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## **EOS Global Corporate Governance Principles: Our expectations of publicly-listed companies**

2023

### **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 views on best practice corporate governance and our expectations of board directors and companies. This document should be read alongside:

- **EOS Public Engagement Plan:**<sup>1</sup> EOS' engagement priorities and expectations of public-listed companies around the world across the full spectrum of environmental, social, governance and strategic matters.
- **EOS vote guidelines:**<sup>2</sup> EOS' global vote guidelines, regional vote guidelines for North America and Europe and Australia, and market-level corporate governance expectations for Asian and global emerging markets (with vote guidelines for this region planned for 2024).

### **COMPANY PURPOSE AND STRATEGY; CULTURE AND ETHICAL LEADERSHIP**

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. This will, in turn, help protect the long-term interests of the 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.

A clear and meaningful purpose, owned and overseen by the board of directors, should guide company strategy and capital allocation, and enable boards and management teams to identify the right things to do in the short term in order to fulfil their purpose and 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 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 potential re-investment may be chosen to

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<sup>1</sup> [EOS library | Federated Hermes Limited \(hermes-investment.com\)](#)

<sup>2</sup> [EOS library | Federated Hermes Limited \(hermes-investment.com\)](#)

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.

Achieving a company's purpose requires a healthy culture and an emphasis on ethical values across the organisation. The board must set and find effective ways to oversee the values and culture of the organisation. For example, the board must ensure that its CEO has the highest ethical standards and should 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 serious unethical behaviour come to light.

The board 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 board and management take action to improve the culture where it is not aligned with the board's expectations. This should include robust and accessible whistleblowing systems together with a demonstrable commitment to protect those that use such systems.

### **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 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 boards, and we expect chairs and independent directors 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.

### **ENDORSEMENT OF GOVERNANCE CODES**

We generally endorse the principles and provisions outlined by local corporate governance codes and rules outlined by various stock exchanges across the global markets in which the companies that EOS engages with operate. Where we believe such guidelines to be insufficiently ambitious or robust, we will encourage companies to show leadership and adhere to higher standards, rooted in international good practice.

While we recognise that good governance cannot be guaranteed by adherence to local codes or listing requirements, we expect companies to provide meaningful reporting on how they apply the expectations defined by local listing rules or governance codes in the markets where they are publicly listed, especially in instances where a company's principles, policies or practices may differ from those outlined by local code or listing requirements.

## **BOARD COMPOSITION AND EFFECTIVENESS**

Boards should ensure they comprise members with 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 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 board as a whole displays the necessary skills, independence, diversity and other attributes to meet the company's evolving needs.

### **Effectiveness**

Engagement with 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>3</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.
- 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 board allocates its time spent in board meetings and between board meetings is equally important. We expect a board to maximise the time spent on strategy and other forward-looking activities during structured board meetings, committee work, site visits and engagement with stakeholders.
- The 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.

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<sup>3</sup> <https://www.hermes-investment.com/wp-content/uploads/2020/04/guiding-principles-for-an-effective-board-april-2020.pdf>

- 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 boards to be committed to continuous improvement and therefore to be regularly reflecting on their performance. We encourage boards across markets and corporate structures to conduct regular evaluations with the goal of enhancing board effectiveness. 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 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 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 board should implement an action plan and a clear timeline for addressing the points raised in the evaluation. Disclosure should demonstrate how the board has taken the necessary steps to enhance performance and provide reassurance to investors about the quality of the board evaluation.

### **Chair, CEO and Lead Independent Director roles**

We advocate for the roles of CEO and chair to be held by separate individuals and believe boards should ideally be led by an independent, non-executive chair. Where alternative structures are used, this should be convincingly explained and justified, as well as being regularly reviewed. We believe the role of the CEO is to manage the business, while the role of the Chair is to manage the board and maintain robust, independent oversight of management. Combining the roles brings inherent conflicts and risks weakening the independent oversight of the board and overly concentrating power in one person. This issue is particularly compounded by the absence of a lead independent director (LID) with robust powers. Companies with combined chair/CEOs should, in the short term, appoint a LID with the necessary formal powers and attributes and, over the longer term, move to separate the roles.

### **Independence and tenure**

On all boards, we expect a strong core of independent directors, including an appointed lead independent director, 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 guiding the board's decision-making and in the recruitment and nomination of directors. 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.

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 board (which we believe can be useful and justified, provided minority shareholder interests are protected) or significant management representation on the board.

In their disclosures, companies should clearly state which directors they consider to be independent and the criteria by which independence is determined. We expect at least half of the board directors to be independent in companies with a dispersed ownership structure, and at least one third to be independent in controlled companies. We see one third independence at controlled companies as a minimum standard but encourage controlled companies to consider a minimum of at least half of the board of directors to be independent. We place real emphasis on quality, not quantity of independence, however.

