

EOS *Equity Ownership Services*
Public Engagement Report



2003
2008

Q3

www.hermes.co.uk

This report contains a summary of the responsible ownership activities undertaken by EOS on behalf of its clients. It covers significant themes that have informed some of our intensive engagements with companies over the past quarter. The report also provides information on our voting decisions and the steps we have taken to promote global best practice, improvements in public policy and collaborative work with other shareholders.

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What is EOS:

Hermes Equity Ownership Services (EOS) helps institutional shareowners around the world to meet their fiduciary responsibilities and become active owners of public companies. EOS' team of engagement and voting specialists monitor its clients' investments in companies and intervene where necessary with the aim of improving performance. EOS' activities are based on the premise that companies with informed and involved shareholders are more likely to achieve superior long-term performance than those without.

As the largest pension fund in the UK, Hermes' parent the BT Pension Scheme (BTPS), has substantial interests across international markets. Through pooling resource with other like-minded funds to create a stronger and more representative shareholder voice, our joint company engagements are more effective.

Hermes has the largest stewardship resource of any fund manager in the world. Our team includes former CEOs and other board members of public companies, as well as senior strategists, corporate governance experts, investment bankers, fund managers, lawyers and accountants.

The depth and breadth of this resource reflects our philosophy that ownership activities require an integrated and skilled approach. Intervention at senior management and board director level should be carried out by individuals with the right skills and with credibility. Making realistic and realisable demands of companies, informed by significant hands-on experience of business management and strategy setting is critical to the success of our engagements.

Hermes and the BTPS have extensive experience of implementing the United Nations' Principles for Responsible Investment (UN PRI). EOS' Chief Executive Colin Melvin chaired the committee that drew up the original principles, and the current chair is a trustee of the BTPS. This insight enables EOS to help clients who wish to become signatories or have already achieved signatory status to meet the challenges of the PRI.

How does EOS work?

EOS uses a proprietary screening process to determine which companies will benefit from intensive engagement. The first element of this screen looks at the companies' ability to create shareholder value by comparing the weighted average cost of capital with cash returns to investors. The second element assesses the prospects for engagement success. We apply further screens across a range of other metrics including environmental and social issues.

The Hermes Principles set out our basic expectations of companies in which our clients invest. These cover business strategy, communications, financial structure, governance and management of social, ethical and environmental risks. *The Principles* and their regional iterations guide our intervention with companies throughout the world. Our approach is pragmatic and company and market specific, taking into account individual company circumstances.

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

At any one time there are many companies included within our engagement programmes, meaning that significant additional resources are dedicated to these situations. All of our engagements are undertaken subject to a rigorous initial assessment and ongoing review process to ensure that we are focusing our efforts where they can add most value for our clients.

While we are robust in our dealings with companies, the aim is to deliver value to clients, not to seek headlines through campaigns. These can often undermine the trust which would otherwise exist between a company and its owners. We aim to be honest and open with companies about the nature of our discussions and will seek to keep such discussions private. Not only has this proved the most effective way to bring about change, it also acts as a protection to our clients, so that their position will not be misrepresented in the press.

For these reasons, this public report does not contain specific details of our interactions with companies but aims to bring clarity on some of the most important issues relevant to responsible owners today and EOS' related activities in these areas.

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

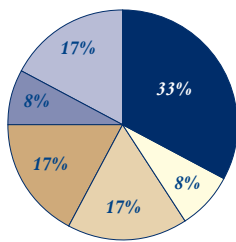
For further information please contact Colin Melvin on 020 7680 2251.

Engagement by region

Over the last quarter we engaged with 129 companies on a range of social, environmental and governance issues. EOS' holistic approach to engagement means that we will typically engage with companies on more than one issue simultaneously. The engagements included in these figures are in addition to our discussions with companies around voting matters.

