs. To achieve this, we expect companies to be guided by a purpose that serves not only shareholders, but also other stakeholders, society and the environment. Achieving this purpose will, in turn, require a healthy culture and an emphasis on ethical values across the organisation. The pursuit of a stakeholder-inclusive purpose in support of long-term societal interests will then help protect the long-term interests of the

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<sup>1</sup> The latest public version of the EOS Engagement Plan can be found at: [www.hermes-investment.com/stewardship/eos-library](http://www.hermes-investment.com/stewardship/eos-library)

savers and pensioners – current and future – invested in companies, who require sustainable financial returns and an economy, society and environment which can provide a secure future. This will require review of those critical ESG-related issues of concern to the company and its stakeholders, such as climate change or human rights, through an ethical lens.

A clear and meaningful business purpose should enable business leaders to identify the right things to do in the short term, in order to fulfil their purpose over the long term. This is critical in a time of crisis – such as that caused by the Covid-19 pandemic – when difficult trade-offs arise, particularly between shorter-term financial returns and maintaining strong relationships with key stakeholders, including government, the workforce, customers and supply chains.

As the effects of the pandemic continue to be felt around the world, it remains vital that boards and executive teams continue to consider their key stakeholders and their organisation's purpose, and make decisions that best support sustainable returns over the long-term. Companies need to be able to explain their decisions affecting key stakeholders. This includes the most difficult decisions, such as redundancies, but also how they allocate capital, including dividend payments and share buybacks.

We expect management boards to consider and disclose capital allocation policy in the context of a company's purpose and long-term strategy. We are concerned that buybacks and similar diversions from re-investment in key stakeholders may be chosen to improve the share price or other related metrics over the short-term but are not always the best use of capital to support the creation of long-term, sustainable returns.

We are supportive of alternative corporate structures that explicitly mandate the consideration of key stakeholders alongside shareholders, where companies believe this to be beneficial in service of their purpose.

### **Stewardship and engagement**

Investors must act as responsible stewards and promote long-term sustainable returns on investment through constructive engagement with companies and their directors. All substantive correspondence from major institutional investors' representatives should be shared promptly with all supervisory board members to help directors fulfil their role to safeguard the interests of all shareholders. Our experience has shown that dialogue between companies and committed, long-term investors on strategy, finance, risk management and material environmental, social and governance (ESG) issues can improve the governance and performance of companies. Developing relationships of trust with long-term shareholders can be invaluable for supervisory and management boards, and we expect supervisory board chairs, and other shareholder representatives where appropriate, to make themselves available for investor engagement, beyond opportunities at formal shareholder meetings.

We expect companies to engage with long-term investors across a range of asset classes, including different types of corporate debt, in addition to their shareholders. Companies should now recognise that the expectations of debt investors are similar to those of long-term shareholders and substantially aligned in relation to governance, long-term strategy, capital allocation and environmental and social matters. Debt investors now expect accountability and constructive dialogue on opportunities and risks which might enhance or impair earnings and cashflow.

We support the recommendation of the revised German Corporate Governance Code (the Code) stipulating that chairs of supervisory boards should be available for investor dialogue (suggestion A.3).<sup>2</sup> Our expectations of the format and content of communication between supervisory boards and investors are shaped by the *Guiding Principles for the Dialogue between Investors and German Supervisory boards*<sup>3</sup> which we developed in collaboration with key stakeholders. We encourage companies to refer to these guiding principles, which outline key features of this dialogue such as participants, content and format.

### BOARD COMPOSITION AND EFFECTIVENESS

Supervisory boards should ensure they comprise members with strong ethics and diverse skills, experience, perspectives and psychological attributes, as well as sufficient independence and strength of character to challenge, as well as advise and support executive management teams. They should ensure overall composition and individual membership of the supervisory board is frequently reviewed and refreshed, and that directors are elected and re-elected by shareholders on a regular basis to ensure accountability. Biographies for all directors should be provided to shareholders, indicating which are considered independent and the particular attributes that they bring to the board. This should be accompanied by an analysis of how the supervisory board as a whole displays the necessary skills, independence, diversity and other attributes to meet the company's evolving needs.

#### Effectiveness

Disclosure of measurable aspects of supervisory boards, such as those outlined below, are important but insufficient indicators of a board's functionality.

Engagement with supervisory board directors provides a valuable opportunity for investors to sufficiently assess how well a board is functioning. Our white paper, *Guiding Principles for an Effective Board*,<sup>4</sup> highlights the factors that we consider to be most important in determining board effectiveness, focusing on the human, relational, and behavioural elements that are more difficult to assess.

They can be summarised as follows:

- Genuine independence, diversity and inclusion support directors' ability to effectively question long-held assumptions and mitigate the risk of groupthink.

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<sup>2</sup> Deutscher Corporate Governance Kodex, 9 May 2019, German and English version available at <https://www.dcgk.de/en/code/code-2019.html>

<sup>3</sup> Leitsätze für den Dialog zwischen Investor und Aufsichtsrat, German and English version available at <https://www.dirk.org/ir-wissen/neuigkeiten/idx/1239/leitsatze-fur-den-dialog-zwischen-investor-und-aufsichtsrat>

<sup>4</sup> <https://www.hermes-investment.com/wp-content/uploads/2020/04/guiding-principles-for-an-effective-board-april-2020.pdf>

- The role of the chair should be held by an independent director to support the overall conditions for board effectiveness, which includes setting and enforcing the expectations for a board culture that is based on mutual respect, openness and trust, and encouraging diverse voices and behaviours of independent thinkers.
- How the supervisory board allocates its time spent in board meetings and between board meetings is equally important. We expect a supervisory board to maximise the time spent reviewing strategy and other forward-looking activities during structured board meetings, committee work, site visits and engagement with stakeholders.
- The supervisory board's relationship with the CEO should ideally be characterised by transparency, trust and constructive collaboration, and the board should build relationships with the wider workforce through formal and informal channels.
- A commitment to continuous improvement should be encouraged and supported through regular board evaluations, and disclosure should strike a balance between transparency and confidentiality.

