



# 2019 ANNUAL REVIEW

Voting and Engagement Highlights

ENVIRONMENTAL ■ SOCIAL & ETHICAL ■ GOVERNANCE ■ STRATEGY, RISK & COMMUNICATION

For professional investors only

[www.hermes-investment.com](http://www.hermes-investment.com)



Welcome to our 2019 Annual Review, which outlines the engagement, voting and public policy work carried out by EOS on behalf of our clients. We have worked with companies across the globe to address their key risks, challenges and opportunities, covering environmental, social, governance, strategy, risk and communication matters. Alongside this, we have continued to engage with policymakers, regulators and standard-setters to help improve market best practice.



This report has been written and edited by Claire Milhench, Communications & Content Manager, EOS





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# ABOUT EOS

EOS at Federated Hermes is a leading stewardship service provider. Our engagement activities enable long-term institutional investors to be more active owners of their assets, through dialogue with companies on environmental, social and governance issues.

We believe this is essential to build a global financial system that delivers improved long-term returns for investors, as well as better, more sustainable outcomes for society.

## Our services



### Engagement

We engage with companies that form part of the public equity and corporate fixed income holdings of our clients to seek positive change for our clients, the companies and the societies in which they operate.

### Public policy

Engaging with legislators, regulators, industry bodies and other standard-setters to shape capital markets and the environment in which companies and investors can operate more sustainably.

### Voting

We make recommendations that are, where practicable, engagement-led and involve communicating with company management and boards around the vote. This ensures that our rationale is understood by the company and that the recommendations are well-informed and lead to change where necessary.

### Screening

We help our clients to fulfil their stewardship obligations by monitoring their portfolios to regularly identify companies that are in breach of, or near to breaching, international norms and conventions.

### Advisory

We work with our clients to develop their responsible ownership policies, drawing on our extensive experience and expertise to advance their stewardship strategies.

## The EOS advantage

- **Relationships and access** – Companies understand that EOS is working on behalf of pension funds and other large institutional investors, so it has significant leverage – representing assets under advice of US\$877 billion as of 31 December 2019. The team's skills, experience, languages, connections and cultural understanding equip them with the gravitas and credibility to access and maintain constructive relationships with company boards.
- **Client focus** – EOS pools the priorities of like-minded investors, and through consultation and feedback, determines the priorities of its Engagement Plan.
- **Tailored engagement** – EOS develops engagement strategies specific to each company, informed by its deep understanding across sectors, themes and markets. It seeks to address the most material ESG risks and opportunities, through a long-term, constructive, objectives-driven and continuous dialogue at the board and senior executive level, which has proven to be effective over time.

## FOREWORDS



**Dr Hans-Christoph Hirt**

Executive Director, Head of EOS

At Hermes we have engaged with companies for over 30 years, with a systematic stewardship service in place for more than 15 years.

EOS, which was established in 2004, helps institutional investors engage with companies worldwide on the most important risks and opportunities they face. For us, stewardship has always been about sustainable value creation for our clients and their beneficiaries and delivering holistic returns that result in positive outcomes for society.

Since joining EOS in 2004 I've seen stewardship and responsible investment move from the fringes to the mainstream, gaining broader acceptance within the asset management industry. The experience suggests that effective stewardship can deliver tangible changes and improved corporate performance. Moreover, there are academic studies supporting the view that successful engagements can reduce investment risk and enhance returns. Yet short-termism remains a bugbear of markets, and investment managers often lack the right incentives to invest in their stewardship capabilities. As a result, the quantity and quality of stewardship around the world falls short of what is needed.

With the UK revising its Stewardship Code in 2019, and the implementation of the updated Shareholder Rights Directive across the European Union, engagement is moving front and centre. Investors must now seek measurable outcomes for their stewardship activities, reporting on them in a meaningful way.

Our vision for stewardship in the next decade sets a challenge for the industry! We believe stewardship should be at the heart of the way investment managers fulfil their business purpose: creating sustainable value for clients and their beneficiaries. The investment industry will need to evolve from an allocator of capital into a steward of capital. This will require a significant investment in resources and skills. More importantly, it will require a change in mindset.

Our world faces multiple complex challenges – from the climate crisis to the misuse of artificial intelligence. These problems will not be solved quickly or easily. As the magnitude of sustainability issues grows, so will our expectations of companies. Investors have an important role to play in helping to address these issues as active owners.

We look forward to working with our clients and the wider investment industry to take stewardship to the next level. Make no mistake: the toughest battles lie ahead.



**Donald MacDonald**

Former Chair of the PRI

Integrating ESG factors and sustainability into the investment process is increasingly being regarded as received wisdom, but that was not always so.

Even 20 years ago, the view that “the business of business is business”, combined with a very narrow view of fiduciary duty, was dominant. This was particularly the case in the US where any other view was regarded at best as philanthropy or altruism, and therefore not in the interests of shareholders. True, there were some funds based on ethical principles and largely designed by or for foundations with charitable or religious objectives, but they were by no means within the investment mainstream.

The investment chain's missing link was the involvement of the asset owners, so the PRI was created to complete the ESG integration jigsaw. This was launched by Kofi Annan in 2006 following the 2005 publication of the UNEP FI Freshfields report<sup>2</sup>. The early days of the PRI were a struggle - there were initially fewer than 100 signatories and finances were tight. However, gradually we managed to attract more signatories and build resources.

Valuable progress has been made over the last two decades, but the strategic challenges facing the investment community and society are now much greater. By actively promoting collaborative endeavours, asset owners and fund managers can consider how best to deal with this century's greatest challenge – the water, food and energy demands of 11 billion global citizens, and the danger of passing the tipping point of catastrophic climate change.

It is doubtful that policymakers and institutional investors have tried hard enough to avoid future disaster scenarios. Greenwash will not cut the mustard. Fear of the financial and political costs of climate change mitigation and adaptation has stayed the hands of many policymakers, but delay will only exacerbate climate instability and resource scarcity, while increasing the financial burdens of the future. This is a threat to humanity and when policymakers finally awaken from their slumbers, they may well make up for lost ground.

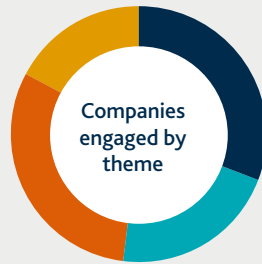
Smart institutional investors will want to take up the investment challenge before being forced to do so. They will see they have a duty to work together to press for policy frameworks that can meet both the long-term needs of society as well as fulfilling their fiduciary obligations to their beneficiaries. The window of opportunity is very short.