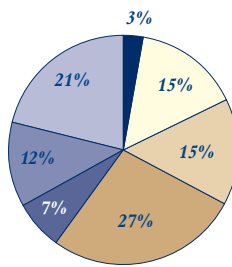
Africa/Middle East

We engaged with 5 companies over the last quarter



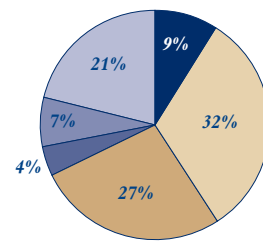
Americas

We engaged with 15 companies over the last quarter



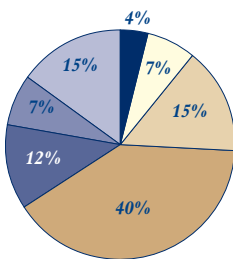
Asia Pacific

We engaged with 22 companies in Asia over the last quarter



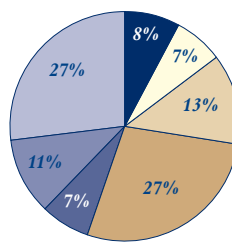
Europe

We engaged with 47 companies over the last quarter



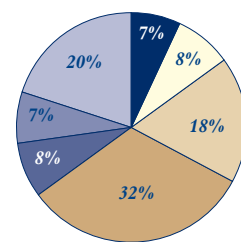
UK

We engaged with 40 companies over the last quarter



Global Summary

We engaged with 129 companies over the last quarter



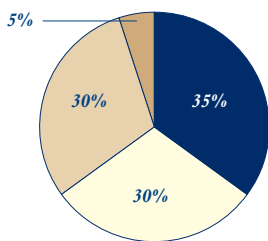
- Social
- Environmental
- Business strategy
- Governance
- Remuneration
- Risk management
- Ethical

Engagement by issue

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

Social

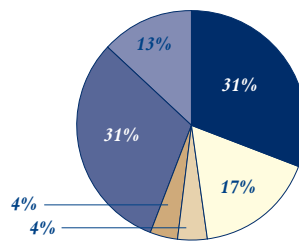
Social issues featured in 7% of our global engagements over the last quarter



- Community/employee relations
- Health and safety
- Labour issues (including child labour)
- Other

Environmental

Environmental issues featured in 8% of our global engagements over the last quarter



- Environmental issues
- Water use
- Waste
- Carbon intensity
- Climate change
- Oil sands

Other Engagement

Business strategy featured in 16% of our engagements over the last quarter.

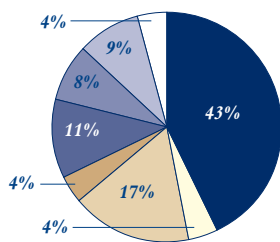
Returns to shareholders featured in 2% of our engagements over the last quarter.

Risk management featured in 7% of our engagements over the last quarter.

Remuneration featured in 8% of our engagements over the last quarter.

Governance

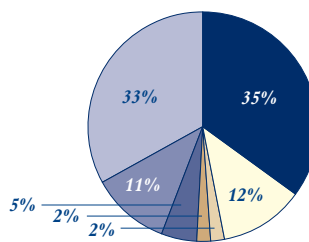
Governance issues featured in 32% of our global engagements over the last quarter



- General governance issues
- Accounting
- Board structure
- Capital structure
- Succession
- Other
- Poison pill
- Combined CEO/Chair

Ethical

Ethical issues featured in 20% of our global engagements over the last quarter



- Operations in troubled regions
- Munitions manufacture
- Access to medicines
- Clinical trials
- Bribery and corruption
- Other
- Supply chain issues

Governance: Business strategy and board structure

Strategic engagements

Many of EOS' most successful engagements combine discussions of business strategy and structural governance issues.

Engagement statistics

Number of companies engaged with on strategic matters this quarter: **48**

Africa/Middle East	2
Americas	5
Asia	14
Europe	19
UK	8

Number of significant steps forward in strategic/governance engagements this quarter: **6**

Africa/Middle East	1
Asia	1
Europe	2
UK	2

Includes only companies which this quarter have made substantive strategic or major governance changes.

Number of strategic/governance engagements reaching their conclusion this quarter: **4**

Africa/Middle East	1
Asia	1
Europe	1
Americas	1

Overview

EOS' holistic approach to engagement combines discussions on business strategy and risk management, including social and ethical risks, with structural governance issues. Our engagements fill the gap left by the investment industry's tendency to focus on the short-term. The result of this tendency is that management too often goes unchallenged in its approach to the long-term future of its business and there is minimal pressure for change. EOS assesses and engages with underperforming companies from a long-term perspective, asking questions which encourage management and boards to think afresh to overturn long-running periods of underperformance. This proven approach is often successful in adding value or ending destruction of value.

Business strategy is a key feature of other engagements such as those highlighted elsewhere in this report. We are generally most successful in achieving change on environmental, social and other matters where we lead the conversation from a business perspective and focus on these issues as risks to the company's strategic positioning. Companies can become locked into historic patterns where they are overdue for refreshment and new perspectives on the board. Injecting new thinking at the head of the company – an independent chair or change of CEO – is frequently the key to unlocking change and driving renewed operational performance, creating long-term value for shareholders.

Engagements on governance and business strategy may require a series of meetings over months and years. It takes time for board changes to generate business and strategic changes which improve long-term performance.



Highlighted sample engagements

In the **Africa/Middle East** region, we met with the chair of a company facing a hostile bid from a rival to discuss our long-running concerns about the operational performance of the business. We shared our perception that the bid had been received favourably by some shareholders because of the erosion of trust in the CEO due to ongoing operational failings – which we had verified on visits to some of the company’s key operations. We suggested that a bid was an expensive way to replace a single individual and argued that addressing the CEO’s position needed to be included in any defence to the hostile bid. This would produce a better deal for shareholders or board change which reflected the need for significant operational improvement.