### Evaluation

We expect supervisory boards to be committed to continuous improvement and therefore to be constantly reflecting on their performance. We encourage supervisory boards across markets and corporate structures to conduct regular evaluations with the goal of enhancing board effectiveness. We endorse the Code's recommendation that the supervisory board should undertake a regular process of evaluation, and we recommend an independent evaluation at least every three years. When conducted with this intention, and not simply as a compliance exercise, the evaluation process offers a unique opportunity for the board to pause, reflect and optimise its performance. The supervisory board should embrace the evaluation process as an opportunity to recalibrate focus, identify skills gaps on the board, highlight the need for succession, and raise concerns related to performance and culture.

Furthermore, conducting regular board evaluations signals to investors that the supervisory board is open to constructive criticism and willing to improve. We recommend that independent external board evaluations are conducted at least once every three years, with internal evaluations conducted in the interim years. The supervisory board should implement an action plan and a clear timeline for addressing the points raised in the evaluation. Disclosure should demonstrate how the supervisory board has taken the necessary steps to enhance performance and provide reassurance to investors about the quality of the board evaluation.

### Management board chair progressing to supervisory board chair

It used to be widespread practice in Germany that the chair of the management board (the CEO) became chair of the supervisory board after retiring from day-to-day management. There may be a case for appointing a successful former chair of the management board to the supervisory board, not least because he or she will have an in-depth knowledge of the company. However, the roles of

chair of the supervisory board and chair of the management board, as well as the competencies, knowledge and experience required for these posts, differ significantly and are thus generally best served by individuals with different characteristics.

The supervisory board chair plays a vital oversight, challenge and mentoring role, which is different from the executive function of the management board chair. Furthermore, conflicts of interest may arise where a supervisory board chair has to lead a review of decisions taken during, or issues that relate to, his or her tenure on the management board.

We therefore believe that, as a general rule, the chair of the management board should not become supervisory board chair and, for similar reasons, not become a member of the audit committee. By adopting this approach, the potential for conflicts of interest is reduced. Instead, a successful former chair of the management board could be proposed for election as an ordinary member of the supervisory board.

In cases where it is proposed that the former chair of the management board becomes the chair of the supervisory board, we do see value in a two year "cooling-off" period. We support the recommendation of the Code C.10 that the chair of the supervisory board, as well as chairs of the audit and remuneration committee shall be independent from the company and the management board. Criteria for independence recommended by the Code include, among others, that the individual was not a member of the company's Management Board in the two years prior to appointment (C.7). However, we believe that this two-year period may in exceptional cases lead to the loss of valuable experience and relevant knowledge from the supervisory board, potentially resulting in the diminishing rather than a strengthening of the board's efficiency. Any exception should be discussed with investors extensively giving providing a clear rationale.

### **Independence and tenure**

On all supervisory boards, we expect a strong core of independent directors, to ensure that stakeholder interests are protected, to exercise objective judgement and, if necessary, to act as agents for change. This group should play an important role in holding the management board to account and in the identification of candidates as proposed shareholder representatives on the supervisory board. It should be empowered to meet independently, including before and after board meetings, and should do so in practice. It should be granted unfettered access to members of management, information and resources as required. Shareholder representatives serving on the audit and remuneration committees should be independent.

The independent directors should constitute the majority of the shareholder representative directors on the supervisory board. Employee representatives are required by law for companies that have over 2000 employees. As employee representatives are considered non-independent, the level of independence of the entire supervisory board should be at least one third. This means at least two-thirds of the shareholder representative directors should be independent.

Ensuring sufficient levels and quality of independence is particularly important for founder-led companies, those with executive or non-independent chairs, significant shareholder representatives on the supervisory board (which we believe can be useful and justified, provided minority shareholder interests are protected). In such cases of controlled ownership we expect at least one third of the shareholder representative directors on the supervisory to be independent, but encourage controlled companies to consider a minimum of at least half of the shareholder representatives to be independent. However, we place real emphasis on quality, not quantity of independence. We do not support the disproportionate representation of significant shareholders. In their disclosures, companies should clearly state which directors they consider to be independent and the criteria by which independence is determined.

We expect a healthy mixture of tenures on supervisory boards, supported by regular board refreshment. We consider the overall composition of boards and recognise the value that long-serving directors can contribute. However, too many directors serving concurrently can increase the risk of groupthink and complacency. We concur with the Code states that directors are no longer considered independent after completing a tenure of 12 years.

### **Committees**

We expect larger supervisory boards (typically of eight or more directors) to have specific board committees covering audit, executive remuneration and board nominations, as well as a risk committee where relevant. For some companies, additional committees may be required to cover other material issues, for example a sustainability committee for highly environmentally-exposed companies. For those smaller supervisory boards that choose to address these matters at full board meetings, there should be clear narrative reporting to demonstrate these receive adequate time and attention.

### **Director attendance and commitment**

We expect supervisory board directors to be able to devote sufficient time to fulfil their duties, including to build and maintain a good understanding of the company and to fully absorb and be able to challenge the information presented to them by the management board. As a broad guideline, we do not support directors holding more than five directorships at public companies and, in this context, we consider a non-executive chair role to be roughly equivalent to two directorships and, at complex companies, other committee chair roles, in particular the chair of the audit and risk committee, may be considered more burdensome than a typical non-executive directorship.

Whether a director may be over-committed depends on a range of factors beyond the number of other roles they hold, including the size and complexity of the company and additional responsibilities, such as being a committee chair. We consider that certain industries such as banking (due to its business model and regulatory complexity) and businesses with large and/ or complex operations will require site visits and therefore more time commitment.

