Federated Hermes

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Dear Sir/Madam

EOS at Federated Hermes is a leading stewardship provider, advising on USD1.2tn[1] of assets (as of 30 September 2020), on behalf of global international institutional investors. Federated Hermes is a global leader in active, responsible investing with USD614.8bn[2] in assets under management (as of 30 September 2020). Our goals are to help people retire and invest better, to help clients achieve better risk-adjusted returns, and to contribute to positive outcomes that benefit the wider world.

EOS Japan Corporate Governance Principles 2021

Enclosed is a copy of our 2021 Japan Corporate Governance Principles. This document expresses our expectations of companies across a number of important strategic, governance, environmental and social topics and guides our approach to our corporate engagement programme, as well as our approach to recommending votes at shareholder meetings. We seek to take an engagement-led approach on voting where practicable and to take account of company circumstances when making vote recommendations. Our voting policies reflect the importance of long-term issues such as board effectiveness, climate change and diversity. However, when making voting recommendations on the election of directors, particularly board and committee chairs, we will continue to consider the importance of consistent leadership for companies facing acute distress caused by the ongoing coronavirus pandemic.

We would like to emphasise the following points:

Board composition and independence

Boards should comprise members with strong 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. It is also important that the roles of the chair and board committees are clearly defined. In 2021, we will recommend voting against the chair or president of Nikkei 225 constituent companies if the board is less than one-third Independent.

Diversity and inclusion

We support the aspiration that all levels of management and the wider workforce should broadly reflect the diversity of society and believe boards should seek diversity in its broadest sense to support high quality debate and decision making. In 2021, we will continue to recommend voting against the chair or president (or the chair of the nomination committee if known) at companies that we judge to be making insufficient progress on diversity, including:

- TOPIX 100 constituent companies where less than 10% of board directors are female
- Other companies which have no female director

Cross-shareholdings

The widespread practice of strategic or cross-shareholdings can lead to various problems including inefficient use of capital, anti-competitive practice, supporting poor governance practices and unfair treatment of shareholders. We welcome the significant reduction in these holdings in recent years and will continue to press for further reduction. We will continue to oppose the election of non-executive

[1] Source: Federated Hermes as at 30 September 2020

[2] Please note the total AUM figure includes US$8.0bn of assets managed or under an advisory agreement by Hermes GPE LLP ("HGPE"). US$69.9m of total group AUM figure represents HFM mandates under advice. Source: Federated Hermes as at 30 September 2020.

directors from cross-shareholding partners and may introduce new ways to voice our concerns about cross-shareholdings in future.

Climate change
The breakdown of the climate is a systemic risk to the value of our clients' portfolios, due to the economic and political consequences, as well as the physical impacts of climate change. We expect as standard annual reporting using the guidelines of the Taskforce on Climate-related Financial Disclosures. We will consider recommending voting against the chair of the board or other responsible directors of companies which we do not believe to have demonstrated sufficient management of climate-related risks, such as those below a Level 3 management rating from the Transition Pathway Initiative[3], or where a company's strategy is materially misaligned with the goals of the Paris Agreement.

We welcome any comments and observations on our 2021 Corporate Governance Principles and would welcome the opportunity to answer any queries or concerns they may raise.

Yours sincerely
Sachi Suzuki

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[3] http://www.lse.ac.uk/GranthamInstitute/tpi/the-toolkit/

Corporate Governance Principles

Japan

Our expectations of Japanese-listed companies

EOS at Federated Hermes
2021

Federated Hermes

www.hermes-investment.com
For professional investors only

Introduction

EOS at Federated Hermes represents a broad range of long-term investors, who seek to be active stewards and owners of their beneficiaries' assets, including the shares or debt of the companies in which they invest. EOS engages with these companies around the world to promote long-term, sustainable returns. These Principles express our expectations of companies across a number of important governance, environmental and social topics. More detail on our expectations, particularly on environmental and social topics, can be found in our public, annually updated Engagement Plan[1].

Stewardship and engagement

Investors must also act as responsible stewards and promote long-term value through constructive engagement with companies and their directors. All substantive correspondence from institutional investors 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, performance and value 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 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 debt investor expectations have similarly aligned expectations to long-term shareholders 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 or cashflow.