In the **Americas**, we continued our engagement with a major energy company. We believe the recent appointment of a new CEO will lead to a review of the company’s strategy, which has suffered from a lack of focus and a conglomerate approach. As well as this change in the CEO role, strategic change will first require wider refreshment and renewal on the board. In particular, we have been pressing for the appointment of a genuinely independent lead director to take on many of the roles of an independent chair and provide an appropriate foil to the CEO and a counterbalance the potential for excessive control in the hands of one individual. Our arguments have earned a positive reception within this company.

In **Asia**, we continued to engage with a large Japanese conglomerate which has operations across such a broad spread of activities that it is impossible for material synergies to be present. It is notable that the firm’s listed subsidiaries perform better than the parent company, which suggests that the centre is destroying rather than adding value. We urged a tougher approach to underperforming businesses and tighter financial discipline across the organisation. We also encouraged the company

to appoint genuinely independent directors, noting that its adoption of the US-style board with committees structure does not of itself lead to better board decision-making – the key is the individual directors’ performance.

We held a series of meetings with a major company in **Europe** whose governance and financial performance continue to give us cause for concern and we visited one of its operating sites. We challenged senior management over the slower than targeted progress of its major restructuring programme. With the management of one of the divisions we discussed in detail the practicalities of the devolved and decentralised manufacturing process. Following EOS’ prolonged engagement, there has been significant board change, but we will continue to encourage the board to consider if further change is necessary and to make tough strategic decisions to refine its business structure.

In the **UK** we successfully encouraged the board of a company whose governance has raised concerns to take some substantive positive steps. The board will meet more frequently, diminishing the dominance of an executive committee that had effectively assumed some of the board’s functions. In addition, the roles of the senior members of the board will be more formalised, reducing the influence of the dominant shareholder. These changes should enable the company to respond to key risks more effectively and to move forwards strategically – strong leadership being vital given the technological challenges in its sector.

Governance: Pay and risk management

Financial sector remuneration and culture

In response to the financial crisis, EOS intensified its engagements with financial companies, highlighting issues such as risk management, compensation, and governance structures.

Statistics

Number of companies engaged with	22
Reassurance gained	0
Number of companies where substantive change sought	22
Number of these showing progress so far	8

‘EOS has strongly pressed for reassessment of the ways in which risk management is approached at financial institutions.’



Overview

The credit crisis struck initially at the major investment banking institutions and highlighted the weaknesses of many companies’ pay structures and risk management systems. This marked the further intensification of EOS’ systematic programme of engagement across the financial sector which began towards the end of 2007 as the severity of the problems in the financial markets began to emerge. EOS’ engagement has encompassed all the major financial institutions impacted by the financial crisis. Our approach was an iterative one, as we learned more about the causes of the crisis and addressed concerns and reasoning through a series of meetings with senior management and board members at these institutions. Our engagements encompassed financial institutions in continental Europe, the US, Australia and the UK which caused us concern because of their aggressive business strategies and governance structures.

In response to this crisis EOS encouraged greater accountability within governance structures to ensure that boards are willing and better able to call management to account. Where appropriate we have sought board change at individual institutions – not as punishment for directors who have failed, but to ensure that the right individuals are in place to take the companies forwards. Many of these changes have occurred; others are likely to occur over the coming months, as appropriate candidates become available and to maintain continuity through the crisis. We have in all cases sought significant reforms in the approach of financial institutions to remuneration. We have repeated the case that we made to the Institute of International Finance (IIF), and used its final report as a model – generated from within the industry itself – for future reform.

EOS has strongly pressed for reassessment of the ways in which risk management is approached at financial institutions. We have argued for greater integration of risk management systems and analysis in the development of new products, rather than a siloed approach to risk as a question which is asked only at the end of the process, often resulting in undue pressure on the risk management staff to certify products expected to produce high returns. To enable risk management staff to deal with these pressures and play a greater role in product development they need to be accorded higher status and rewards to ensure staff are of sufficient stature and quality to influence and debate these issues effectively. In our engagements we have pressed for risk management to be interwoven into board culture and form part of wider considerations across all issues. Ensuring that non executive directors have a strong understanding of the firm's business model and inherent risks will be key to helping firms recover from, and avoid future crises.

To support our work with individual companies, we engaged with the IIF, the leading representative organisation for the financial sector. In early 2008 the IIF issued an interim report which was the industry's first response to the crisis, dealing with a number of crucial issues, in particular risk management, off-balance sheet vehicles and the ratings process. However, its coverage on remuneration was notably weak. EOS' response to this interim report called for dramatic change in the way pay systems are structured, in particular with regard to the time-frame over which performance is measured. We believe that EOS was the sole respondent to voice the perspective of shareholders in these financial institutions. We were pleased to see that the IIF's final report highlighted the need for appropriate time-scales and the consideration of cost of capital in the calculation of performance.