We expect companies to encourage their executives to take on a non-executive role (but not normally more than one) outside their own company to assist in their development, bring current experience to boards and to build a pipeline of future board directors.

### **Succession planning**

Effective succession planning at the supervisory and management board level, as well as senior leadership is essential for safeguarding the ability of companies to deliver long-term returns. It should involve contingency planning for the sudden loss of key personnel, as well as planning for foreseeable change such as impending retirement. It should include consideration of the current and future required diversity of skills, experience and other attributes required at board and senior management level, including the need for any candidate to demonstrate the highest levels of ethical integrity. Robust succession planning also can help to counter the tendency of many boards to over-pay current executives relative to the senior executive labour market and peers.

Overseen by the supervisory board, the management board should create a pipeline of suitable candidates from within the organisation to become senior managers and executives.

### **Granting discharge**

The discharge of the management board and of the supervisory board are standard voting items on the agenda of annual shareholder meetings and can be regarded as an approval of the actions and performance of their members, either bundled or individualised. We believe that there should be repercussions whenever shareholders do not strongly support the discharge of a supervisory or management board member, or the board in its entirety in the case of bundled elections. Whenever a member of the supervisory board has lost the confidence of a significant percentage of shareholders, he or she should, as a minimum, not be permitted to be chair or vice chair of the supervisory board or a member of any of its committees. Any supervisory board member, whose discharge was not unequivocally supported during his or her tenure, should generally not be proposed to shareholders for re-election.

If a member of the management board has lost the confidence of a significant percentage of shareholders, the supervisory board should consider whether, as a minimum, refreshment of the management board is required.

We see voting against the discharge as a warning gesture; somewhat similar to giving a yellow card in a football match. We will recommend a vote against the discharge to express our dissatisfaction with one or more actions taken (or not taken) and/or with a disappointing performance of the management and/or supervisory board member, before using other escalation mechanisms.

## DIVERSITY, EQUITY AND INCLUSION

Beyond the clear moral and ethical imperative, the system-wide benefits of social and economic inclusion and the risks of continued exclusion, a growing body of evidence supports the link between more diverse company leadership and financial performance.<sup>5</sup> We believe improving diversity, equity and inclusion performance, both in at the leadership level and the wider organisation, creates enduring value by improving decision-making, attracting talent, enhancing workforce satisfaction and stimulating insight and innovation.<sup>6</sup>

Recent tragic events, including George Floyd's murder in the US in May 2020, have brought into focus glaring racial and ethnic injustices around the world that are reflected on boards and in workforces, including those of companies' suppliers and in unfair impacts of business practices on diverse communities. In many parts of the world, Mr Floyd's death triggered difficult conversations that exposed barriers, in the workplace and elsewhere, faced by diverse groups, including but not limited to race, ethnicity, gender, sexual orientation, age, disability, nationality and socioeconomic background; and highlighted the additional challenges that individuals who belong to multiple diverse groups experience. It also focused attention on the need to build more inclusive company cultures that dismantle obstacles and enable all individuals to thrive and maximise their contributions to their companies, communities and society.

Discrimination against persons from different ethnic and migration backgrounds is an issue that must be addressed in Germany. 13.3% of Germans are considered to have a "migrant background," while 12.1% of the population is foreign.<sup>7</sup> The 2019 annual report of the German Federal Anti-Discrimination Agency (ADS),<sup>8</sup> highlights that ethnicity is the category of discrimination which receives the most requests for advice, and the number of reported cases of racial discrimination has risen by almost 10% in the year. A key hinderance for companies to address ethnic diversity in their workforce to date has been the lack of data collection both in census data and by companies themselves.

In 2022 we will continue tightening our voting policies and thresholds on diversity, as we believe most companies need to improve their diversity towards representation of all groups throughout all roles and levels. Supervisory and management boards should seek diverse composition in its broadest sense to support high-quality debate and decision-making, considering diversity of skills, experience, networks, psychological attributes and characteristics (including, but not limited to, race, ethnicity, gender, sexual orientation, age, disability, nationality and socioeconomic background). Supervisory boards should give careful consideration to how they can find members from outside of their typical networks and the breadth of attributes or perspectives that may be valuable to their decision-making.

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<sup>5</sup> For example, The 30% Club has compiled a list of studies examining the benefits of gender diversity <https://30percentclub.org/initiatives/investor-group>

<sup>6</sup> [Delivering growth through diversity in the workplace | McKinsey](#)

<sup>7</sup> German Federal Statistical Office 2019, quoted in <https://www.dw.com/en/is-insufficient-data-germanys-biggest-hurdle-to-tackling-workplace-discrimination/a-50130289>

<sup>8</sup> [https://www.antidiskriminierungsstelle.de/SharedDocs/Downloads/DE/publikationen/Jahresberichte/2019\\_englisch.pdf?\\_\\_blob=publicationFile&v=4](https://www.antidiskriminierungsstelle.de/SharedDocs/Downloads/DE/publikationen/Jahresberichte/2019_englisch.pdf?__blob=publicationFile&v=4)

We will consider diversity and inclusion at the different levels of the company, starting with the supervisory and management board in our analysis of company performance that informs our voting recommendations. As a first step we will look to discuss challenges the company faces and plans to address these. In future, we may recommend a vote against the chair of the supervisory board where the board, and management boards and broader senior management teams are clearly not representative of society, including representation of minorities.

We welcome recent regulatory mandates and voluntary commitments in some countries on ethnic as well as gender diversity. For example, in August 2021, the US Securities and Exchange Commission (SEC) approved Nasdaq's Board Diversity Rule, which requires disclosure of board diversity statistics and at least two diverse directors including one female and one under-represented racial minority or LGBTQ+ director.<sup>9</sup> The integration of targets for representation of people of colour and women by the UK chapter of the 30% Club encourages boards to strategically prioritise racially- and ethnically-diverse director recruitment and set thresholds for gender representation at board and executive committee levels. However, we note that some racial and ethnic groups are much less likely to obtain board roles than others, reflecting societal bias and we expect boards to address these biases. Therefore, even where regulations exist we expect boards to actively address biases and enable inclusion.