At EOS, our model is to provide stewardship on behalf of a collective of investors – mainly pension funds and other long-term, institutional investors from around the world. We engage with investee companies on matters material to long-term value, encompassing ESG and strategic topics, and make voting recommendations on resolutions at shareholder meetings. This collective model aims to make the engagement process more efficient and effective, for companies and investors, by pooling resources and assets. We also aim to reduce potential conflicts of interest through a collective focus on long-term, sustainable value, shaped with input and agreement from our clients.

Company purpose and leadership

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

It is our strong belief that companies can only create and preserve long-term value 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 helps 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 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 coronavirus pandemic in 2020 – when difficult trade-offs may be required, particularly between shorter-term financial returns and maintaining strong relationships with key stakeholders, including government, the workforce, customers and supply chains[2].

Companies need to be able to rationalise and 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 capital allocation in the context of a company's purpose and long-term strategy. We are concerned that buybacks 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 value.

Endorsement of Japan's Corporate Governance Code

We welcome the progress Japan has made on corporate governance in recent years. In particular, since the introduction of the Corporate Governance Code in the country in 2015 as well as that of the Stewardship Code[3] in 2014, we have observed an increased level of interest among companies in discussing corporate governance with institutional investors and their representatives, including EOS. Following the revision of the Corporate Governance Code in 2018, we have seen further improvements to governance practice of many companies. We are hopeful that next revision in 2021 will accelerate the change. We welcomed the added emphasis on long-term sustainability and ESG factors in the 2020 review of the Stewardship Code, which we believe will help expand the scope of investor-company dialogue.

We strongly support the comply-or-explain approach taken by Japan's Corporate Governance Code. We believe that a thoughtful and effective use of the comply-or-explain mechanism will help facilitate constructive dialogue between companies and their shareholders, as well as foster trust and good long-term relationships.

To ensure the comply-or-explain approach works as effectively as intended, there needs to be a shared belief about what constitutes good corporate governance and its

[2] We expand on our expectations of companies in responding to Coronavirus in more detail in our open letter to CEOs: https://www.hermes-investment.com/ukw/eos-insight/eos/stewardship-during-and-after-the-pandemic

[3] Formally called "Principles for Responsible Institutional Investors «Japan's Stewardship Code» -To promote sustainable growth of companies through investment and dialogue".

value. We expect companies, particularly in their communications with investors, to demonstrate that good governance is important to them and that they are striving constantly to improve it.

Companies should not confuse superficial compliance with good corporate governance. We have concerns that a large number of companies use the same or very similar language when providing explanations of why they do not comply with the principles. We strongly discourage such boilerplate reporting, which suggests a box-ticking approach to governance rather than a thoughtful process specific to the company's particular circumstances. Explanations should be tailored to the company's position and provide a meaningful level of detail and a coherent rationale for the chosen governance arrangements. Investors, helped by regulators, need to make continuous efforts to encourage and assist listed companies to gain a greater understanding of the purpose and standards of good disclosure.

We hope that constructive and meaningful dialogue between companies and their investors will continue to develop, in turn enabling higher standards of governance and enhancing long-term value creation for stakeholders, including shareholders.

Board effectiveness and composition

Boards should ensure they comprise members with strong 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 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 value 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.

Role of the chair

The chair of the board plays a significant role in leading the discussion and ensuring the effectiveness of the board. However, not many Japanese companies explicitly identify the chair of the board (gicho) as the assumption is that the board is typically chaired by the president or the chair of the corporation (kaicho). The chair of the corporation is usually someone who was the president or senior executive immediately before appointment, and therefore non-independent. This arrangement suggests that there is often no clear separation between executive and monitoring and oversight functions. We encourage companies, as a first step, to reflect on the roles that the chair of the board should play, and then clearly name the chair and disclose the responsibilities of the role. We believe that in the efforts to improve board independence and effectiveness, having an independent non-executive chair can have a considerable effect. While very few companies have appointed an independent chair, we encourage other companies to consider this as a viable option.