Companies and issues

Financial institutions sustained significant losses generated by transactions on which generous bonuses had already been awarded. Many banks were keen to highlight that they deferred portions of annual staff bonus payments, locking this portion of the bonuses into shares which were not available for some years – typically three. However, it was apparent that this was not sufficient to make investment bank staff long-term in their outlook, with the deferred bonus elements dismissed as valueless comparative with cash bonus payments. This failure of deferral structures to drive appropriate behaviour may perhaps be most easily demonstrated by the fact that Lehman Brothers (US), the firm allowed to fail by the US authorities, had the lengthiest deferral period of any of this group of firms. Other institutions in this category or with portions of their businesses operating in the field were Bear Stearns (US) and Merrill Lynch (US), both forced into abrupt sales to peers; Barclays (UK), Citigroup (US), Credit Agricole (France), Credit Suisse (Switzerland), Deutsche Bank (Germany), Goldman Sachs (US), HSBC (UK), Investec (South Africa/UK), JP Morgan (US), Macquarie Bank (Australia), Morgan Stanley (US) and UBS (Switzerland).

The credit crunch also exposed issues at many other banking and financial institutions which had been run on the assumption that the good times would continue. These more mainstream organisations have challenges related to their governance and management of credit risks and of their liquidity requirements. Among those in this category are: Bank of America (US), BNP Paribas (France), Bradford & Bingley (UK), Countrywide Financial (US), Fannie Mae (US), Fortis (Belgium/Netherlands), Freddie Mac (US), HBOS (UK), Hypo Real Estate (Germany), KBC Group (Belgium) and Royal Bank of Scotland (UK).

Social, ethical and environmental: Supply chain

Brazilian iron and steel supply chain

This was a long-running EOS engagement, the first collaborative shareholder engagement to be launched on the UNPRI clearinghouse, and carried forward for two years to its completion in the last quarter. Over the period, we engaged with companies from across the world, including Japanese, US and European companies.

Statistics

Number of companies engaged with	15
Reassurance gained	3
Number of companies where substantive change sought	12
Number of these showing progress so far [†]	8

[†]With the remaining four companies, we continue to engage on this and a range of other issues.

‘Those companies which sourced iron and steel linked to these abuses would face a step-change in their cost base, as the wages of workers and sustainable charcoal sourcing was priced into the iron and steel they bought.’

Overview

In 2006, an article in *Bloomberg* magazine discussed the pig iron supply chain in Brazil. In particular it covered the creation of charcoal used in iron production in the country, and highlighted some very concerning abuses of workers. Essentially, workers were enticed into the trade by the offer of well-paid work but were then kept in camps and either not paid, or their wages taken to pay for their living. Trapped by the physical remoteness of these camps, these workers were essentially slave labourers. In addition, these slave labourers were producing charcoal from rainforest trees, damaging the environment and using a resource in an unsustainable way. The case that we put to the companies using iron and steel drawn from Brazilian supply chains where there were allegations of slave labour emphasised the reputational risk of sourcing iron in this way – something potentially damaging to their perception among their staff and customers (a particularly acute concern for consumer-facing businesses) – but also from a more direct economic perspective.

Only a handful of the companies using Brazilian pig iron in their supply chains were already aware of these issues when we began our engagement. In those few cases, our dialogue focused on gaining reassurance that this awareness had been turned into effective action to mitigate the risk that their suppliers were taking advantage of these unsustainable practices. For the majority of the companies, however, the entire issue was unknown to them. Indeed for a number of them, the idea that shareholders might ask questions about their supply chain and practices within it was a novel one. This was particularly true of some of the Japanese companies, which were taken by surprise that these might be matters which shareholders had concerns about. With the Japanese companies in particular, the fact that EOS' Asian engagement team



were able to set out these concerns in their own language was a key driver for making progress. For these companies our initial aim was to alert them to the issue and their need to address it. We then worked with them to assist in the development of appropriate and substantive responses to the effective management of their supply chains.

It is particularly because of the need for education of these companies and the requirement to develop from scratch processes to manage such issues in company supply chains, that this engagement has been such a long-running one. But we are pleased that some of these companies – most notably two Japanese ones in the last quarter – have been able to demonstrate some very substantial processes to manage such risks in their supply chains, not just in respect of the immediate Brazilian iron issue, but more generally. In a sense, it is remarkable that they have come so far in such a short period of time.

Issues and Companies

The *Bloomberg* article focused on the efforts of the Brazilian authorities to clamp down on the abuse of workers and to free slaves from individual camps. However it was clear that the problem persisted and EOS acted to ensure that its implications were managed by companies in which its clients were invested. Those businesses directly involved in the trade were either sole traders or not publicly listed, but our investigations suggested that a number of companies in which clients were invested used iron from Brazil which was implicated in this way.