In Germany, we believe that supervisory and management boards should have achieved a minimum of 30% female representation as a first step to gender equality. As such, we support the intentions of the "law for the equal participation of women and men in leadership positions,"<sup>9</sup> which introduced a mandatory gender quota of 30% at the supervisory board level in 2016. We have been deeply concerned that voluntary targets for senior executives and management boards show a lack of ambition and progress. Therefore, we support the second law on women in management positions (Zweites Führungspositionen-Gesetz - FüPoG II)<sup>10</sup> that entered into force on 12<sup>th</sup> August 2021. This law stipulates a minimum of one woman on the management board for companies that are publicly listed and codetermined, if this board has more than three members. Progress on gender diversity in Germany is urgently needed,<sup>11</sup> especially for listed companies.<sup>12</sup>

We will seek a dialogue with companies to discuss their plans to promote greater diversity at different levels of the organisation. Where new appointments do not show sufficient progression towards 30% women on the supervisory board, we may recommend a vote against a directors' appointment. On the management board, we expect at a minimum one female director for DAX and MDAX companies in 2022. We will consider recommending a vote against the discharge of the chair of the supervisory board if there are no female directors on the

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<sup>9</sup> [BMFSFJ - Gesetz für die gleichberechtigte Teilhabe von Frauen und Männern an Führungspositionen in der Privatwirtschaft und im öffentlichen Dienst](#)

<sup>10</sup> [BMFSFJ - Zweites Führungspositionen-Gesetz - FüPoG II](#)

<sup>11</sup> [AIIBrightBericht\\_Herbst+2020.pdf \(squarespace.com\)](#)

<sup>12</sup> [AIIBright-Bericht-Juni-2021\\_Börsenneulinge.pdf \(squarespace.com\)](#)

management board and the company has not communicated plans to rectify this imbalance.

We expect supervisory and management boards not only to address their own diversity, but that of the whole organisation and its impacts on stakeholders; and to provide meaningful disclosure assessing progress against complex challenges.

In 2022, we will hold supervisory and management boards accountable for more effective oversight of inclusive culture and diversity across all levels of the company's workforce and effects on the ecosystem upon which the company's long-term health depends, including suppliers, customers and communities. When developing director voting recommendations, we will take into account a range of considerations. From a workforce perspective, these may include, but are not limited to, diversity on the management board, broader senior leadership team members and talent pipeline; the existence of a thoughtful diversity, equity and inclusion strategy, targets and action plan rooted in rigorous analysis of underlying problems that incorporates employee survey data; and a board-driven process for evaluating management's inclusion performance and issues surrounding all strands of diversity across the employee lifecycle.

## EXECUTIVE REMUNERATION

We are increasingly concerned that executive remuneration structures and practices in a number of countries are not fit for purpose, neither serving long-term investors nor aligning properly with the core long-term objectives of companies, and that poor practices are at risk of spreading to other countries where pay is more restrained.

Some of our key concerns relate to the limitations of 'pay for performance' models, which are common in countries like the US and the UK and which we see increasingly adopted in other countries. Although perhaps well-intentioned, this approach risks damaging, unintended consequences, including:

- Increasing quantum beyond the executive labour market median, and expanding pay disparities between executives and the broader workforce
- Encouraging short-termism or financial engineering, particularly in schemes which focus on share options or where large proportions of pay are subject to metrics like total shareholder return or earnings per share, which can focus executives on actions to drive up the share price in the short-term rather than on drivers of long-term strategic value. Focusing large portions of pay on incentive schemes risks strongly incentivising executives to hit targets over relatively short time frames, regardless of whether these actions are best aligned to long-term, high-quality sustainable returns to shareholders and other stakeholders.
- Obscuring meaningful assessments of performance in the context of long-term value due to the use of complex, overlapping incentive schemes.
- Undeserved windfall gains for executives which can result from share-based incentive schemes, which has occurred at many companies as a

result of the market rally that followed government interventions in the wake of the Covid pandemic.

We continue to make the case for switching to simpler pay schemes aligned to long-term success and the desired culture in the organisation, based on a combination of fixed pay and long-term time-restricted stock, with an emphasis on long-term share ownership for executives.

We expand on our views on executive pay in our paper, *Remuneration Principles: Clarifying Expectations*.<sup>13</sup>

They can be summarised as follows:

1. **Simplicity:** Pay should be simple; for example, fixed pay (mix of cash and long-term shares) plus a single incentive scheme (an annual bonus).
2. **Alignment:** Pay should be aligned to long-term strategy and the desired corporate culture, incentivising long-term value creation, including wider social and environmental outcomes. Where metrics and targets are used in incentive pay, they should reflect strategic goals, rather than focus attention on total shareholder return, stock price appreciation or earnings per share.
3. **Shareholding:** Management should become long-term stakeholders in the company's success through substantial shareholdings. Significant shareholding requirements should remain in place for at least two years following departure from the company.
4. **Accountability:** Pay outcomes should reflect outcomes for long-term investors and take account of falls in a company's performance or reputation. The board should intervene and apply discretion whenever formulaic outcomes do not achieve this. The potential pay outcomes under a policy should be rigorously scenario tested in advance, with a cap on the total possible pay published, to help reduce the risk of unintended consequences.
5. **Stewardship:** Pay outcomes should be communicable to all stakeholders, including employees and the public. Boards should take into account wider workforce pay practices and ratios when judging the appropriateness of pay opportunities and outcomes. Boards should then write to employees each year explaining the outcomes of executive pay and the alignment to long-term value, and the company's strategy and purpose. Companies and investors should regularly discuss strategy, long-term performance and the link to executive pay.