*Donald MacDonald was a member-nominated director of the BT Pension Fund and chaired the board of the PRI from September 2006 to December 2010. He later chaired the board of the Institutional Investors Group on Climate Change from September 2011 to December 2016.*

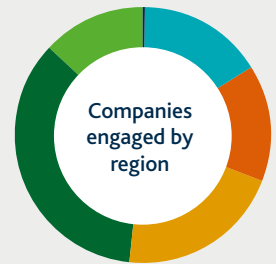
<sup>1</sup> <https://www.hermes-investment.com/ukw/insight/stewardship/stewardship-the-2020-vision/>

<sup>2</sup> [https://www.unepfi.org/fileadmin/documents/freshfields\\_legal\\_resp\\_20051123.pdf](https://www.unepfi.org/fileadmin/documents/freshfields_legal_resp_20051123.pdf)

# ENGAGEMENT ACTIVITY



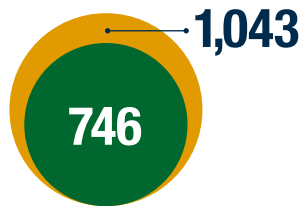
■ Environmental 31.0%  
 ■ Social and Ethical 21.0%  
 ■ Governance 31.0%  
 ■ Strategy, Risk and Communication 17.0%



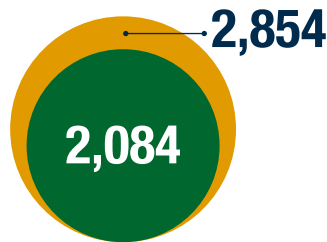
■ Australia and New Zealand 1  
 ■ Developed Asia 59  
 ■ Emerging Markets 56  
 ■ Europe 77  
 ■ North America 127  
 ■ United Kingdom 46

Number of engagements: ■ 2019 ■ 2018

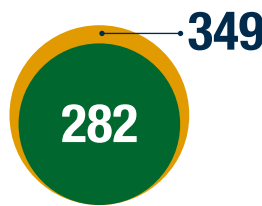
Companies:



Issues and objectives:



On objectives:



Languages spoken

# 73%

year-on-year increase in assets under advice engaged

We engaged with companies that together account for

# 60%

of the value of the MSCI ACWI All Cap

# \$877 BN

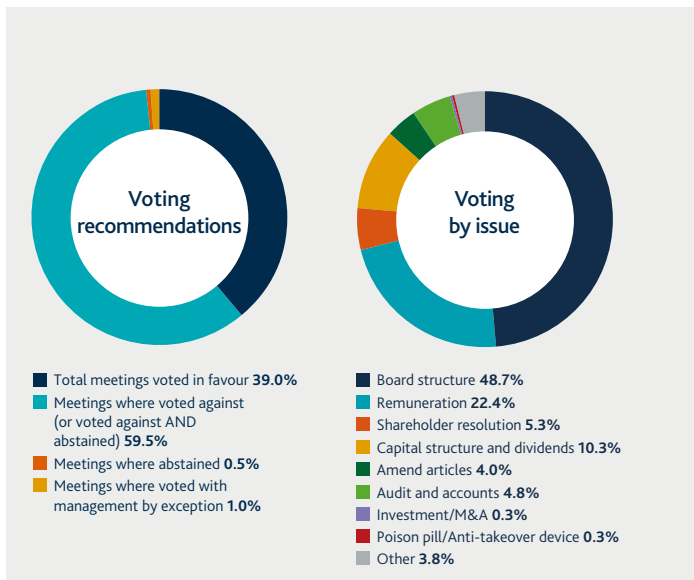
assets under advice

## KEY STEWARDSHIP INITIATIVES

We are an active participant in the following:

- Climate Action 100+: lead or co-lead for 27 engagements and supporting another 14
- Principles for Responsible Investment: lead investor for engagement with Vale on tailings dam failure, and actively involved in other groups, including cyber risk, water stress, cattle deforestation, palm oil, plastics, cobalt and tax
- CDP
- The Institutional Investors Group on Climate Change
- Investors for Opioid & Pharmaceutical Accountability
- Investor Alliance for Human Rights
- Investor Initiative on Mining & Tailings Safety
- International Corporate Governance Network
- ShareAction
- UN Guiding Principles Reporting Framework
- 30% Club





Number of voting recommendations made in 2019:

**109,959**

at **10,584** meetings

Number of recommended votes against:

**17,806**

**21** Regional voting principles

**48** Country-level voting policies

### RATINGS

For Hermes, recognising EOS activity:

PRI Rating:	<b>A+</b>	InfluenceMap Climate Engagement Score:	<b>A+</b>
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### PUBLIC POLICY

Number of consultation responses made in 2019:	<b>36</b>	Number of discussions held with relevant regulators and stakeholders:	<b>182</b>
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# A GUIDE TO ENGAGEMENT TERMINOLOGY

Our engagement approach is systematic and transparent. Our proprietary milestone system allows us to track the progress of our engagements relative to the objectives set for each company.

## Objectives

We set clear and specific objectives within our company engagements to ensure we achieve positive outcomes. An objective is a specific, measurable change defined at the company – an outcome we are seeking to achieve. Each objective is tracked using milestones. Objectives are regularly reviewed until they are completed – when the company has demonstrably implemented the change requested – or discontinued. Objectives may be discontinued if the objective is no longer relevant, or because the engagement is no longer feasible or material.

**We only consider companies to be engaged when we have an individual interaction with the company which relates to an objective or issue.**

We may engage with a company on multiple objectives at any one time, covering a variety of material ESG issues. An example of an objective could be: "Development of a strategy consistent with the goals of the Paris Agreement, including setting science-based emissions reduction targets for operating emissions (scope 1, 2 emissions)." Each objective relates to a single theme and sub-theme.

## Issues

How does an objective differ from an issue, another term we use within our engagement? An issue is a topic we have raised with a company in engagement, but where we do not precisely define the outcome that we are seeking to achieve. This can be more appropriate if the issue is of lower materiality and so we do not anticipate engaging with the frequency required to pursue an objective.

Or perhaps we are still in the process of identifying what type of change we may want to see at a company and so are not yet able to set a precise objective. Issues are frequently used for companies outside our continuous engagement programme, for example those where we typically engage only around the annual shareholder meeting and our voting recommendation.

## Milestones

To measure our progress and the achievement of engagement objectives, we use a four-stage milestone strategy. When we set an objective at the start of an engagement, we will also identify recognisable milestones that need to be achieved. Progress against these objectives is assessed regularly and evaluated against the original engagement proposal.



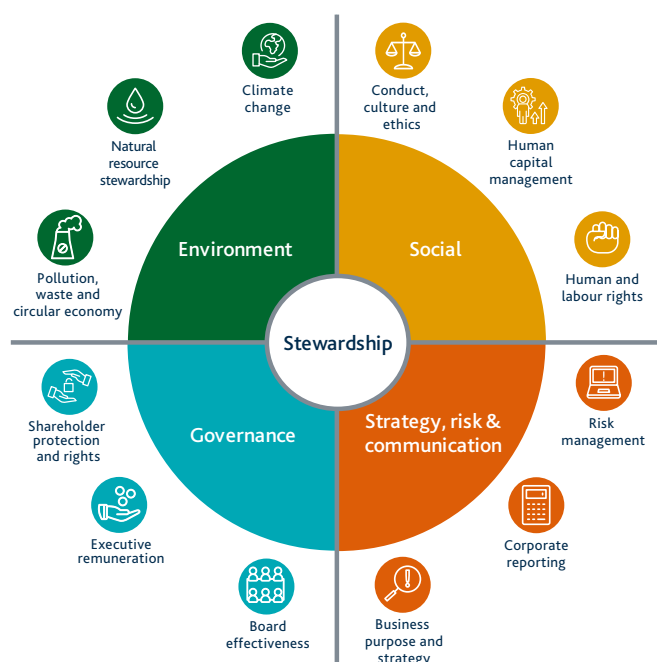
## Actions

These are the interactions that take place between our engagement professionals and the companies or public policy bodies with whom they are engaging. Every call, meeting or correspondence is recorded as an action. Actions can be linked to objectives or issues. We only consider companies to be engaged when we have an individual interaction with the company which relates to an objective or issue.