EOS' clients are long-term investors, looking to promote long-term positive performance by companies, rather than short-term profitability. It was apparent that over time the efforts of the Brazilian authorities against this trade would be successful and that this abuse of workers and unsustainable use of rainforest charcoal would be brought to an end. Those companies which sourced

iron and steel linked to these abuses would at that point face a step-change in their cost base, as the wages of workers and sustainable charcoal sourcing was priced into the iron and steel they bought. Indeed, it appeared to us that the profitability of these companies was potentially misleading and could lead them to make poor investment decisions. These factors indicated to us that long-term investors in these companies should be encouraging them to manage their supply chains effectively to ensure they are not misled by prices or exposed to reputational risk.

Our analysis identified that there were essentially two groups of companies taking iron and steel from Brazil whose supply chains might be implicated in this way. As we indicate above, a few of these companies were already managing the issue effectively. As a result of our engagements, the vast majority of them are now doing so.

The first group of companies impacted by this issue were the large-scale steel producers, which have significant steel operations across the world. Generally, these take iron as a raw material for their steel mills. Among those in this group are: ArcelorMittal (Luxembourg), Gerdau (Brazil), JFE Holdings (Japan), Nippon Steel (Japan), Sumitomo Metal (Japan) and ThyssenKrupp (Germany).

The second group of companies which were identified as possible users of iron and steel from the relevant supply chain were manufacturers of cars and other similar machinery, particularly those with substantial operations in the Americas and therefore more likely to be sourcing raw materials from that region. This group included: Bombardier (Canada), Deere & Co (US), Daimler – at the time still DaimlerChrysler – (Germany), Ford Motor (US), General Motors (US), Honda Motor (Japan) and Suzuki Motor (Japan). A further company was Russel Metals (Canada), a metal distributor and processor.

Social and ethical: Operations in troubled regions

Focus on Zimbabwe

The sharp escalation of the troubles in Zimbabwe led EOS to accelerate its engagement with companies which are reported to have operations in the country.

Statistics

Number of companies engaged with	16
Reassurance gained	11
Number of companies where substantive change sought	5
Number of these showing progress so far	2

‘Our approach to engagements on operations in troubled regions is to place these operations in the wider context of the business and to discuss the risk/reward balance from continuing operations in the region in question.’



Overview

The sharp escalation of the troubles in Zimbabwe led EOS to accelerate its engagement with companies reported in the media as having operations in the country.

Typically EOS’ approach to engagements on operations in troubled regions is to place these operations in the wider context of the business and discussing the risk/reward balance from continuing operations in the region in question.

Where the returns that the company is earning from the country are minimal, and the prospect is that they will remain so, then it is harder for the company to articulate that the benefits outweigh the risks. These risks are typically reputational, and so particularly acute for consumer-facing businesses.

In a few cases it may be appropriate for a company to remain in a troubled region even if the returns it gains are minimal. Principally this would be where withdrawal might harm the broad population or would itself add to the financial resources of the regime and its individual members.

Our engagements involved discussions with a wide range of companies from around the world. In most cases, we were able to gain reassurance that the scale of the operations they have in Zimbabwe is so limited that they offer minimal if any support to the incumbent regime. Almost no company has increased its investment in the country in recent years and most feel very real obligations to their employees and their dependents who rely on their support (often in the most practical terms of food and fuel as well as paid salaries). In a number of cases, despite NGO and media reports, EOS was able to confirm that the companies have no presence in the country at all.



It is therefore only at a minority of companies that we have felt the need to seek specific change. In some cases, this applies to specific issues within Zimbabwe. However, this also highlights a wider need for change in overall corporate approach to managing risks in relation to operations in troubled regions. In the case of two companies, we have agreed that due to the very specific circumstances of these companies, it will not be possible to address one of our specific requests until the current political situation in Zimbabwe has been resolved.

Companies and issues

There are essentially three categories of companies which are still active in Zimbabwe: mining companies, banks and other financial institutions and various consumer operations.

The mining companies are typically the most high-profile. Zimbabwe is one of the only countries to have significant platinum resources, in the so-called great dyke geological feature and it enjoys significant diamond resources. These have over the years attracted the attentions of many of the largest mining companies. Two companies share ownership of an operating platinum mine: Aquarius Platinum (Bermuda-registered but UK- and US-listed) and Impala Platinum (South Africa); AngloAmerican (UK/South Africa) is developing a new opportunity. Despite media reports to the contrary, the company has been developing this since 2003 and has taken no recent decision to accelerate the development; the site is still some years away from production. Rio Tinto (UK/Australia) has a small diamond mine. Although NGO reports have stated otherwise, we believe that BHP Billiton (Australia/UK) has no presence in the country. The departure of a mining company from the country would leave behind valuable assets, which would likely then be sold by the regime.