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<sup>13</sup> <https://www.hermes-investment.com/wp-content/uploads/2018/10/remuneration-principles-clarifying-expectations.pdf>. The principles contained in this paper are global in nature, but some of the specific references to structures are more applicable to certain markets such as the UK.

In 2018, EOS worked with a group of key stakeholders, including chairs of several DAX companies and the main German institutional investors, to devise simple, sustainability-focused, best practices guidelines for management board remuneration at German listed companies.<sup>14</sup> These Guidelines for sustainable management board remuneration systems build on the principles of the Code and best practice examples. They provide guidance for the design of remuneration policies, reporting and investor engagement. They represent a compromise between different stakeholders, as well as more ambitious recommendations that we strongly support. In 2021, the working group on remuneration in Germany EOS is participating in has also published a white paper providing guidance on ESG metrics “Nachhaltigkeit, ESG-Ziele und deren Verankerung in der Vorstandsvergütung.”<sup>15</sup>

While we do not automatically oppose all pay models that do not appear to align to our principles, we set various thresholds and requirements to guide our voting recommendations which are tailored to the context of each market. Through engagement with companies on these thresholds and requirements, we seek to improve market practice and encourage closer alignment with our principles.

At present, in Germany we take the approach of setting a number of pragmatic guidelines and thresholds in our voting policy to improve market practice and encourage closer alignment with our principles. In 2022 we will consistently apply key expectations communicated in 2021 including:

- **Executive shareholdings:** Management board members and senior executives should be required to invest in or be paid in shares and hold a significant amount of equity over the long term. Ownership of shares over the long term is the best form of alignment between executives and shareholders. We expect companies to move towards shareholding requirements of an absolute minimum of 300% of gross fixed salary for management board members or 500% of gross fixed salary for CEOs. We may vote against a remuneration policy that has no specified shareholding requirement. Compliance processes to ensure contractually agreed share investments are legally permissible purchases should be put in place (e.g. by automatic purchases on pre-determined dates). Shares should be owned for a minimum period, with a proportion to be held post-employment.
- **Alignment of performance metrics to strategy:** Variable remuneration should be based on metrics that align to long-term strategic value and the company’s sustainable performance in comparison with its peers. These should reflect long-term company objectives, derived from the company’s strategy, and should include material sustainability parameters (e.g. innovation, environmental and social impact, corporate culture, customer service and employee satisfaction) alongside strategic

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<sup>14</sup> Leitlinien für eine nachhaltige Vorstandsvergütung/Guidelines for sustainable management board remuneration systems [http://www.guidelines-executivecompensation.de/wp-content/uploads/2018/08/Leitlinien\\_EN\\_Web.pdf](http://www.guidelines-executivecompensation.de/wp-content/uploads/2018/08/Leitlinien_EN_Web.pdf)

<sup>15</sup> [http://www.leitlinien-vorstandsverguetung.de/wp-content/uploads/2021/09/whitepaper\\_esg.pdf](http://www.leitlinien-vorstandsverguetung.de/wp-content/uploads/2021/09/whitepaper_esg.pdf)

and financial objectives. We will generally oppose schemes which use TSR, whether relative or absolute, as their dominant metric.

- **Caps on remuneration:** We support the Code's<sup>16</sup> concept of the target and maximum total remuneration for each management board member. This allows an evaluation of remuneration over a variety of outcomes and ensures that payments are not unexpectedly higher than shareholders would expect, a feature that has been lacking at some companies in the past. Total remuneration is considered capped when all individual components of variable remuneration elements have an upper limit and include share price performance, while we expect pension contributions to only be linked to fixed remuneration.

### Remuneration reporting

We support the requirements of the revised EU Shareholder Rights Directive, transposed in Germany in the 'Gesetz zur Umsetzung der zweiten Aktionärsrechterichtlinie (ARUG II).'<sup>17</sup>

The remuneration system must be presented at the annual general meeting as an advisory vote item by publically listed companies if the supervisory board has made material changes, or at least every four years (§ 120a AktG 1). This allows companies to articulate policies on remuneration and explain how they support strategic objectives and enables shareholders can assess whether the interests of senior management have been aligned with their own. In cases of shareholder dissent the law requires companies to present an improved remuneration system at the annual general meeting of the following year (§ 120a AktG 3).

Furthermore, the law now includes a requirement for publically traded companies to present a separate remuneration report (§ 162 AktG) that is subject to an advisory vote at the annual general meeting (§ 120a AktG 4). The reports should also explain the remuneration system and the resulting amounts of remuneration clearly and concisely, including the use of representative charts and tables, to show the performance metrics, explanations on the pay-for-performance relationship, the maximum achievable remuneration level – and under which conditions this can be achieved for each management board member. Further, the report should include underlying key performance indicators (KPIs) for every variable remuneration component, the target levels (threshold, target and maximum amounts), their weightings and the performance achieved against the targets for the last performance period at least on an ex post basis.

One-time payments, if exceptionally granted, should be transparent and adequately justified. The remuneration report should also state the factors that led the supervisory board to exercise any discretion. Increases in remuneration should be presented clearly and adequately justified, including peer comparisons.

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<sup>16</sup> The German Corporate Governance Code, May 2019: Recommendation G.2

<sup>17</sup> [https://www.bmjv.de/SharedDocs/Gesetzgebungsverfahren/DE/Aktionaersrechterichtlinie\\_II.html](https://www.bmjv.de/SharedDocs/Gesetzgebungsverfahren/DE/Aktionaersrechterichtlinie_II.html)

We encourage companies to refer to the white paper “Transparenz der Vorstandsvergütung im Vergütungsbericht”<sup>18</sup> published September 2021 for suggestions and best practice examples of transparent remuneration reporting.