## OUR ENGAGEMENT PLAN

### Engagement themes for 2019-21



**Our engagement plan identifies 12 key themes and 36 related sub-themes. We find this breadth of coverage is necessary so that we can address the most material issues relevant to the companies in our global engagement programme, which covers all regions and sectors. However, our work maintains areas of focus on the most material themes, as outlined below.**

#### Climate change

This theme is relevant to nearly all sectors and geographies and continues to be our number one priority. We are active supporters of Climate Action 100+, the collaborative engagement initiative representing over US\$35 trillion of assets, acting as lead or co-lead engager for 27 companies – higher than any other supporter and the only player to lead engagement in each of the major geographic regions.

In 2019 we maintained our focus on the energy 'supply' side businesses of oil and gas, coal mining and utilities. However, we began allocating more resources to other sectors, which drive high demand for fossil fuels and are exposed to significant transition risk. These included the transportation sector (covering automotives, airlines and shipping); energy intensive industrials (steel, cement, petrochemicals and metals smelting); and financial services, among others.

#### Human and labour rights

Human and labour rights underpin a company's wider corporate culture, business ethics and enterprise risk management, which affect a company's reputation and the ability to create and preserve value over the long term. Changes in regulations and government policies, such as

the UK Modern Slavery Act and the Dutch child labour due diligence law have set new minimum levels of obligation for companies to identify and report how they manage these risks.

In addition, the UN Guiding Principles on Business and Human Rights set out international guidelines covering the identification of salient human rights in company operations and supply chains and the range of actions to consider in order to respect and, where necessary remedy, human rights abuses.

### Our engagement plan identifies

# 12

 key themes

#### Human capital management

In a knowledge economy where intangible assets, such as employees, are estimated to comprise on average more than half a company's market value, it is vital that companies look beyond physical assets to understand the sources of long-term value. Our engagement is focused on all aspects of a company's workforce, including diversity and inclusion; fair wages, incentives and benefits; and health, safety and wellbeing.

The UN Sustainable Development Goals provide additional leverage with three goals focused on the pursuit of gender equality, reduced inequalities and decent work and economic growth. Best practice human capital management supports long-term performance as it drives the alignment of culture, strategy and purpose, which helps improve productivity. Wider society also benefits from a happy and fulfilled population, given that many people spend more time at work than anywhere else during their working lives.

#### Board effectiveness

There is considerable evidence that the performance of the board is vital to the long-term success of a company. We believe that boards should be composed of directors with technical skills aligned with the strategic needs and direction of the company, and a diversity of perspectives to improve decision-making.

Equally important is that boards contain enough independent directors to challenge management and that directors are able to dedicate sufficient time to fulfil their duties. An effective board should also be involved in good dialogue with its shareholders, the workforce and other key stakeholders.

## NEWER THEMES

In 2019 we set out to explore and initiate engagement in the following new areas:



### Ethical data governance and artificial intelligence (AI)

The need for strong data governance is critical as company business models become increasingly reliant on harvesting, storing and analysing data. This will mean ensuring the security, accuracy and integrity of personal data, and that individuals have consented to its use.

Companies must take care to avoid discriminatory biases or unintended consequences arising from the application of artificial intelligence, which could lead to significant business risk and adverse social impacts.



### Plastics – circular economy solutions

Consumption of plastic has increased 20-fold in the last 50 years and is set to triple again by 2050, yet only around 14% is recycled.

Meanwhile, microplastics threaten to contaminate all living organisms, with unknown health consequences. Over the long term, plastics must either be removed altogether, reused or recycled in a closed loop.



### Sustainable food

Food supply chains account for approximately 25% of global greenhouse gas emissions, as well as putting significant stress on water resources and pollution through overuse of fertilisers and pesticides. Moving towards more environmentally sustainable food sources such as plant-based



proteins as an alternative to meat; avoiding excessive use of antibiotics in meat supply chains; and delivering healthier food choices to consumers will be essential for long-term sustainable wealth creation.

## EXPANDING THEMES FOR 2020



### Business purpose and capital allocation

It is our belief that companies can only create and preserve long-term value if they provide goods and services that meet societal needs in a positive manner. The board should ultimately be responsible for articulating this purpose and identifying those stakeholders most critical to long-term value creation.

The board should then ensure that capital allocation is consistent with this business purpose and the company's long-term strategy, clearly justifying its approach to share buybacks, mergers and acquisitions, cross-shareholdings and high cash holdings, and ensuring that capital allocation is consistent with the goals of the Paris Agreement.



### Sustainable land-use and biodiversity

The UN's landmark 2019 global assessment report on biodiversity and ecosystem services identified a major decline in biodiversity at a level unprecedented in human history, with extinction rates accelerating. In addition to our current focus on creating more sustainable food supply chains, we will look into ways to directly affect land-use change through sustainable management and production of palm oil, timber, biomass and fisheries, which all contribute directly to biodiversity loss.



### Fast fashion

Textile production is estimated to account for over one billion tonnes of CO2 equivalent every year, more than international flights and maritime shipping put together. It is also water intensive, and a major source of microplastics. Yet once the consumer has finished with the clothing item, some 73% is either incinerated or goes to landfill, with less than 1% recycled. The current business model of fast fashion is unsustainable, and we will work with companies to find the right solutions.