Banks also face very specific reputational exposures due to local regulations requiring the purchase of government bonds and also the provision of financing which may support some of the recent changes to agricultural land. The international banks with operations in the country are Barclays (UK), Standard Chartered (UK) and Standard Bank (South Africa). Despite NGO reports, we have established that ING Group (Netherlands) and Societe Generale (France) do not have local operations in Zimbabwe. One of Zimbabwe's largest financial institutions is the local arm of Old Mutual (South Africa). While Old Mutual is reported as the largest investor on the Zimbabwe stock market, this investment is on behalf of the thousands of past and current retail customers for its insurance and investment products.

The consumer-facing companies form an eclectic group. Two leading oil giants (UK and UK/Netherlands) have a petrol retailing joint venture. Apart from retail outlets, its direct customers are largely hospitals and clinics. British American Tobacco (UK) and Tongaat-Hulett (South Africa), have significant plantation operations in the country producing their raw materials (tobacco and sugar cane respectively). Such plantation operations are often nearly as fixed as mining operations. Nestlé (Switzerland) and Unilever (Netherlands/UK) each have very small operations in the country, providing locals with food and soap respectively.

Environmental: Carbon intensity

CO₂ in retail and transportation sectors

In conjunction with the Carbon Trust, EOS commissioned a report to identify engagement candidates from a range of sectors in the UK economy, with emphasis on those industries with high emissions.

Statistics

Number of companies engaged with	18
Reassurance gained	0
Number of companies where substantive change sought	18
Number of these showing progress so far	9

‘Companies with greater carbon intensity than their peers will need to change their behaviour and prepare for a carbon-constrained future. Companies which do not disclose how they are managing the carbon element of their cost base in particular will need to give greater reassurance to their investors that they are effectively managing these future costs.’

Overview

Initially in partnership with the Carbon Trust, a UK government body which has a remit to reduce the carbon used by the UK economy, EOS agreed to engage with an initial set of with six companies from across a range of industries. The EOS team achieved some successes in changing the behaviour of the relevant companies, which will be measured over the coming years by Trucost assessing the relative carbon intensity of these companies. The Trucost analysis commissioned by EOS highlighted not only where companies had emissions greater than their sector peers but also those companies where disclosure was relatively weak. We will also monitor the extent by which reporting in this area improves.

We have since developed this model internationally by engaging with companies across the world, again using Trucost data as the basis for our engagement. We have initiated this approach on a sector-by-sector basis as the Trucost analysis is most relevant on a sector-comparative basis. Two early sectors in this programme have been food retail and ground transport. Food retail has environmental impacts not only through stores themselves, whose lighting and refrigeration are significant costs, but also through their logistics chains, which are some of the most complex across any business and which tend to aggregate foods in centralised distribution centres before sending them out to stores on a daily basis. In addition to the CO₂ issues we have also sought to engage on the issue of waste, which is very significant for these companies. Ground transport – both vehicle manufacturers and transportation firms – can have significant impacts on emissions by relatively minor changes to their approach to carbon intensity.



Issues and companies

Trucost's research assisted us in identifying a financial cost for environmental externalities (costs borne by wider society rather than by the company itself). Increasingly, governments are using the tax regime to internalise environmental externalities – that is, companies are being obliged to pay a specific price for those costs which are borne by society. This process is perhaps furthest advanced (in Europe at least) with regard to CO₂, through the emissions trading mechanism. Even outside Europe it is clear that we are moving towards a carbon-constrained world and that carbon will increasingly have a cost. Companies which are not yet planning their businesses around an expectation that this element of their cost base will see significant increases will be at a severe competitive disadvantage as the movement to carbon pricing intensifies.

Thus companies with greater carbon intensity than their peers will need to change their behaviour and prepare for a carbon-constrained future. Companies which do not disclose how they are managing the carbon element of their cost base in particular will need to give greater reassurance to their investors that they are effectively managing these future costs. Poor disclosure raises concerns that these issues may not be managed effectively, and that the board does not give this area of costs due attention.

Among the major supermarket chains where these issues were a concern were: Ahold (Netherlands), Carrefour (France), Delhaize (Belgium), Metro (Germany), Sainsbury (UK), Seven & I (Japan), Tesco (UK), Walmart (US), WM Morrison (UK) and Woolworths (Australia). We were pleased to note that this quarter Delhaize issued its first ever corporate responsibility report, which dealt among other things with the issue of carbon emissions in some detail.