Independence and tenure

For boards to effectively discharge their responsibilities, they should include a sufficient number of independent directors. We expect them to hold management to account on a wide range of matters by exercising objective fiduciary judgement. We also expect them to steer a company in a way that ensures the creation of long-term value for all stakeholders, to advise and support the decision making of executives, assisting them to improve performance of the company, to ensure sustained profitability and returns above the cost of capital.

While the Corporate Governance Code currently requires boards to include at least two independent non-executive directors, we expect companies – especially large ones – to ensure that at least a third of the board is independent. In 2021, we will recommend voting against the chair or president of Nikkei 225 constituent companies if the board is less than one-third independent. We also believe that the board should be of a size conducive to meaningful discussions and effective decision-making. If the size of the board exceeds 15 members, we expect it to achieve a higher proportion of independence.

We expect independent directors to exercise professional and objective judgement and we therefore urge boards to apply strict definitions of independence when considering candidates for such positions. For example, we do not consider those who work or recently worked for: group companies; significant shareholders or cross-shareholding partners; business partners, including major lenders; or those who have any material transactions with the company independent. We also believe that long tenure undermines independence and does not consider non-executive directors independent if their tenure exceeds nine years. Therefore, we have independence criteria that go beyond those provided by the Tokyo Stock Exchange whilst believing that over time the definition of the Exchange will also be tightened.

While we acknowledge the valuable contributions that statutory auditors can make to companies, we do not believe that independent statutory auditors can effectively fulfil the expected role of independent directors, in particular, because they do not have a vote at board meetings. We therefore expect companies to ensure a high proportion of independence among directors, regardless of the proportion of independence of the statutory auditors.

Senior advisors and consultants

Many Japanese companies have the positions of senior advisors and consultants held by retired senior executives. While some of them are honorary positions and unpaid, others are paid, and the advisors and consultants often have access to company offices and vehicles. They are typically engaged in external affairs such as industry associations and are not meant to interfere with current management. However, we continue to be concerned about their potential influence over management, not least in the Japanese cultural context where seniority and hierarchy are important.

Although companies are now required by the Corporate Governance Code to disclose information about these individuals in the corporate governance report, such as their names and whether or not they are paid, we do not believe this arrangement fits into the formal governance structure of the company and lacks an appropriate level of accountability. These individuals are not board members and therefore not elected by shareholders. We encourage companies to consider removing these positions or as a first step, provide further details on the individuals including their precise roles, interactions with management, pay and other entitlements.

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.

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 multi-site operating companies such as international mining (due to the need for site visits) require more time commitment.

We expect companies to encourage their executives to take on non-executive roles outside their own group companies to assist in their development, bring current experience to boards and to build a pipeline of future board directors. However, we do not expect executives to hold more than one non-executive role at listed companies outside the group companies.

Effectiveness

Measurable aspects of boards, such as those outlined above, are important but insufficient indicators of a board's functionality. While we welcome improvements to disclosure of these around the world, ticking all the good governance boxes does not necessarily translate into good governance, as demonstrated by continuing large-scale corporate failures.

Engagement between investors and board directors provides a valuable opportunity to more deeply assess how well a board is functioning. Our white paper, *Guiding Principles for an Effective Board*[4], 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.

Nomination process

We welcome the voluntary establishment of a nomination and remuneration (advisory) committee at many companies in recent years. We believe these committees can help enhance focus and transparency on these matters. The nomination committee should play a key role in nominating independent directors,

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

ensuring the right mix of skill sets, diversity and independence among board members, as discussed above. It should also lead on succession planning for key executives, including the chair and president, by identifying individuals who have the skills, diversity and expertise needed for the business, instead of endorsing seniority-based promotions.

It is important that the nomination committee has a majority – if not comprising solely – of independent directors, to be effective and to maintain objectivity. While the committee is usually described as an advisory body because companies are not legally required to have one, we expect boards to ensure that the committee's decisions are upheld unless the executive management has strong evidence to refute its recommendations.

The nomination process and the role of the relevant committee for appointing senior executives, directors and statutory auditors should be transparent. In addition, meaningful dialogue with investors, in particular involving directors, on these issues is crucial.