## THE UN SUSTAINABLE DEVELOPMENT GOALS

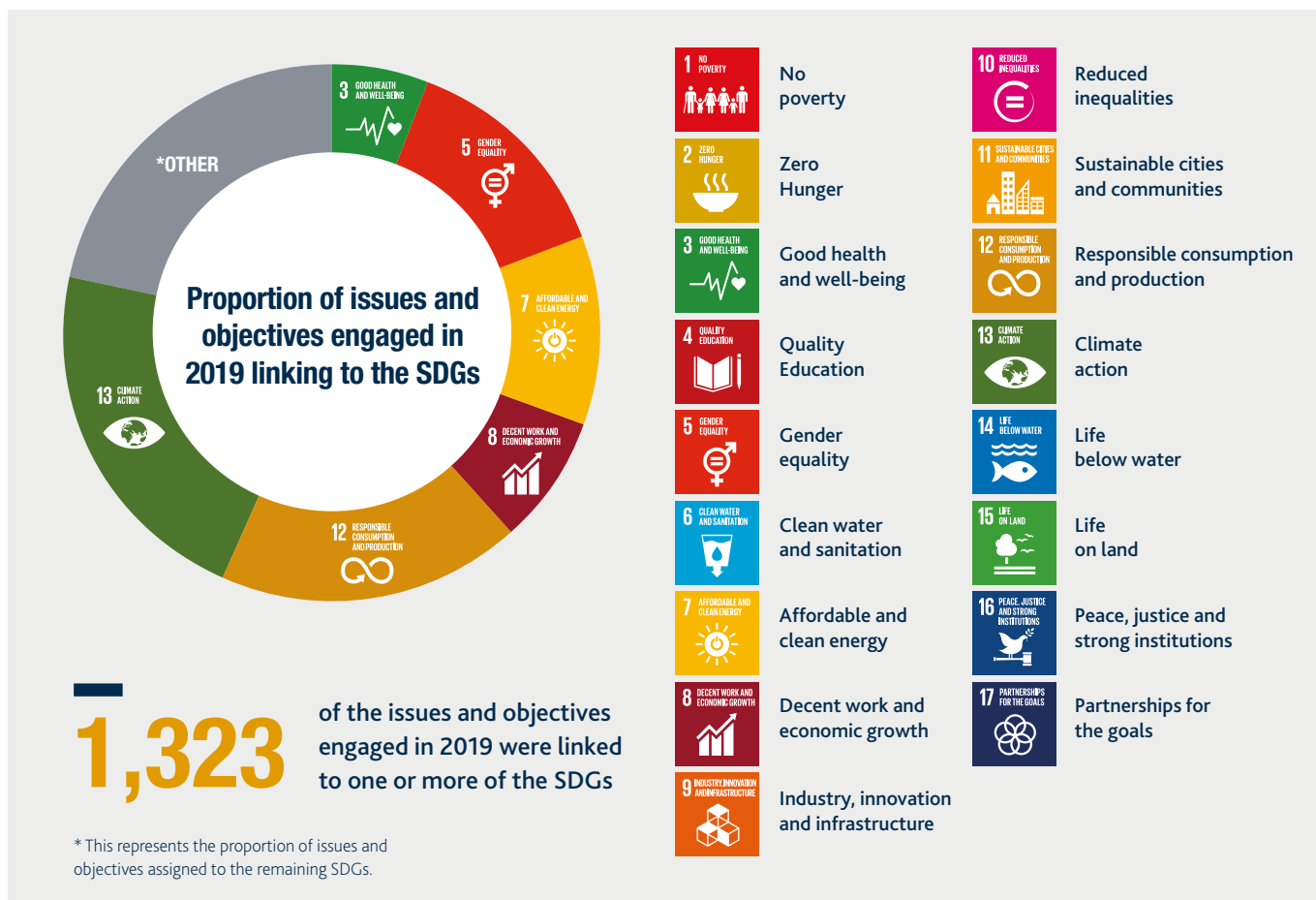
The UN's 2030 Agenda for Sustainable Development sets out 17 goals and 169 underlying targets, providing a blueprint for shared prosperity in a sustainable world. The goals call for action by all countries to promote prosperity while protecting the natural environment, and have been adopted by all UN member states.

## Why do we engage on the Sustainable Development Goals?

Our view is that the long-term success of business is inextricably linked to that of the goals. This is because the goals help to create a more sustainable economy in which businesses can thrive. And by seizing market opportunities in line with the goals, businesses help to deliver the economic growth necessary to achieve them.

The SDGs provide a common purpose and language for investors and companies to work together on externally agreed objectives aligned to some of the world's biggest challenges. They also provide a clear time frame in which change needs to take place, helping to set targets and create a greater sense of urgency. This allows us to have more robust engagement discussions with companies with opportunities to achieve positive change along the entire value chain from supply through to distribution.





## Our approach

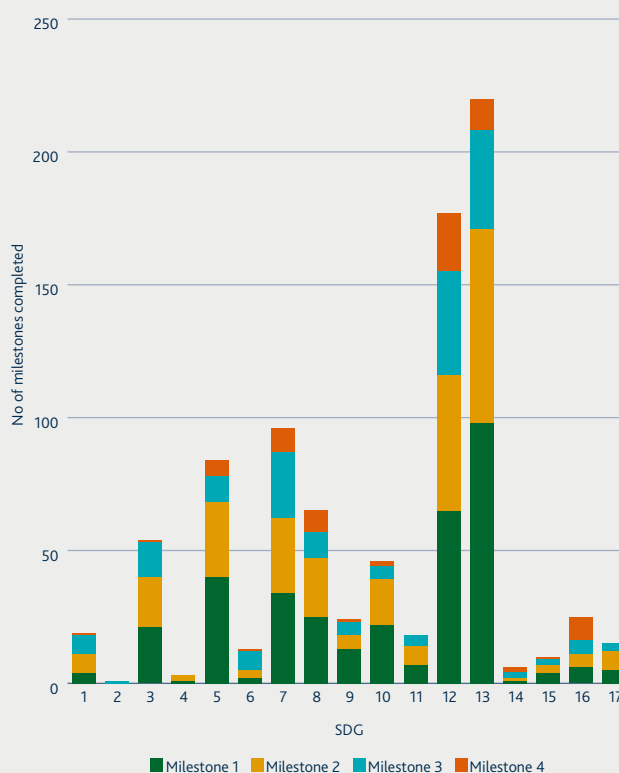
There is no universally accepted standard or benchmark for reporting on the SDGs, so we have developed our own approach in alignment with our engagement plan. We attribute a direct link between one of our engagement themes and an SDG if our engagement objective directly supports at least one of the UN’s targets underpinning the relevant goal.

The diagram illustrates the number of engagement objectives and issues on which we have engaged in 2019, which we believe are directly linked to an SDG (noting that one objective may directly link to more than one SDG).

The data shows that we undertake the most engagement on SDG 13 as most companies rely directly or indirectly on energy and its associated emissions in their operations and supply chains. For similar reasons, we see a high number of engagements linked to SDG 7 – affordable and clean energy.

**The SDGs provide a common purpose and language for investors and companies to work together on externally agreed objectives aligned to some of the world’s biggest challenges.**

Milestone progress of SDG-linked engagement objectives

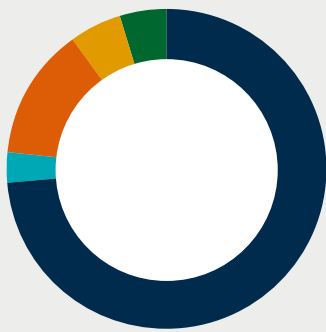


Source: EOS data for 2019

ENVIRONMENTAL

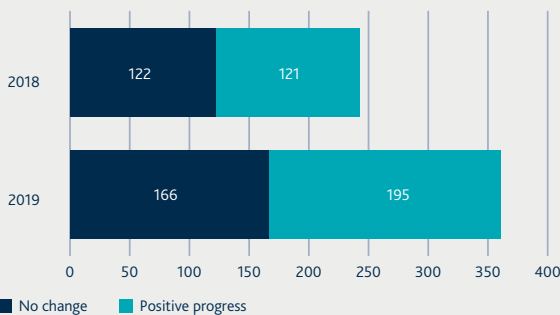
# THE CLIMATE CRISIS AND THE ROAD TO NET ZERO

Environmental topics comprised 31% of our engagements in 2019.