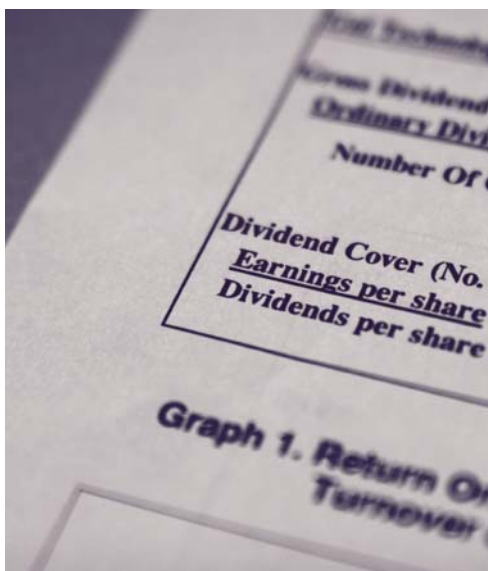
The EU and other markets are developing an increasing focus on emissions limits for car manufacturing companies. These will begin to bite most strongly over the next few years, driving manufacturers to consider much more actively how they can reduce the carbon intensity of their fleets. Those firms which do not respond early are likely to face significant added costs. The motor manufacturers and transportation firms which face particularly significant issues in respect of the carbon intensity of their current business models include: Arriva (UK), BMW (Germany), Burlington Pacific (US), CSX (US), Daimler (Germany), East Japan Railway (Japan), Fiat (Italy), General Motors (US), Honda (Japan), Hyundai Motors (South Korea), Michelin (France), MTR (Hong Kong), Nissan Motor (Japan), Renault (France), Stagecoach (UK), TDG (UK), TNT (Netherlands), Toyota Motor (Japan), UPS (US) and Volkswagen (Germany).

Public policy and best practice:

Protecting and enhancing value by promoting better regulation

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

'Investment institutions are typically absent from public policy debates even though they can have profound impact on shareholder value. EOS seeks to fill this gap.'



Overview

EOS actively participates in debates on public policy matters to protect and enhance value for clients by increasing shareholder rights and boosting protection for minority shareholders. This work extends across: company law, which in many markets sets a basic foundation for shareholder rights; securities laws, which frame the operation of the markets and ensure that value creation is reflected in value for shareholders; and in developing codes of best practice for governance, management of key risks and disclosure. In addition to this work on a country-specific basis, we address regulations with a global remit, which are currently in the areas of accounting and auditing standards.

Investment institutions are typically absent from public policy debates even though they can have profound impact on shareholder value. EOS seeks to fill this gap.

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



Highlighted sample activities

International accounting issues

We continue our efforts to ensure that International Financial Reporting Standards (IFRSs) works to the benefit of investors and drives better reporting rather than more opacity. IFRS is now the dominant form of financial reporting across the world – and seems likely also to be adopted in the US. That its standards reflect the needs of users is therefore crucial, particularly as some experience suggests that International Accounting Standards Board (IASB) approaches can be driven by academic approaches rather than the practical needs of users.

Our principal vehicle for this engagement is through participation in the Corporate Reporting Users' Forum (CRUF), a small group of individuals from the analyst community which liaises with the IASB, and thus far appears to have influence. We also work through our membership of a key CFA committee. Among our principal activities on these issues this last quarter have been:

- engaging the IASB on its plans for equity/liability accounting. These caused concern as the desire to draw a bright-line distinction between debt and equity seemed to be driving the Board to some impractical conclusions. We pressed for a reassessment.
- engaging the IASB Foundation on its own constitution. This is the body of trustees which oversees the IASB, appointing its members and making it accountable for its actions. It proposed constitutional changes in response to political pressures, which risked making standards-setting less responsive to the needs of users and too reflective of political pressures. To counteract these risks, we met with a Foundation trustee to test their plans and later followed up on this with a formal response to the consultation.

- engaging the IASB on complexity in financial instrument reporting. The issues surrounding financial instruments are some of the most complex and controversial – not least the current furore around so-called fair value accounting. We urged greater clarity and simplicity, but raised concerns about moves to limit hedge accounting, because we were concerned that such moves might set a precedent for hedge accounting in broader business contexts.

Taiwan Financial Supervisory Commission

We held a further meeting with a deputy director of the Taiwan Financial Supervisory Commission (FSC) to discuss progress on the agenda of regulatory changes which we have been arguing for in our discussions with the Commission. We are very pleased to report that they have addressed our concerns on the barriers which foreign investors faced in exercising voting rights at general meetings in Taiwan. Recently the requirement for publishing a detailed and final AGM agenda has been extended and an amendment to the Companies Act has been proposed to allow beneficial owners to split their voting – enabling investors in pooled accounts to vote differently for the first time. We have also:

- emphasised the need to enforce disclosure rules, particularly ensuring timely and adequate information on director nominees
- raised concerns about the large number of companies in Taiwan which include 'other business' resolutions on their AGM agendas, as this gives those present at the meeting a disproportionate influence over proceedings.

Continued on next page.