We expect a healthy mixture of tenures on 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.

### **Committees**

We expect larger boards (typically of eight or more directors) to have specific board committees covering audit, risk, executive remuneration and board nominations. For some companies, additional committees may be required to cover other material issues, for example a sustainability committee for environmentally-exposed companies. For those smaller 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.

We expect companies to follow the guidelines outlined by local codes, at minimum, but encourage companies of all sizes to have fully independent audit, remuneration and nomination committees. We strongly prefer these key board committees not to have any executive members, as another means by which the board provides robust, independent oversight of management.

### **Director attendance and commitment**

We expect 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 management. 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 board and senior management level 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 board, senior management should create a pipeline of suitable candidates from within the organisation to become senior managers and executive directors.

### **DIVERSITY, EQUITY AND INCLUSION**

Diversity, equity and inclusion (DE&I) is an ethical and business imperative. Expanding and improving upon DE&I, both at the leadership level and throughout the wider organisation, creates enduring value by improving decision-making, attracting talent, enhancing workforce satisfaction and stimulating insight and innovation.<sup>4</sup> A growing body of evidence supports the system-wide benefits of social and economic inclusion, and the risks of continued exclusion, by linking more diverse company leadership with greater financial performance.<sup>5</sup>

Recent world events, including George Floyd's murder in the US in May 2020, have brought into focus gender, racial and ethnic injustices around the world, which 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, difficult conversations triggered by these events have 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.

In 2023 we will continue tightening our voting policies on diversity, focused on boards and management teams, as we believe most companies need to improve

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<sup>4</sup> For example, [Delivering growth through diversity in the workplace | McKinsey](#)

<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>

representation of different groups at these levels, as well as throughout wider organisations. See our vote guidelines for more detail.<sup>6</sup>

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). 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. Where boards have made insufficient progress on critical dimensions of diversity, including racial and ethnic or gender representation at either board and senior management level, we will recommend opposing the re-appointment of relevant responsible directors.

While there is still much progress to be made globally, we welcome recent regulatory developments and voluntary commitments in some countries. 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>7</sup> Also in 2021, the Hong Kong Stock Exchange proposed changes to its corporate governance codes and listing rules to enhance diversity standards and support gender diversity;<sup>8</sup> the Tokyo Stock Exchange updated its corporate governance codes to require increased diversity disclosures;<sup>9</sup> and the Singapore Exchange Regulation published a consultation paper<sup>10</sup> proposing that issuers be required to have a board diversity policy and provide disclosures on related targets, plans and timelines in annual reports.<sup>11</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. Meanwhile, new listing rules introduced by the FCA in 2023 require UK companies to disclose whether they comply – or, if not, why – with the following targets: at least 40% of board seats and at least one senior board position (Chair, CEO, CFO or SID) held by women, and at least one board seat held by someone from an ethnic minority background.

We expect 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. While we recognise that there are regulatory limitations in some jurisdictions which may impede the ability for companies to request and disclose certain workforce diversity data, we encourage self-disclosure by directors, management and employees where possible.

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<sup>6</sup> [EOS library | Federated Hermes Limited \(hermes-investment.com\)](#)

<sup>7</sup> See Rule [Board Diversity Disclosure Five Things.pdf \(nasdaq.com\)](#)

<sup>8</sup> See [Consultation Paper, Review of Corporate Governance Code and Related Listing Rules, HKEX](#)

<sup>9</sup> See [Enhancing Corporate Governance, JPX](#)

<sup>10</sup> See [Consultation Paper on Climate and Diversity, SGX](#)

<sup>11</sup> [Preparing for Potential Updates to HCM & Board Diversity Disclosure Requirements \(harvard.edu\)](#)



We will hold 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. We will take into account a range of considerations including, but not limited to, diversity of named executive officers, senior executive 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 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 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. Delivering large portions of pay through 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 occurred at many companies as a result of the market rally that followed government interventions in the wake of the Covid pandemic.

### **EOS vote policy approach to executive pay**

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>12</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.

While we do not automatically oppose all pay models that do not appear to align to our principles, we set various vote policy guidelines that seek to address the most concerning aspects of current pay models and to encourage greater alignment with our principles. See EOS' global vote guidelines, regional vote guidelines for North America and Europe and Australia, and market-level corporate governance expectations for Asian and global emerging markets<sup>13</sup> for more detail on how our views on executive pay guide our vote recommendations to clients.

### **Board accountability for executive remuneration**

Boards should explain to all company stakeholders how the approach to executive pay helps to drive the desired culture in the organisation, how it aligns to long-term value creation and the company's strategy and purpose. When pay is awarded, boards should, in simple terms and plain language, justify to

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<sup>12</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.