- Climate change 73.7%
- Forestry and land use 3.0%
- Pollution and waste management 13.3%
- Supply chain management 5.4%
- Water 4.7%

### Progress against environmental objectives



Source: EOS data

The clamour for urgent action to address the climate crisis intensified in 2019 with global school strikes led by Swedish climate activist Greta Thunberg and acts of civil disobedience by campaign group Extinction Rebellion. As a participant in Climate Action 100+ we stepped up our own efforts to engage with some of the world’s largest emitters of greenhouse gases. Within this initiative we are leading or co-leading the engagement on 27 companies and collaborating with other investors on another 14 companies.

We encourage companies to set science-based targets, conduct climate-risk stress tests, and make enhanced disclosures. We also ask them to link executive pay to the achievement of climate change outcomes, and to ensure they do not lobby policymakers or regulators to hinder the achievement of the Paris Agreement goals. In 2019 we attended six annual shareholder meetings to promote action on the climate crisis – mining company Anglo American, oil major BP, utility Centrica, and car manufacturers Daimler, General Motors and Volkswagen.

We also help to co-ordinate the work of the Institutional Investors Group on Climate Change’s shareholder resolutions sub-group, identifying companies that could be potential targets for climate change-related resolutions, and the utilities sector sub-group, formulating and co-ordinating engagement strategies for the sector.

**We encourage companies to set science-based targets, conduct climate-risk stress tests, and make enhanced disclosures.**



### Notable positive outcomes at companies in 2019 following collaborative engagement supported by EOS include:

- *BP* supporting a shareholder resolution that we developed in our role as CA100+ lead co-ordinating investor, which called on the company to set out a strategy consistent with the goals of the Paris Agreement. This had co-filing support from investors owning almost 10% of BP – the largest ever secured for a climate change shareholder resolution – and it passed with the support of over 99% of shareholders at the 2019 AGM.<sup>1</sup>



- *Centrica* announcing the ambition to help its customers reduce emissions by 25% by 2030, and to develop a path to net zero by 2050. This followed a long dialogue with the company, including speaking at its annual shareholder meeting for the last four years.
- *Daimler* and *Volkswagen* announcing the ambition or goal for all new car sales to be carbon neutral by 2040.
- *PetroChina* improving disclosure of its climate change risks and opportunities, including its plans to contribute to the goal of limiting climate change to below 2°C.
- *Lafarge Holcim* submitting its greenhouse gas targets for accreditation as a science-based target, which were subsequently validated by the Science-Based Targets initiative.<sup>2</sup>

We are also supporters of the Transition Pathway Initiative (TPI), a global, asset-owner led initiative that assesses companies' preparedness for the transition to a low carbon economy. In 2019 we introduced the guideline that we would consider recommending a vote against the chair of the board of a company with a management ranking of 0 or 1 by the TPI, unless the company has provided a credible plan to address the climate risks and opportunities of the low carbon transition.

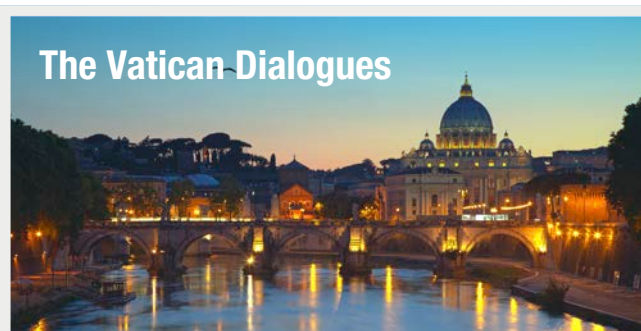
South Korea's Kia Motors was initially ranked level 1 by the TPI. After we communicated our voting recommendations and engaged with the company by phone, it disclosed more information about its climate change strategy and emissions in its sustainability report. Its TPI ranking then improved to level 3 in December 2019.

In 2020 we will continue to engage with companies on lobbying reform, goal-setting for emissions reductions, and implementation of the TCFD recommendations. We will also do this for companies outside CA100+. For example, we have engaged with Amazon on the sustainability implications of its strategy over several years, and it has now committed to reaching net zero carbon emissions by 2040.

### Climate Action 100+ brings together:



### The Vatican Dialogues



In June, Saker Nusseibeh, CEO, International at Federated Hermes, and Bruce Duguid, head of stewardship at EOS, attended a two-day Vatican summit on the energy transition, along with CEOs from major oil companies, asset managers and asset owners. The summit highlighted the need for urgent action on the climate emergency and focused on three key issues:

- 1 A just transition to a low carbon economy
- 2 Introducing reliable and meaningful carbon pricing
- 3 Transparency in reporting climate risks

Our CEO signed two accords on behalf of Hermes on carbon pricing and transparency of financial risks, showing our commitment to taking genuine action on the climate crisis.

<sup>1</sup> <https://www.iigcc.org/news/climate-action-100-investors-seek-net-zero-business-strategies-through-company-engagement/>

<sup>2</sup> <https://www.worldcement.com/special-reports/19122019/lafarge-holcims-carbon-emissions-targets-validated-by-science-based-targets-initiative-sbti/>

## Q&A: TAILINGS DAM RISK AND VALE



With Jaime Gornstejn  
Theme lead: Board Composition  
& Effectiveness  
Sector lead: Industrial & Capital Goods

The collapse of Vale's iron ore tailings dam at Brumadinho in January 2019 killed over 250 people and sparked renewed investor concern about mining industry practices. The accident, which followed a similar dam failure at Vale and BHP's joint venture Samarco in 2015, was both a human tragedy and an environmental disaster. Most of the victims were employees of Vale but local communities were also impacted, with the region's whole ecosystem thought to have been affected. Clean-up costs, fines and compensation payments resulted in a first quarter US\$1.6bn loss to Vale and prompted a second wave of divestments.<sup>1</sup>

### Q. What was our initial response to the Brumadinho disaster?

**A.** We immediately engaged with the company's senior independent director to ensure that a comprehensive disaster response plan was in place, including assistance for the victims and their families. Shortly after, the PRI launched a collaborative engagement. Following a planning meeting with the investors, the PRI invited us to act as the lead engager for this initiative.

### Q. What did we ask for as part of the PRI co-ordinated engagement?

**A.** The number one priority was how the company was going to support affected communities and contain the damage to the environment. We also looked at the role that the company's culture had played in the disaster, pressing Vale to develop a plan to make any necessary reforms.

On behalf of the group I had a private meeting with Vale's chair at which I reinforced the message about making reparations and investigating the causes of the disaster. I challenged the chair to seek ambitious improvements and commit to transforming Vale into a global leader in safety management.