### **Remuneration committee chair**

In the event of egregious pay practices or when we issue a negative vote recommendation on remuneration-related proposals for the second time in a row, we will hold the remuneration committee chair accountable and recommend a vote against his/her re-election.

## **PROTECTION OF SHAREHOLDER RIGHTS**

We rigorously defend shareholder rights on behalf of institutional investors, including the right to receive good quality corporate reporting and material information on a timely basis, to vote at shareholder meetings on issues such as the annual election of directors, to propose new candidates to the board or other shareholder resolutions.

We support a single share class structure, with one share one vote, and oppose any deviation from this.

### **Hybrid or virtual shareholder meetings**

Annual and other shareholder meetings are a critical part of corporate governance. As well as being the highest decision-making procedure of the company, they allow shareholders to hear directly from the company about its performance and to challenge directors on important topics, supporting strong transparency and accountability.

We believe dialogue between shareholders and the supervisory and management boards is enhanced by the in-person meeting format of annual meetings. Although formats vary around the world, when working well, it presents the opportunity for shareholders to make points to the whole board, the ability to ask questions immediately in response to board comments and to build on the questions asked by others. Further, it is more difficult for directors to avoid challenging questions or topics; directors must provide answers in a public forum and, accordingly, be accountable for them.

However, we recognise that the restrictions brought about by the Covid-19 pandemic rendered in-person meetings unviable for many companies and that there were already valid arguments in favour of adopting alternative formats to improve shareholder access and participation, for example, in geographically dispersed countries or for companies with a global shareholder register.

Given this, we are supportive of meetings being convened in a ‘hybrid’ format – where shareholders have the option to join the meeting via an online platform or to join in person, provided all shareholder rights are protected or enhanced in both formats. Online participation can increase opportunities for participation, while retaining the accountability of in-person meetings.

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<sup>18</sup> [http://www.leitlinien-vorstandsverguetung.de/wp-content/uploads/2021/09/whitepaper\\_transparenz.pdf](http://www.leitlinien-vorstandsverguetung.de/wp-content/uploads/2021/09/whitepaper_transparenz.pdf)

We do not generally support 'virtual-only' meetings unless these are a temporary solution in response to restrictions on in-person gatherings, such as those prompted by the Covid-19 pandemic, or other exceptional circumstances. In those cases, we expect all shareholder rights to be protected and the meeting to be run as it should be in-person: giving ample opportunity for any shareholder to ask questions, and for these questions to be answered live by the board. We also expect a clear commitment to return to in-person or hybrid meetings as soon as restrictions allow.

For further information please refer to our *Principles of Annual Meeting Good Practice*.<sup>19</sup>

We will generally oppose requests for the authority to hold virtual-only meetings unless we gain comfort that it is to be used in exceptional circumstances only, and that the rights and access of attending shareholders are comparable to those of in-person meetings. For smaller companies we may relax the expectation that virtual-only meetings are for exceptional circumstances.

### Capital issuance requests

We are concerned about capital issuance requests from companies, especially requests to issue new capital without pre-emption rights for existing shareholders. We believe that pre-emption rights are an important safeguard for shareholders and their interests in the companies they invest in. Therefore, we generally do not support any proposal for capital issuance without pre-emption rights that would involve the issuance of additional capital of more than 10% of the already outstanding share capital.

### Share repurchases

We generally do not support share repurchase programmes which allow companies to buy back shares for a price which exceeds the market price of the shares by more than 10%. We oppose the authorisation of share repurchase programmes whose validity exceeds 18 months, or which allow companies to buy back more than 10% of the outstanding shares.

## SOCIAL, ETHICAL AND ENVIRONMENTAL RESPONSIBILITY

Taking a responsible and long-term approach to social, environmental and ethical issues is critical to the creation and preservation of long-term sustainable returns and should be reflected in the company's values, purpose, strategy and culture. Companies must identify and disclose the most material social and environmental issues for the company and its significant stakeholders. They must seek to address the associated risks and opportunities through their core business strategy and value proposition. We expect supervisory and management boards to have oversight of material sustainability issues and to be accountable to shareholders for effectively managing the associated risks and opportunities.

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<sup>19</sup> <https://www.hermes-investment.com/ukw/wp-content/uploads/2021/03/eos-principles-of-annual-meeting-good-practice-february-2021.pdf>

We support the UN Sustainable Development Goals (SDGs) and believe that the private sector has an important role to play in achieving them by the increasingly pressing deadline of 2030. Companies should assess the relevance of each SDG, identifying those that they can make a direct contribution to, and incorporate the most material SDGs into their strategies. We encourage companies to go beyond highlighting any SDG that the company could be connected to and to be purposeful in selecting those to which it intends to make an active, direct contribution, including through the allocation of resources and setting targets. We urge companies to report on their approach to the SDGs and to engage with its shareholders and civil society on how best to contribute to the SDGs.

Further detail on our views on and expectations of companies with regards to a wide spectrum of environmental and social issues can be found in the EOS Engagement Plan.<sup>20</sup>

Below we highlight two key environmental and social topics which will inform our vote policies in 2022: climate change, and human and labour rights.

### Climate change

The breakdown of the climate is a systemic risk to the value of our clients' portfolios, due to the social, economic, and political consequences of climate change.

We strongly support the goal of the 2015 Paris Agreement – to limit global warming to well below 2°C and pursue efforts to not exceed 1.5°C of warming – and we expect companies to publicly do the same, as well as ensuring that any third-party organisations they support or are members of, such as trade bodies or lobbying organisations, are aligned to this goal.