Succession planning

Effective succession planning at 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 diversity of skills, experience and other attributes required at board and senior management level.

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 and inclusion

As well as the intuitive, social case that companies should embrace diversity and realise its benefits through inclusive cultures, there is a growing body of evidence supporting the link between more diverse company leadership and financial performance[5].

Boards should seek diversity in its broadest sense to support high quality debate and decision-making. Considering diversity of skills, experience, networks, psychological attributes and demographics (including gender, ethnicity, nationality, sexual orientation and age) will equip the board to effectively serve the company and its stakeholders.

Diverse perspectives throughout an organisation are also likely to more accurately reflect employees, customers, and suppliers across the company's geographic footprint. As such, we support the aspiration all levels of management and the wider

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

workforce, should broadly reflect the diversity of society, including in the company's core functions, such as operations and sales.

We expect boards and management teams to monitor key indicators to assess the composition of the workforce and how the company's culture supports inclusivity. Where diversity is found to be lacking – for example, the under-representation of women or ethnic minorities in the workforce or leadership positions – we expect companies to develop timebound targets and initiatives to address it.

Gender equality

Advancing gender equality in company leadership and throughout organisations remains critically important, with many companies around the world still falling far short of equal representation. We continue our global support for initiatives like The 30% Club, including its Japan Chapter, which advocates for companies to achieve a minimum of 30% female representation on boards and in leadership populations.

Japanese boards have one of the lowest proportions of female representation in major markets. They are typically very homogenous, comprising a large majority of male Japanese executive directors who have been with the same company for many decades. We believe that boards with too much commonality of background run the risk of groupthink and complacency.

Despite the historical challenge[6] to secure a sufficient pool of female candidates, a growing number of companies have appointed female directors in recent years. We strongly encourage this trend and advocate a substantial increase in the proportion of women on boards. In 2021, we will continue to oppose the re-election of the chair or president[7] of companies which have no female director unless they are able to provide a convincing explanation. As we believe that larger Japanese companies should aspire to be more ambitious with their targets and are in a better position to appoint more female candidates. We expect that at least 10% of directors of TOPIX 100 companies to be female.

We encourage Japanese companies to consider younger candidates for director positions, which would not only add age diversity to the board but also help expand the pool of female candidates. It is important to promote diversity at board and executive level, but companies should also focus on promoting a diverse and inclusive workforce. At least to be in line with the Japanese government's target of raising the ratio of female managers to 30% by 2030, companies should make plans including specific efforts to substantially improve the proportion of women at board and senior management level.

Improving the representation of women should not be considered in isolation from other dimensions of diversity and, particularly, internationality and ethnic diversity.

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[6] Few opportunities for career development were available for women in Japan until the Equal Employment Opportunity Law was introduced in 1986, followed by the 1997 ban on gender discrimination in recruitment and promotion. This has resulted in a severe lack of female employees in senior positions at most companies.

[7] We will recommend voting against the chair of the nomination committee or similar when the role is identified.

We continue to encourage companies, particularly those with significant international operations, to reflect this in their board composition. While many boards consider language a barrier to having non-Japanese directors, we continue to encourage companies to find a workable solution, as we believe diversity of nationality is beneficial for companies.

Racial inequity

A series of tragic incidents in the US have re-energised the anti-racist movement around the world, renewing concerns about poor representation of ethnic minorities in business, particularly in senior positions, and the role that companies may play.

We welcome the steps taken by companies around the world to acknowledge and commit to addressing racial inequity, in the workforce and beyond, but we expect this to be followed up with concrete action.

We believe many companies, including our own, have much more to do to address this urgent problem. Although the issue of race is complex and the context is different in each country, we encourage Japanese companies, particularly those with significant overseas operations, to reflect on their current practice and take a step towards improvement. More specifically, we aim to engage with companies to understand how ethnic and racial groups are identified and measured, and how minorities are supported in the major markets that the company operates.

Strategic (and cross-) shareholding

We believe that the widespread practice of strategic shareholdings – also known as cross-shareholdings – among Japanese companies leads to various problems.