### Q. How did Vale initially respond?

**A.** In the immediate aftermath of the disaster, the board established three independent expert committees. These were asked to investigate the causes of the dam's collapse, monitor the company's response, and develop new safety procedures for tailings storage. The board also suspended the payment of bonuses to executives and dividends to shareholders.

Vale subsequently changed its management team and brought in a new CEO with strong mining expertise. Five new board directors were elected at its shareholder meeting. In a group meeting with investors, the new CEO apologised sincerely to all stakeholders and made a commitment that Vale would become the safest mining company in the world. This is a major step. Now we have to see how Vale embeds a culture of safety, which will take time.

### Q. How is Vale approaching this challenge?

**A.** It has appointed a new executive officer to lead a centralised safety and asset integrity function. Crucially, this will be independent of operations, to guard against potential conflicts of interest.

The board has acknowledged that Vale's culture played a role in the dam's collapse, and that it was not just a technical problem or engineering failure. The new CEO and head of safety and operational excellence are setting the tone from the top and leading a full review of safety policies and culture. It is now critical that Vale embeds a new culture of safety into the business. The company's reputation has been damaged, and some investors and stakeholders are sceptical about its commitment to change.

### Q. What still needs to be done?

**A.** Vale has to decommission nine tailings dams that were built using the same technique as the one that collapsed, while monitoring and improving the safety of its other dams. The company has a target to reduce its reliance on tailings dams and increase the use of dry processing to 70% of its total volume by 2023. This goal will be achieved by the use of "dry-stacking" for tailings and dry concentration technology. Vale also still needs to improve its engagement with the families of its employees and members of the local community who were affected by the dam's collapse, to make full reparations, settle claims and promote development in the region.

### Q. What has been the wider industry response given the concerns about other tailings dams?

**A.** The Investor Mining and Tailings Safety Initiative, which we support, is building a global database of tailings dams.<sup>2</sup> The initiative is governed through a steering committee chaired by the Church of England Pensions Board and the Swedish Council of Ethics of the AP Funds, and backed by investors with more than US\$14 trillion under management. It has written to over 700 extractive companies seeking greater disclosure on the management of tailings dams. By 20 December 2019, 40 of the top 50 mining companies had made disclosures. Participants in the initiative will seek to engage directly with those who did not respond, including those that are privately-owned.

In a further response to the disaster, the International Council on Mining and Metals, the United Nations Environment Programme and the PRI co-convened a global tailings review to establish an international standard.<sup>3</sup> The aim is to prevent catastrophic failures by creating a step change for the industry in the safety and security of tailings facilities.

### Q. What else do we think is necessary?

**A.** In our own engagements with mining companies we are seeking improvements in terms of governance, targets, culture, monitoring and incentives. Good practice is a three-tier review system for assessing tailings facility risk involving the engineer of record, an independent consultant and an independent review panel. The board of directors also plays a vital role in the oversight of tailings facility risk, and related controls and culture, plus emergency response plans. A culture of safety first and an absence of any fear when employees flag concerns about facilities is vital for effective management of tailings risk. This culture must come from the top.

<sup>1</sup> <https://www.ft.com/content/8c2f26f6-72b0-11e9-bf5c-6eeb837566c5>

<sup>2</sup> <https://www.churchofengland.org/investor-mining-tailings-safety-initiative>

<sup>3</sup> <https://www.icmm.com/en-gb/news/2019/tailings-review>



## Q&A: REDUCING PLASTIC WASTE



With Lisa Lange  
Theme lead: Pollution,  
Waste & Circular Economy

The problem of plastic waste shot up the consumer agenda in 2019 and regulators and policymakers have responded accordingly. Over 60 countries have implemented bans or levies on plastic packaging, while countries across Southeast Asia are banning imports of plastic waste from the West, following China's lead.<sup>1</sup> This is forcing the developed world to rethink its approach, with fashion retailers and supermarkets trialling recycling schemes, and manufacturers seeking alternatives to plastic packaging.

### Q. How have we approached this topic?

A. Plastic was a new engagement issue for us in 2019, included in our Pollution, Waste and Circular Economy theme. We identified three priority sectors on which to focus – chemicals, consumer goods and retail. Chemicals companies play a crucial role in finding innovative materials solutions for their customers, the consumer goods sector is instrumental in product and packaging design, and retailers can help make sustainable plastics choices easier for consumers.



We then looked at individual companies to determine whether plastic waste was a material issue for them, and whether it would be feasible to engage with them on it. We are now actively engaging on 20 objectives with companies in key sectors.

After further research, we plan to publish an investor expectations paper on plastics in the first half of 2020. This will set out the key risks and opportunities for investors in this space, and the questions that they must put to companies. We hope this paper will be a strong engagement tool for the investor community.

**The challenge is enormous, but the action taken by companies to date is woefully insufficient.**



### Q. How will we act on this in 2020?

A. We will be setting objectives for high-risk companies and communicating our views with investors and broader audiences. We expect companies to move away from the treatment of plastic as an "externality", and to develop strategies that consider it as a resource requiring responsible management throughout its lifecycle.

### Q. We have been working with a number of other organisations on this topic. Can you tell us more about that?

A. We are an active member of the PRI's Plastics Investor Working Group, advising on strategy and engagement. For example, we gave feedback on the research for three reports published in 2019, setting out what investors would find useful. The three reports explore why plastic is a problem, plastic value chain risks and opportunities, and how the plastic landscape is changing. The aim is to help investors identify where and how their portfolios might be exposed to plastic, so they can engage at the corporate and policy levels accordingly.

We participate in the Plastic Solutions Investor Alliance led by the NGO As You Sow. This is a collaborative initiative to engage with consumer goods companies such as PepsiCo and Nestlé on plastic packaging.

We are also participants in the Investor Forum's plastic pellet management initiative. This aims to reduce ocean plastic pollution by encouraging national and international standard-setting bodies to include plastic pellet management. And we are a signatory of the New Plastics Economy Global Commitment led by the Ellen MacArthur Foundation with the UN Environment Programme. This unites over 400 organisations behind an ambitious set of 2025 targets to address the plastic waste and pollution problem.

My colleague Aaron Hay appeared on a panel at a New Plastics Economy roundtable in London last May, addressing evolving investor expectations on company strategy for plastics. The key point he made was that the challenge is enormous, but the action taken by companies to date is woefully insufficient in terms of the overall material impact on plastics usage, and its recovery across value chains.

Since then, however, we have started to see some more ambitious commitments, with UK supermarket Sainsbury announcing a plastics packaging reduction target of 50% by 2025, for example.<sup>2</sup> This is ahead of expectations under the UK Plastics Pact, which aims to create a circular economy for plastics.