We urge companies to:

- Establish strong governance of the risks and opportunities presented by climate change and the energy transition. Supervisory and management boards should ensure that climate-related issues are included on the agenda at least annually. We expect the supervisory and management boards to engage with outside experts who can advise on strategic risks and opportunities that climate change presents, including challenging the company's approach if necessary. For those companies materially exposed to climate-related risks and opportunities, we expect the energy transition to be clearly articulated in governance documents, including board committee charters and the articles of association.
- Commit to achieving net-zero emissions by 2050 at the latest and set supporting short- and medium-term science-based targets to reduce greenhouse gas emissions in line with the goals of the Paris Agreement. This should include material Scope 3 emissions associated with a company's value chain or use of products with an explanation of why any Scope 3 emissions are not included.

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<sup>20</sup> The latest public version of the EOS Engagement Plan can be found at: [www.hermes-investment.com/stewardship/eos-library](http://www.hermes-investment.com/stewardship/eos-library)

- Integrate climate considerations into the forward-looking strategy for the company. Companies should consider the implications of the energy transition on their business, and what aligning to the goals of the Paris Agreement will mean for their strategy, minimising the potential risks and capitalising on the opportunities presented by climate change.
- Adopt the framework set out by the Task Force on Climate-related Financial Disclosures (TCFD) for the management and reporting of climate-related risks and opportunities. Where the risks are particularly acute (for example in energy intensive sectors), this should include conducting scenario analysis to establish the potential financial and other impacts of climate change on the business at different levels of warming. Companies should ensure that the financial risks associated with climate change and the energy transition are appropriately reflected in reports and accounts. As outlined in the Audit section below, the audit committee should be responsible for ensuring these risks are accounted for and the external auditor should be engaged to provide an opinion on this matter.
- Ensure supervisory and management board oversight and robust governance processes are in place to identify incidents of misalignment of views between companies and organisations of which they are members. Where issues are identified, all available avenues to influence these third parties should be used to encourage effective action on climate policy in line with the goals of the Paris Agreement. The company should be transparent about its governance procedures by describing the actions taken to reduce or eliminate any misalignment, and any progress made, in-line with the IIGCC Investor Expectations on Corporate Lobbying on Climate Policy.<sup>21</sup> Ultimately the board should be prepared to cease membership where misalignment persists without progress. Companies should also proactively support and advocate for positive action to mitigate climate change risks in their spheres of influence.

We engage intensively with companies across different countries and sectors on climate change and reinforce this through the voting recommendations we make to our clients at shareholder meetings.

In 2022, we continue to hold the chairs of the management board accountable through voting recommendations where we believe companies' actions are materially misaligned with the goals of the Paris Agreement and/or where companies are not responding sufficiently to the risks and opportunities posed by climate change. We include a particular focus on companies that are involved in activities that are clearly incompatible with limiting global warming to safe levels, such as causing deforestation and the expansion of coal-fired power. We assess companies using a range of frameworks and benchmarks, including the Transition Pathway Initiative (TPI),<sup>22</sup> the Climate Action 100+ benchmark,<sup>23</sup> Forest 500<sup>24</sup> and others.

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<sup>21</sup> <https://www.iigcc.org/resource/investor-expectations-on-corporate-lobbying/>

<sup>22</sup> <http://www.lse.ac.uk/GranthamInstitute/tpi/the-toolkit/>

<sup>23</sup> <https://www.climateaction100.org/progress/net-zero-company-benchmark/>

<sup>24</sup> <https://forest500.org/>

In addition to the above criteria, we may also reflect other concerns about a company's response to climate change in our vote recommendations, for example, where a company has been unresponsive to investor concerns or where we have concerns about the views held by particular directors regarding the reality and urgency of climate change.

We will consider and support on a case-by-case basis shareholder resolutions relating to climate change and may file or co-file resolutions where we believe them to be warranted.

In principle, we support the concept of having a shareholder vote on climate change transition plans (so-called 'Vote on Transition' or 'Say on Climate' resolutions). We will support climate change transition plans which are aligned to the goals of the Paris Agreement, with indicators of alignment including science-based greenhouse gas reduction targets over the short, medium and long-term, supported by a clear and credible strategy to achieve these.

### Human and labour rights

We believe that how a company manages its human rights strategy is of critical importance to its licence to operate, its impact on people's lives and ultimately its ability to create and preserve long-term holistic value. We endorse and expect companies to align with the UN Guiding Principles on Business and Human Rights (the UNGPs). The UNGPs framework outlines the corporate duty to respect human rights. Companies have a responsibility to disclose and act upon a policy commitment to human rights in their operations and value chains. This includes carrying out human rights due diligence to identify potential and actual human rights impacts; a plan to prevent, mitigate and account for how to address these impacts and providing or cooperating in the provision of remedy if a company has caused or contributed to adverse impacts.

Companies should have a governance structure for human rights which identifies board level oversight and executive accountability. They should report on obligations under the UNGPs, as well as under national legal requirements and relevant international frameworks.

The concept of human rights is simply the universal right to human dignity. However, we acknowledge that human rights strategies and impacts may involve complex and sensitive aspects and seek to engage with companies on these considerations. We may recommend a vote against relevant meeting items, such as re-electing a director, discharging management or approving its reporting if:

- a company is in clear breach of its applicable regulatory responsibilities related to human rights (such as the UK's Modern Slavery Act) or responsibilities outlined in the UNGPs; and/or
- there is sufficient evidence that a company has caused or contributed to egregious, adverse human rights impacts or controversies and has failed to provide appropriate remedy.

## TRANSPARENCY, TAX AND AUDIT

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

### Tax

Companies should recognise the importance of taxation to the funding of public services on which they and their stakeholders rely, and pay their fair contribution. The Covid-19 pandemic has emphasised the importance of companies paying their fair contribution as all businesses have directly or indirectly benefitted from government action to support the economy.

Fair payment of tax, based on the intention of tax law and in proportion to the location of economic value generated, is an important pillar of a company's social licence to operate. We believe that companies that seek to aggressively minimise their tax payments will face increasing reputational and financial risks.