1. Despite being commonly referred to as being strategic, many of these holdings lack a clear strategic purpose or are not proven to be the best use of shareholder funds. In addition, these holdings contribute to reducing the free float.
2. Many companies believe it is acceptable to hold shares of other companies to maintain long-term business relationships, including the winning and maintaining of contracts for distribution and the stable supply of goods and services. This can, however, conflict with market principles of fair competition because it appears that companies are expected to do business with those with whom they have shareholding relationships instead of those who can offer the best quality products or services or the lowest price.
3. Strategic shareholdings may also contribute to poor corporate governance. The holders of such shares tend to support management of the investee companies instead of exercising their shareholder rights when necessary to hold management and the board to account. Similarly, strategic shareholdings can also help to prevent takeovers.

4. The practice therefore leads to the unequal treatment of shareholders because those who hold shares in such a fashion may receive benefits for their business, while other shareholders, including institutional and retail investors, do not.

Some companies, including major banks, have begun to unwind many of the legacy holdings. We also welcome the new requirement by the Financial Services Agency (FSA) for companies to increase the number of strategic holdings companies are required to name from 30 to 60[8]. However, more needs to be done. EOS would like to see these holdings phased out. We understand that this may not be easy in the short term, due to the number of parties involved and companies may fear that the unilateral sale of strategic shares could have a detrimental effect on their business. In the meantime, we ask companies to disclose the following:

- All strategic holdings, the aggregate amount and the percentage of total share capital it owns in each company.
- The board's approach to strategic shareholdings including: what factors it considers when conducting its review; anti-competitive or anti-ethical implications concerning any of its shareholdings and what it does in these cases, how it assesses the risk and reward of shareholdings; any cases where business cannot be conducted without strategic shareholdings and the reasons; and any cases where business is improved through these shareholdings as well as the reasons.
- Targets to reduce overall strategic shareholdings, such as [X%] by [date], as part of their strategy to eliminate all strategic holdings by [date]
- Details on how shareholder rights, including voting rights are exercised at each company.

We have begun to see some positive developments in this area and will expect these efforts to become more widespread, and for progress to accelerate. We will continue not to support the election of outside directors who represent strategic shareholding partners and may introduce new ways to voice our concerns about strategic shareholdings in future.

Efficient capital management

Companies should seek a balance when making capital management decisions. They should strive to maximise long-term corporate value by implementing rigorous financial and business discipline. The best capital structure is a question for the board and depends on the particular circumstances of the company concerned. However, we note that many Japanese companies still have substantial cash balances or investments in strategic shareholdings for considerable periods of time, without providing a solid strategic plan or sufficient explanations for this use of shareholder capital.

[8] https://www.fsa.go.jp/news/30/sonota/20190131.html

More companies are setting targets for higher returns on equity (ROE) and are seeking to discuss their plans with shareholders. We welcome this development and expect management to clearly explain the company's capital policy, demonstrating a strategy and roadmap for using capital more efficiently, to enhance long-term corporate value and achieve sustained growth. In doing so, management should consider a wide range of metrics in addition to ROE.

Pre-emption rights

As a representative of long-term investors, EOS strongly supports the principle of pre-emption. We believe that it is a fundamental right, by which current shareholders of a company can retain their proportional ownership without finding their interest diluted by the introduction of other investors. We have seen a number of share issues which resulted in significant dilution of existing shareholders. Rights issues offer an important, efficient and fair way for companies to raise further equity, and we much prefer companies to choose them over private placements. We accept that flexibility and diversity of new sources of capital can be required to reflect the individual circumstances of companies. However, we expect companies to provide sufficient strategic explanations for any capital raising beyond a minimal level either with or without pre-emption rights, so that we can be assured that any funds raised will be used in the best interests of all shareholders. We encourage regulators to address this issue as well.

Takeover defence schemes

We have concerns about the purpose, legitimacy and effectiveness of poison pill schemes and discourage companies from adopting them. We will only accept such a scheme if the company is able to provide a convincing rationale for it and assure us that it will not be used merely to entrench management. We will carefully consider management's track record and the company's overall governance profile and progress, such as board composition and actions to optimise sustainable shareholder value, before making a decision on whether to support poison pills. We welcome the abolition of such schemes by a number of companies in recent years and continue to encourage others to abolish them. To support a poison pill, we require a specific explanation on how it will be in the interest of and protect minority shareholders.