<sup>13</sup> [EOS library | Federated Hermes Limited \(hermes-investment.com\)](#)

stakeholders (including employees) the rationale for the CEO's and senior management's pay, considering the pay, benefits and other employment conditions of the wider workforce, including those who do not have employment contracts. Remuneration committees should engage directly with shareholders and address concerns if there is a lack of support (80% or less) for pay policies before the next annual meeting.

### **Simplicity and alignment**

Pay should be simple and easy for executives and other stakeholders to understand. We believe that pay schemes are very often too complex and include variable remuneration schemes that are almost guaranteed to pay out,<sup>14</sup> with – at times – insufficiently transparent methodologies and performance metrics that risk being gamed or promoting unintended consequences and/or short-term decision-making. We see considerable limitations in reducing complex strategies and the roles of executives (which require, amongst other things, substantial problem-solving and judgement) to a set of metrics and targets. While we see a role for incentive schemes, we believe these should comprise a relatively small proportion of pay and are best focused over a single year where meaningful targets can be set (including annual milestones towards long-term targets), with the majority of pay delivered through long-term stock, which should rise in value over time if executives focus on long-term strategic value drivers. Where metrics and targets are used in incentive schemes, they should reflect strategic goals, rather than focus on total shareholder return, stock price appreciation or earnings per share, all of which should be an outcome of good management, not its direct focus. We prefer smaller grants of long-term (ideally 5 years or more) time-restricted stock to grants of options and generally recommend opposing options-only plans or those with options that vest in under 36 months. In our view, share options compound concerns about short-term decision-making as they incentivise executives to focus on short-term changes in share price, particularly around the exercise date and so we generally do not support these.

### **Quantum**

Executive pay is often far too high and pays out significant sums that appear to conflict with many shareholders' and other stakeholders' views of performance. Such significant quantum is also hard to justify as being a fair and reasonable reflection of any individual's specific contribution and worth, rather than reflecting a distorted market. We see this issue as particularly acute in the US. Setting absolute guidelines for quantum and how much is 'too much' is challenging, but we assess various internal and external indicators to inform our vote recommendations. These include: the size of variable pay opportunity offered in addition to base salary and whether this could result in unjustifiable quantum at maximum; how CEO pay is positioned relative peer median, recognising that targeting pay above median contributes to the ratcheting of pay across sectors; and, potentially, comparability with the workforce via indicators like a CEO to employee pay ratio or adherence to workforce living wage standards. We do not believe CEO pay should be significantly more than the peer group average over the long term without strong justification, or in the top quartile compared to peers without sufficient justification of alignment with performance. To promote transparency and accountability in the US, companies should disclose the three-year realised pay of all named executive officers who served during the year.

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<sup>14</sup> [remuneration-principles-clarifying-expectations.pdf \(hermes-investment.com\)](https://www.hermes-investment.com/remuneration-principles-clarifying-expectations.pdf)

## Shareholdings

We believe alignment of pay to the long-term success of the company and the desired corporate culture is best achieved through long-term, substantial share ownership by executives with minimal ability to use stock as collateral. Significant shareholding requirements should be in place for at least the duration of an executive's tenure, with no material share sales allowed before shareholding requirements are met (net of any tax obligations from the award or vesting of shares or options). Unvested shares or options should not count towards minimum shareholding requirements. Ideally, given the long-term implications of decisions taken by CEOs, they should be invested in and financially incentivised toward their own successor's success through the requirement of significant shareholdings for at least two years post-departure and potentially into retirement. Companies should discourage executive stock sales in general, and, in particular, sales should be prohibited soon after buyback announcements to discourage executives from favouring stock buybacks at the expense of long-term investment. Companies should clearly disclose the effect of share buybacks on its remuneration plans, how the result of its plans would differ without taking buybacks into account and the adjustments made by the remuneration committee as a result of the buybacks or other changes to the capital structure. This is especially important in cases where earnings per share (EPS) is used as an incentive metric.

## Capital allocation, buybacks and remuneration

We believe that a board policy of regular, reasonable dividend payments is normally a better way to return cash to shareholders than a share buyback policy. We are also concerned about the hidden cost of equity remuneration through the dilution of outside shareholders and managing this dilution by share buybacks, often at too high share repurchase prices. Moreover, executive remuneration metrics such as return on equity and EPS can be flattered or even managed by share buybacks. Given the potential effects of buybacks on longer-term investors, companies should disclose how the board decides on buybacks in addition to other long-term capital allocation choices, whether such buybacks are directly or indirectly financed by debt and how this affects the future risk profile of the company, as well as the company's ability to invest in growth and employees. Lack of such disclosure may signal to us that executive remuneration is too high or executive succession may be needed.