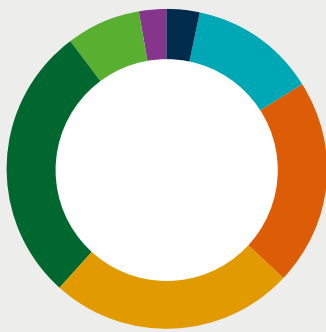
<sup>1</sup> [https://www.no-burn.org/wp-content/uploads/Plastic-waste-trade\\_-Southeast-Asian-countries-restrict-imports-.pdf](https://www.no-burn.org/wp-content/uploads/Plastic-waste-trade_-Southeast-Asian-countries-restrict-imports-.pdf)

<sup>2</sup> <https://www.about.sainsburys.co.uk/news/latest-news/2019/13-09-2019-sainsburys-to-halve-plastic-packaging-by-2025>

SOCIAL & ETHICAL

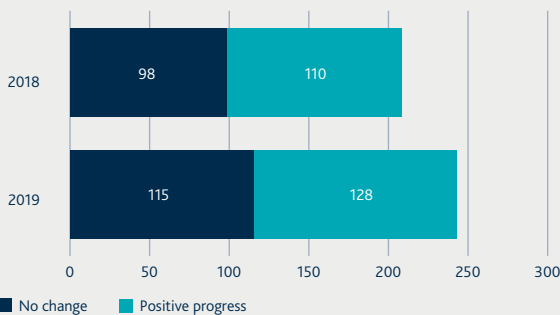
# ENGAGING ON HUMAN RIGHTS ISSUES

Social and ethical topics comprised 21% of our engagements in 2019.



- Bribery and corruption 3.5%
- Conduct and culture 12.6%
- Diversity 21.0%
- Human capital management 24.7%
- Human rights 27.9%
- Labour rights 7.6%
- Tax 2.6%

### Progress against social and ethical objectives



Source: EOS data

We engage on critical human rights issues including eradicating forced labour and child labour in supply chains, promoting access to medicine and nutrition, and protecting the rights of indigenous people. Ignoring such issues can lead to financial, reputational and legal risks for companies, and in the worst cases can limit a company’s social licence to operate.

No sector’s supply chain or geography can be considered safe, although some are riskier than others, such as consumer goods, agriculture and fishing, construction, logistics and hospitality. Migrant workers are particularly vulnerable to exploitation, even in mature economies.

In recent years investors have gone beyond simply expecting companies to disclose their human rights policy. Now they are seeking more robust due diligence and assessment in line with the UN Guiding Principles on Business and Human Rights.

These require companies to do more than meet minimum legal standards, through the consideration of all salient human rights connected to their business and supply chain. We also use the UN Sustainable Development Goals (SDGs) as a framework to engage with companies and policymakers in areas such as access to medicine and nutrition, inequality, decent work and strong institutions.

**The company has implemented a wage management system for all markets, to move beyond the absolute minimum wage and help boost take-home pay.**



## Key engagement themes for supply chain human rights

### 1 Forced labour and modern slavery

Workers may face forced or excessive overtime, curtailment of freedom of movement and debt bondage.

We have engaged with US retailer Home Depot on its approach to managing prison and forced labour risks in the lower tiers of its supply chain. The company has taken a number of steps to strengthen its policies on forced labour, including partnering with the Responsible Business Alliance, and currently has no prison labour in its supply chains on the basis of its audit findings. Any suppliers using it would be immediately escalated in its risk rating and investigated.

### 2 Child labour

UN SDG 8.7 aims to end child labour in all its forms by 2025, yet the problem persists, with an estimated 152 million in work. The seasonal and informal nature of many supply chains, such as in agriculture, a lack of decent work for adults in some regions, and limited access to education and contraception, can mean children have to work to help put food on the table.

We have engaged with Swiss food and drink company Nestlé on its cocoa supply chain and child labour risks. The company has made progress in recent years, developing local partnerships with NGOs and in 2019 extended its Nestlé cocoa plan initiative to Ghana.

### 3 Living wages and purchasing practices

Growing awareness of how some companies' low-cost approach can drive down labour standards has led to increasing debate about the sustainability of their business models and purchasing practices.

We have engaged with Swedish fashion retailer H&M on supply chain living wages for several years. The company has implemented a wage management system for all markets, to move beyond the absolute minimum wage and help boost take-home pay. We have also discussed how it will use its collaboration with industry initiative ACT on Living Wages to achieve living wages for textile workers through collective bargaining.

### 4 Worker voice

Corporate auditing programmes may fail to include genuine worker feedback, limiting the effectiveness of supply chain due diligence. Workers may not feel secure enough in their position to share details of exploitative practices or may even be coached on the answers to give to auditors.

Our engagement with sportswear manufacturer Adidas has looked at ways to adapt due diligence to capture worker grievances, through the development of hotlines and worker voice technology, which is being extended to all strategic suppliers.

### 5 Gender-specific issues

An average of 68% of the global apparel sector workforce is female, and women and girls are more vulnerable to exploitation. We expect companies to articulate how they are incorporating gender-specific issues into their supply chain human rights due diligence.

UN SDG 8.7 aims to end child labour in all its forms by

**2025**

An average of

**68%**

of the global apparel sector workforce is female

#### Public policy and best practice

- We responded to the UK Home Office's consultation on potential revisions to the Modern Slavery Act and argued for a requirement to report on all six of the currently recommended areas, instead of adopting a 'comply or explain' approach. We supported the creation of a registry to enable stakeholders, including investors, to access companies' modern slavery statements. We argued that a central registry should include a list of the companies caught by the Act's reporting requirement, regardless of whether they had submitted a compliant statement.
- We supported 'Find It, Fix It, Prevent It', a collaborative initiative to combat modern slavery. This will call on UK-listed companies to increase their efforts to address this issue and to support the provision of remedy to victims. The initial focus will be on engaging companies in the hospitality sector and we will lead engagement for a number of companies on the initiative's behalf.
- As an advisory committee member of the PRI cobalt supply chain collaborative engagement, we were the only investor representative to attend an OECD-led field trip to the Democratic Republic of Congo to see first-hand the human rights challenges, particularly around artisanal-scale mining. We wanted to look at how companies, civil society organisations and service providers can work together to formalise artisanal mining and improve conditions for miners and communities. We also participated in an on-site OECD roundtable, sharing our perspective and experience with local and international stakeholders.



Cobalt price board, Kasulo mining site in Kolwezi, DRC

## Q&A: THE OPIOID EPIDEMIC



With Kimberley Lewis  
Theme lead: Human Capital Management  
Sector lead: Pharmaceuticals & Healthcare



With Katie Frame  
Sectors: Pharmaceuticals & Healthcare,  
Retail, Technology Software

The US opioid epidemic has been declared a public health emergency, estimated to cost the US economy up to US\$100bn a year. On average, 130 US citizens die every day from an opioid overdose, according to data from the US Centers for Disease Control and Prevention, with overdoses involving opioids killing more than 47,000 people in 2017 alone. This has led to numerous lawsuits as authorities try to recover the cost of dealing with the epidemic. In October 2019, four drug companies agreed a US\$260m settlement with two Ohio counties, to settle claims relating to the crisis<sup>1</sup>.