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 propose shareholder resolutions and to vote at shareholder meetings.

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

Hybrid or virtual shareholder meetings

Annual general meetings and other shareholder meetings are an important part of the governance process for companies. They provide a forum for shareholders to hear directly from the company about its performance and to challenge directors on important topics, bringing transparency and accountability to shareholders.

We believe dialogue between shareholders and the board is enhanced by the in-person meeting format: it presents the opportunity to make points to the whole board, not just to one or two directors; the ability to ask questions spontaneously and to build on the questions asked by others is valuable; it is more difficult for directors to avoid difficult questions or topics; and directors must provide answers in a public forum and, accordingly, be accountable for them.

We also support 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. Online participation can increase opportunities for participation, while retaining the accountability of in-person meetings. Companies must ensure that this format is not used to suppress dialogue or otherwise reduce opportunities for shareholder participation that would have been available at an in-person only meeting.

We do not generally support virtual-only meetings unless these are a temporary solution in response to restrictions on in-person gatherings prompted by the pandemic. In those cases, we expect all shareholder rights to be protected and the meeting to be run as it would be in-person: giving ample opportunity for any shareholder to ask a question, and for these 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.

Shareholder resolutions

We support the selective use of shareholder resolutions as a useful tool for communicating investor concerns and priorities or the assertion of shareholder rights, and as a supplement to or escalation of direct engagement with companies. When considering whether or not to support resolutions, we consider factors including whether the proposal promotes long-term shareholders' interests; what the company is already doing or has committed to do; the nature and motivations of the filers, if known; and what potential impacts – positive and negative – the proposal could have on the company if implemented.

Executive remuneration

We encourage Japanese companies to ensure that remuneration schemes align management with strategic objectives, key drivers of business performance, long-term value creation, and important stakeholders. We also request that any possible deferred remuneration should be disclosed and explained even if the precise amounts payable are not certain. Companies should also explain the process for determining the pay of the CEO and other senior management, following the principle that no one should determine their own pay. We welcome the new requirement by the FSA for companies to disclose details of executive remuneration programmes including information on the performance link and payment history based on the programme9. Our views and expectations of executive pay can be found in our paper, *Remuneration Principles: Clarifying Expectations*[10].

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 company value 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.

We are not yet taking the position of automatically opposing all pay models that do not align to our principles. However, we set various guidelines and thresholds in our voting policies which seek to improve market practice and encourage closer alignment with our principles. These are tailored to the context of each market.

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 value, and should be

[9] https://www.fsa.go.jp/news/30/sonota/20190131.html

[10] 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.

reflected in the company's 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, rather than through adjacent initiatives which can feature in traditional corporate social responsibility programmes.

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. Boards should consider the issues in this section, although the list is not exhaustive.

UN Sustainable Development Goals

We support the UN Sustainable Development Goals (SDGs) and believe that the private sector has an important role to play in achieving them by 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.

Climate change

The breakdown of the climate is a systemic risk to the value of our clients' portfolios, due to the economic and political consequences, as well as the physical impacts 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 reach 1.5°C of warming – and expect companies to publicly do the same, as well as ensuring any third-party organisations they support or are members of, such as trade bodies or lobbying organisations, are aligned to achieving this.

We urge companies not already doing so to:

- Establish strong governance of the risks and opportunities presented by climate change. Boards should ensure that climate change is included on the board agenda at least annually. We recommend that the board and senior management 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.
- Set science-based targets to reduce greenhouse gas emissions in line with the goals of the Paris Agreement. This should include consideration of material

Scope 3 emissions associated with a company's supply chain or use of products or an explanation where this is not the case.

- Integrate climate change into the forward-looking strategy for the company. This includes 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. The audit committee should be responsible for ensuring these risks are accounted for.
- Adopt the framework set out by the Task Force on Climate-related Financial Disclosures for the management and reporting of climate-related risks and opportunities.