## ESG in pay

We are supportive of well-formulated ESG measures in pay schemes that are material to the company's success in the long-term. We believe that identifying and addressing material ESG risks and opportunities should be built into a company's core strategy and supporting governance structures, with inclusion of key metrics and targets in pay schemes supporting this wider approach. We will assess the extent to which we can see this alignment. We are not supportive of vague or otherwise poorly constructed ESG measures, those that do not relate to the most material factors for a company, or the use of so many measures and/or at such small weightings that they are not effective incentives and rather appear to be tokenism. We do not expect to see loosely governed ESG performance as a means of engorging pay outs and want to see boards hold management accountable for negative performance or inaction by decreasing pay. In particular, on critical and urgent issues like climate, executives should not receive significant awards over the coming decade for hitting targets relating to processes or other

less material considerations, while failing to deliver actual outcomes in material emissions reductions, in-line with the Paris Agreement.

### **Pay outcomes**

Pay outcomes should reflect outcomes for long-term investors and take account of falls in a company's performance or reputation, including on material ESG factors. The board should intervene and apply discretion whenever formulaic outcomes do not properly reflect business performance and be accountable to shareholders for these pay decisions. 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 and windfalls.

In the US, we are concerned by the widespread use of adjusted Generally Accepted Accounting Principles (GAAP) or International Financial Reporting Standards (IFRS) metrics for incentive pay, as this can tilt the scales to unfairly help executives achieve their performance benchmarks. A company should provide clear disclosure in its annual 10-K management discussion and analysis (MD&A) reporting of any adjustments to GAAP or IFRS performance metrics and reconcile these back to GAAP or IFRS metrics, particularly when compliance costs related to illegal activity or settlement costs related to allegations thereof are excluded from financial performance metrics in the compensation framework.

### **Malus and clawback**

Boards should adopt a policy deferring variable compensation which – in addition to enhancing alignment - allows late-arriving information about risk-taking and outcomes to alter pay outs and reduces the need to claw back remuneration already paid out in the event of misconduct. Remuneration policies should include robust malus and clawback provisions in the event of fraud; the discovery that any performance target or condition, or assessment of performance against these, was based on error or inaccurate or misleading information; conduct or reputational issues. The policy should require disclosure to shareholders in the proxy materials about such recoveries.

## **PROTECTION OF SHAREHOLDER RIGHTS**

We rigorously defend shareholder rights on behalf of institutional investors. While the ability for companies to enact these rights may differ across jurisdictions, where able, we strongly support the right to: receive good quality corporate reporting and material information on a timely basis; vote at shareholder meetings on issues such as the annual election of directors via a majority vote standard; call a special meeting of shareholders at a threshold as low as 5% of shares outstanding; and propose new candidates to the board or file shareholder resolutions, in addition to other rights and protections as dictated by local code or market-best practice.

We support a single share class structure, with one share one vote, and oppose any deviation from this. Multiple class share structures disenfranchise minority shareholders and often increase the power of one shareholder disproportionate to financial stake. We advocate for initial public offerings of companies with single class structures that provide a level playing field for all investors that equates voting power with financial stake.



## 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 board 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.

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 paper, *Principles of Annual Meeting Good Practice*.<sup>15</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.

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<sup>15</sup> <https://www.hermes-investment.com/ukw/wp-content/uploads/2021/03/eos-principles-of-annual-meeting-good-practice-february-2021.pdf>



## **SOCIAL AND ENVIRONMENTAL RESPONSIBILITY**

Taking a responsible and long-term approach to social and environmental 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 boards and management to have oversight of material sustainability issues and to be accountable to shareholders for effectively managing the associated risks and opportunities.

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>16</sup>

## **TAX AND AUDIT**

### **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 recent Covid-19 pandemic 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.

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<sup>16</sup> [EOS library | Federated Hermes Limited \(hermes-investment.com\)](#)

- 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.

#### Auditor rotation

Maintaining independent external assurance is a fundamental pillar of good stewardship and the fiduciary duty of a board of directors. 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.

While we recognise that auditor rotation guidelines are mandated by certain local corporate governance codes, 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.

As a guideline, non-audit fees should not exceed 50% of audit fees in any given year. 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>17</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

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<sup>17</sup> <https://www.ivis.co.uk/media/12498/Audit-tenders-guidelines.pdf>

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.

## 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 Investment Management are now undertaken by Federated Hermes Limited (or one of its subsidiaries). We still offer the same distinct investment propositions and pioneering responsible investment and stewardship services for which we are renowned – in addition to important 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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