Public policy and best practice *continued*

Related-party transactions in Italy

We engaged with Consob, the Italian financial markets Commission, on its consultation regarding a comprehensive new framework for related party transactions. We regard this issue as particularly critical in the Italian corporate governance system, since such transactions offer potential for the extraction of private benefits by managers and/or controlling shareholders. We therefore spoke at a conference held at Consob in Rome, highlighting the key issues the new regulation should address in order to provide a more robust protection to minority shareholders interests. We followed up these comments in a formal written response to the consultation, pointing out that the most effective mechanism to prevent shareholders' expropriation through related party deals is a procedure involving approval by the shareholder meeting through a whitewash mechanism and also suggested other possible improvements in the enforcement structure of the regulation.

Other public policy work this quarter included:

Companies Acts and equivalents

- Australian carbon reduction scheme – comments to government
- Hong Kong Companies Ordinance – consultation response
- South African Companies Bill – comments to parliamentary committee

Securities Laws and Regulations

- Brazilian fair treatment of shareholders – comments to regulator
- German shareholder rights rules – comments to government
- Indonesian M&A rules – comments to regulator
- South African listing rules – consultation response
- US regulation of credit ratings agencies – consultation response
- US auditor ratification – comments to regulator

Codes of best practice

- GRI Guide to ESG disclosure – participation in working group (Global)
- Japan corporate governance – promotion of ACGA White Paper
- Netherlands corporate governance code reform – consultation response
- UK guide for audit committees – co-drafted

Global standards

- Ethical standards for auditors – consultation response (Global)

Hermes votes at general meetings wherever practicable. We take a graduated approach and base our decisions on annual report disclosures, discussions with the company and independent analyses. We inform companies before we vote against or abstain on any resolution, usually following up such votes with a letter. We maintain a database of voting and contact with companies and if we believe further intervention is merited, we include the company in our main engagement programme.



Hermes votes at company meetings all over the world, wherever its clients own shares.

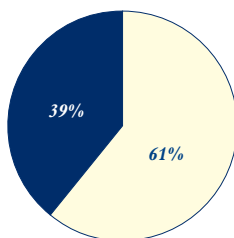
Voting overview

How we voted

Over the last quarter, we voted at a total of 971 meetings around the world, analysing 8,018 resolutions. At 262 of those meetings we opposed one or more resolutions and we abstained at seven meetings. We voted with management by exception at ten meetings, while we supported management on all resolutions at 692 meetings.

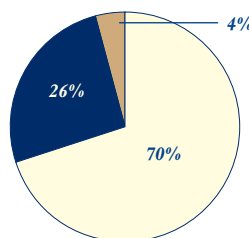
Africa/Middle East

We voted at 59 meetings (389 resolutions) over the quarter



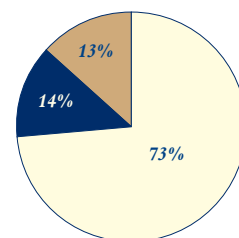
North America

We voted at 223 meetings (1,468 resolutions) over the quarter



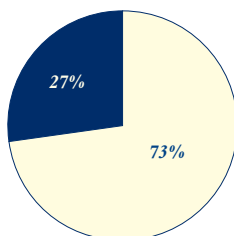
South America

We voted at 15 meetings (52 resolutions) over the quarter



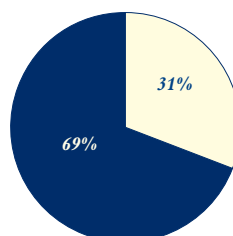
Asia (except Japan)

We voted at 191 meetings (1,277 resolutions) over the quarter



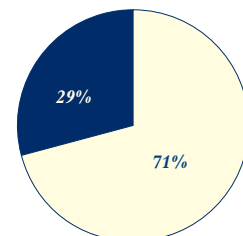
Japan

We voted at 13 meetings (116 resolutions) over the quarter



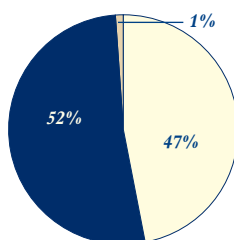
Australia/New Zealand

We voted at 21 meetings (101 resolutions) over the quarter



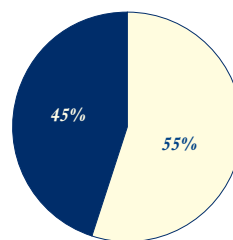
Western Europe

We voted at 119 meetings (1,031 resolutions) over the quarter



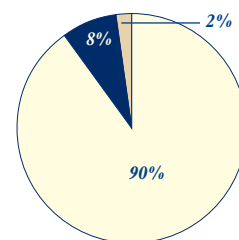
Eastern Europe

We voted at 64 meetings (1,002 resolutions) over the quarter



UK

We voted at 266 meetings (2,582 resolutions) over the quarter



- Total meetings voted in favour
- Meetings where voted against (or voted against AND abstained)
- Meetings where abstained
- Meetings where voted with management by exception

EOS | Equity Ownership Services

Hermes Equity Ownership Services (EOS) enables institutional shareowners 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.