We support the work of The Transition Pathway Initiative (TPI), which assesses companies' management of greenhouse gas emissions and risks and opportunities related to the transition to a low-carbon economy. It also assesses how companies' current and future carbon performance might compare to the international targets and national pledges made as part of the Paris Agreement. Company ratings can be accessed via the publicly available TPI tool[11]. We will consider recommending voting against the chair of the board or other responsible directors of companies which we do not believe to have demonstrated sufficient management of climate-related risks, for example, those scoring below a Level 3 management rating from TPI. For those companies which are not covered by the TPI assessment, we will consider recommending voting against directors in cases where a company's strategy is materially misaligned with the goals of the Paris Agreement.

We understand that companies may have different views on the climate crisis to organisations of which they are members or those which they may be able to influence. Boards should ensure robust governance processes are in place to identify misalignments. Where these are identified, all available avenues to influence these third parties should be used, to encourage effective action on climate policy in line with the Paris Agreement. The company should be transparent on this governance procedure, actions taken to reduce or eliminate any misalignment and any progress seen, in line with the Institutional Investors Group on Climate Change Investor Expectations on Corporate Lobbying on Climate Policy[12]. 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.

Companies should ensure that climate-related risks are integrated into financial reports and accounts. The auditors should consider company relevant climate and energy related financial risks and assumptions, future plans (e.g. capital allocation,

[11] http://www.lse.ac.uk/GranthamInstitute/tpi/the-toolkit/

[12] https://www.iigcc.org/resource/investor-expectations-on-corporate-lobbying/

M&A, capital projects), compliance with laws and regulations and determine whether those risks are adequately disclosed in the financial statements.

Biodiversity

Companies in many sectors are dependent on biodiversity and ecosystem services, including the supply of clean water, the availability of raw materials, and the existence of healthy soils. Company operations and supply chains also have extensive impacts on terrestrial, marine and freshwater biodiversity. There is also an important connection between biodiversity and human health, with the coronavirus pandemic highlighting the increased risk of transmission of viruses from animals to humans resulting from exploitation of wildlife and habitat destruction[13].

Companies must acknowledge the centrality of nature to their continued success and take responsibility for ensuring that their activities do not directly or indirectly negatively impact biodiversity. To protect valuable ecosystems and habitats, companies should prioritise eliminating deforestation from their supply chains and helping farmers transition to more regenerative forms of agriculture. Where feasible, we will expect companies to demonstrate a net positive impact on biodiversity.

Resource efficiency – circular economy

As the global population and consumption levels continue to rise, it is vital to find ways to use resources more efficiently, to tackle environmental challenges such as climate change; pollution to air, water and land; and soil erosion and loss of biodiversity. We expect companies to strive for the most efficient use of resources possible, and to consider how they can introduce circular economy approaches to their business model and operations.

One highly visible example is the urgent need to reduce plastics consumption and waste. We expect companies in exposed sectors to develop strategies and set targets for the reduction of, and optimal and balanced use of plastics in products and packaging; to end reliance on single-use plastics wherever practicable; and to invest in developing more circular supply chains which consider the most sustainable use of plastics or alternative materials throughout their lifecycles.

In the face of looming resource scarcity, another example is the need to shift to more sustainable sources of food, including reliance on inefficient animal and livestock-based proteins. Boards in relevant sectors should consider the potential for healthy, sustainable foods, ingredients and agricultural practices, such as plant-rich dietary options, plant-based proteins, and animal proteins which do not exacerbate further deforestation or fisheries depletion, and which avoid excessive use of antibiotics in rearing.

Human rights

We endorse the UN Guiding Principles (UNGPs) on Business and Human Rights and the UN Global Compact and expect companies to do the same. We expect companies

[13] https://www.hermes-investment.com/eos-insight/coronavirus/the-coronavirus-and-our-relationship-with-nature/

to use the reporting framework of the UNGPs to disclose how they assess and manage human rights impacts related to their operations and supply chain. Companies should conduct regular human rights risk assessments and demonstrate effective human rights due diligence designed to identify, prevent, mitigate and account for how they address their impacts on human rights. They should prioritise their efforts on the salient human rights issues associated with their activities.