We expect companies to:

- Comply with the intention of tax laws and regulations in all countries of operation.
- Pay taxes in-line with where economic value is generated.
- Publish a global tax policy describing their approach to tax risk, controls and oversight, including any material variations across the entity. This should include policy on corporate structuring in low tax jurisdictions, intra-group transactions and the use of tax incentives from public authorities.
- Ensure their tax policies and practices do not damage their social licence to operate in all jurisdictions in which they have a presence.
- Disclose publicly the full extent of taxes paid or collected by them in each country. Reporting on each country should include the purpose of the local corporate entity along with comparable corporate data such as revenue, profit before tax and number of employees. We recommend use of the GRI reporting standard on tax.
- Ensure they have sufficient oversight of tax policy, risk and controls in board and board committee work.
- Avoid the use or promotion of aggressive tax avoidance strategies either for their corporate taxes or those of employees, contractors or customers.

## Audit

Shareholders in listed companies rely on the quality and robustness of the audited information those companies report to the market when making investment decisions, and when holding company management and boards to account. High quality and effective audits are vital to ensure the markets trust and have confidence in the information companies report.

Audits should provide assurance to shareholders that the financial statements present a prudent, true and fair view of the financial results, cash-flows and financial strength of a company. In recent years, we have seen a spate of business failures following poor quality audits. These high-profile cases have raised questions about the quality, relevance, professionalism and independence of audits and external audit firms, and strengthened calls for reform.

### Audit committees

Shareholders, regulators and other stakeholders have increasingly focused on the role and performance of audit committees and how they discharge their duties. Beyond the oversight of the financial reporting process and the appointment and oversight of the external auditor, audit committees have important risk and compliance oversight responsibilities, including oversight of internal audit and whistleblowing facilities, as delegated by boards or as specified by laws or regulations. Assignment of substantial non-audit-related oversight mandates to audit committees may be seen as a signal that the audit committee is overburdened, with the risk that duties are being delegated to management. A better course of action may be to set up a further committee of the board to address other material non-audit matters.

To ensure the proper functioning of the audit committee, all shareholder representatives on the audit committee should be independent. The audit committee should report on their main activities, the most important issues they have considered and how they ensure the quality of the audit on behalf of the company's owners. This should include the assessment of the quality and independence of the lead audit partner which can be affected by working too closely with the management board over time. Audit committees should pay attention to the reappointment of the lead audit partner after five years and discuss the quality of the audit team on an annual basis.

### Auditor rotation

Maintaining independent external assurance is a fundamental pillar of good stewardship and the fiduciary duty of a supervisory board. Independence, and potentially audit quality, is at risk when the same assurance provider is maintained for too long – whether the audit partner or audit firm. Only by rotating the audit firm at regular intervals can auditor independence and quality be protected, in the interests of shareholders and other stakeholders. Our view is that auditor rotation can also add value as it welcomes a new firm with a different approach and a new set of subject specialists with a fresh pair of eyes, fresh challenge and opinions.

We wish to see companies establish policies of mandatory rotation of the audit firm after 20 years tenure, with an open and competitive re-tender process at the interim point of 10 years.

### Non-audit services and fees

As part of overseeing the external auditor, the audit committee must establish and enforce a policy on what non-audit services the company can procure from the external auditor. We pay close attention to these services and related fees to ensure that they do not compromise auditor independence, which could compromise the integrity of the audit. The non-audit fees should normally be substantially lower than the audit fee. Consistent with EU regulation, we expect non-audit fees not to exceed 70% of the average of the audit fees over the previous three years. If this is exceeded, there should be a clear explanation as to why it was necessary for the auditor to provide these services (for example, for certain services such as reviewing interim reporting or performing due diligence on transactions) and how the independence and objectivity of the audit was assured. In these cases, we also expect the committee to take action to ensure this does not reoccur, either by tendering for a new audit firm or reallocating non-audit work to a different firm.

We recognise that audit quality cannot be ensured solely through regular rotation of external auditors or reducing conflicts caused by the payment of fees for non-audit work. We expect audit committee chairs and committee members to understand the organisation, challenge management and external and internal audit teams, and to follow best practice guidance when appointing audit firms.<sup>25</sup> Committee chairs and members should ensure they have sufficient time to fulfil their duties, which we expect to be significant, particularly for large, complex organisations.

### Accounting practices

We are concerned that accounting standards, as applied, do not always reflect underlying company performance. We encourage companies to apply accounting standards in a manner which is prudent and provides a true and fair view. Where application of the standards does not provide such a view, we expect companies and their auditors to make this clear to investors.

As such, we expect companies to avoid aggressive accounting practices that represent the company's financial position in a flattering light. This creates a reliance on the most optimistic of outcomes transpiring in subsequent years, which can easily compound up to the point that a preventable collapse finally occurs. We expect companies to recognise liabilities in a timely fashion, and to only realise profits where there is a very high degree of confidence in their quality. We also expect a clear indication of the quality of any unrealised profits found in the company's income statement.

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<sup>25</sup>[Audit directive 2006/43/EC | European Commission \(europa.eu\)](https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32006L0043)

Audit and climate change

Where material or potentially material we expect companies to disclose climate and other environmental and social matters in its financial statements and clearly discuss the connection between accounting assumptions and the climate change impacts based on alignment to the Paris Agreement. We expect the auditor to communicate climate and other ESG matters as critical audit matters to the audit committee where material and involving challenging, subjective and or complex auditor judgement.

To the extent a company's financial statement does not adequately consider material climate risks and there is no corresponding explanation as to why, we may recommend a vote against the audit committee chair and auditor ratification. For more information on our corporate governance expectations related to climate change, please see the Climate Change section above.

## 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](http://www.hermes-investment.com) or connect with us on social media:



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