Companies' licences to operate are increasingly affected by reputational factors, including their approach to human rights. As a minimum, we expect companies to comply with all legal requirements, including, for example, the obligations of the UK Modern Slavery Act; and to respect all internationally recognised human rights.

Human capital management

For many companies, employees are one of their most valuable assets, yet it is often unclear from disclosure or engagement with boards how companies invest in or manage their people effectively. The pandemic has brought into focus the important role that motivated, engaged workforces with sufficient levels of investment can play in an organisation's successful response to crisis, as well as the responsibility companies have to act as responsible employers.

Companies should set strategies and supporting objectives for the management of their human capital which reflect the importance of employees to long-term value creation and which are overseen by the board. We encourage companies to provide qualitative contextual information describing their approach, as well as annual disclosure of key performance indicators used to manage human capital.

A vital component of effectively managing human capital is for the board to set the expected culture of the company and require management to use various methods to identify the extent to which these expectations are being met in every business unit and department, with a goal to ensure that the culture is one in which employees are engaged and motivated. We expect all companies to disclose the following as a minimum for human capital management:

- The number of people employed by the issuer, broken down by full-time and part-time employees along with contingent workers who produce its products or provide its services;
- Turnover or similar workforce stability metric.

Culture and ethical conduct

We expect companies to set and adhere to standards of ethical conduct through relevant policies and processes, including enforcing best practice anti-corruption and anti-bribery policies and processes. These should be overseen by the board with robust action taken where issues are identified. This, combined with clear cultural expectations and organisational measures provide the best possible defence against corruption and other unethical behaviour.

Policies and processes cannot be fully effective without the right leadership. We expect the board not only to oversee the company's culture and conduct but also to set the tone from the top, to encourage the highest ethical standards, and to drive company values.

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. This has been particularly emphasised during the pandemic, in which 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. Companies should ensure that their tax policies and practices do not damage their social license 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. Companies can use the Global Reporting Initiative Tax Standard as a framework for this disclosure.
- Boards to ensure they have sufficient oversight of tax policy, risk and controls in their and their committee work.

Transparency and reporting

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. 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 ESG, as well as financial and strategic, risks.

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 results, cash flow 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 and independence of audits, and strengthened calls for reform.

In addition, 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, as delegated by boards or as specified by laws or regulations.

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. Our experience is that simply rotating the audit partner is insufficient. Only by tendering 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 with a fresh pair of eyes, fresh challenge and opinions. It will bring a new firm with a different approach and set of subject specialists.

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, we do not expect non-audit fees to 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 statutory auditors or 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, such as those we contributed to with the UK Investment Association[14]. 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.

Corporate actions

Most merger and acquisition transactions are not as successful as the acquiring party expects. When considering our voting recommendation on a commercial transaction, we will consider a range of factors, in the context of seeking to protect and promote long-term, sustainable value. The underlying expectation is that due process is followed, with information made available to shareholders. Considerations include:

- Consistency with strategy: whether the transaction is consistent with the prior stated strategic aims of the company or whether any change in strategy appears coherent and sensible.
- Risks and opportunities: the key risks and opportunities to the business from the transaction and the extent to which these appear to have been considered and managed. This includes factors such as cultural fit, human capital management implications and the post-transaction integration plan.
- Conflicts of interest: any conflicts of interest which may affect the alignment of the interests of directors or particular shareholders with those of long-term

[14] https://www.ivis.co.uk/media/12498/Audit-tenders-guidelines.pdf

outside or minority shareholders. This includes considering whether the proposal is a related party transaction and, if so, whether appropriate disclosures and safeguards are in place; whether the transaction erodes any shareholder rights; and any potential conflict of interest concerning the directors' duty to act in the interests of shareholders, in particular, as these may arise from either existing or newly revised remuneration arrangements.

- Price: including whether any premium or discount to prevailing market share price is appropriate.

The board should form an independent committee to oversee any mergers or acquisitions, particularly when there are potential conflicts of interest for executives who stand to benefit financially from the transaction.

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