Criticism has focused on manufacturers' marketing and sales activities, which downplayed the highly addictive nature of opioids and overstated their efficacy in treating chronic pain. Distributors have faced allegations that they failed to identify suspicious orders of prescription opioids and did not maintain effective controls against diversion or halt suspicious orders when they were identified.

### Q. How have we been engaging on this topic?

A. We have focused on corporate governance, compliance and compensation practices at opioid manufacturers, relevant drug distributors, retail pharmacies and health insurance companies. In 2019 we engaged with 10 companies on this topic, including names such as Johnson & Johnson and Pfizer.

As participants in the Investors for Opioid Accountability (IOA) initiative, we spoke at the annual shareholder meeting of Mallinckrodt, which manufactures generic opioids, and co-presented a shareholder proposal at pharmaceutical company Mylan's meeting.

**In 2019 we saw increasing public and regulatory scrutiny of the pricing practices of pharmaceutical and healthcare companies.**

At Mallinckrodt we asked it to commit to further action on managing opioid-related risks and to publicly disclose what governance measures it had taken since 2012 to monitor and manage the financial and reputational risks related to the opioid crisis. In addition, we asked it to disclose its lobbying activities in the relevant markets.

At Mylan's AGM in June 2019, on behalf of the IOA we presented a resolution pressing the company to adopt a more robust clawback policy. This would allow for the recoupment of senior executive incentive pay in the event of misconduct. We also questioned if the current board committee structure ensured appropriate oversight in managing opioid risks.

### Q. What was the outcome?

A. Mylan did not include the proposal as a voting item at the meeting, instead asking shareholders to submit their opinions for discussion. The proposal received majority support and the board agreed to take this into consideration. At the Mallinckrodt meeting, the shareholder proposals on lobbying disclosures and a board risk report on opioids also received majority support from shareholders of close to 80% apiece.

### Q. What has happened since?

A. We are monitoring companies across this segment to ensure that they uphold their commitments. Most have put in place sound governance practices so we expect our engagement around this issue will wind down. However, we are concerned about anti-competitive practices in the wider pharmaceutical industry and short-term profit-seeking business strategies.



In 2019 we saw increasing public and regulatory scrutiny of the pricing practices of pharmaceutical and healthcare companies. Some 20 generic drug manufacturers were named in a US federal lawsuit alleging that they conspired to artificially inflate and manipulate the prices of more than 100 generic drugs.

We want to make sure that appropriate compliance and governance systems are in place, as well as appropriate board and executive oversight and accountability. Under the auspices of the renamed Investors for Opioids and Pharmaceutical Accountability we have helped to draft the Principles & Practices for a Sustainable Pharmaceutical Industry. These set forth our expectations of what is required of companies to maintain a sustainable, competitive pharmaceutical industry.

<sup>1</sup> <https://www.bbc.co.uk/news/business-50121708>





# KEY ENGAGEMENT AREAS FOR HUMAN CAPITAL MANAGEMENT

Our engagement on human capital management focuses on three key areas – diversity and inclusion, fair pay and labour rights, and health and safety. Human capital management supports long-term company performance as it drives the alignment of culture, strategy and purpose, helping to improve productivity. There is also a significant benefit to wider society from a happy and fulfilled working population.

## Diversity

In 2019 we were particularly active on gender diversity as deadlines for regulatory guidelines or requirements for more women on boards or in senior management roles are looming around the globe.

The UK's Hampton-Alexander Review has a 33% target for women on boards and in the leadership teams of FTSE 350 companies by 2020. So in 2019 we tightened our policy for board-level gender diversity in the UK with a guideline of 30% women for FTSE 100 boards and 25% for FTSE 250 boards. We also introduced a policy on below-board diversity, with the guideline that we would consider recommending a vote against the chair of FTSE 100 companies with no women on their executive committee.

In Germany we released our new German Corporate Governance Principles, which set out our expectations for 2020 and beyond. They included an expectation that companies achieve 30% female representation on executive boards. Currently two-thirds of German companies still have no female management board members. We also helped to establish a Brazil Chapter of the 30% Club, which aims to improve the gender balance on boards and broaden the pipeline of women at all levels.

## Reporting Metrics

We have been working with the Workforce Disclosure Initiative (WDI) and the Human Capital Management Coalition in the US to improve the quality of corporate reporting on human capital metrics. Companies often claim that their workforce is their greatest asset but there is little disclosure around this. The WDI is backed by over 120 investors with some US\$13tn under management. Its survey aims to elicit information from companies about how they manage workers, to generate meaningful and comparable data for investors. We have pushed some non-responding companies to fill it in and publicly disclose the results.

We are also members of the Human Capital Management Coalition, a collaboration between 28 institutional investors and their representatives, with over \$4tn in assets. In 2017 this group petitioned the US Securities and Exchange Commission (SEC) for increased workforce disclosure. Currently, the US only requires companies to report on the number of employees, which is of limited use to investors.

In 2019 the SEC consulted on proposed changes to reporting rules. We wrote to the SEC arguing for a combination of rules-based and principles-based disclosure, covering elements such as workforce diversity and turnover, the gender pay gap, and employees paid the national minimum legal wage in each country of operation.

We have also contributed to the Financial Reporting Council's Workforce Lab project, providing insights on what investors would value in terms of reporting metrics. The aim is to publish a report with baseline metrics on the workforce, that companies can report against.

**In Germany we released our new German Corporate Governance Principles. They included an expectation that companies achieve 30% female representation on executive boards.**

## Fair Pay

We participated in a campaign co-ordinated by ShareAction in which a group of investors and their representatives wrote to 15 leading UK companies with economically vulnerable staff encouraging them to pay their staff the real Living Wage. These included United Utilities, JD Sports and Royal Mail.

Living Wage accreditation has been proven to boost productivity, reduce staff turnover and improve employee relations. Paying a fair wage also reduces the risk of negative reputational or operational damage due to disruptions caused by industrial action. Following a meeting where we pressed for accreditation, the chair of Compass indicated his intention for Compass to become a Living Wage Foundation accredited Recognised Service Provider for its UK operations within the next 18 months. We will follow up on this.



## Security services company G4S demonstrated a sustained reduction in health and safety incidences including fewer fatalities and road traffic incidents.

G4S is a global integrated security company operating in over 90 countries, offering a range of services including the supply of security personnel, response units and security technology. It is one of the largest private sector employers in the world, but as it operates in an inherently risky business environment, the workforce is exposed to high security risks. The consequences of poor health and safety risk management are therefore far-reaching, and can include reputational, financial and operational risks.

After G4S disclosed 54 fatalities in its 2008\* annual report, we set an objective to ensure that the health and safety record, specifically fatalities not related to attacks, improved over a prolonged period of time. We first raised our concerns with the chair, then reiterated our concerns with the CSR chair in 2015 when we were alarmed by the number of road traffic-related fatalities. These had remained high for three years.

We had a number of further meetings with the company, probing on its roll-out of new health and safety programmes. G4S introduced mandatory health and safety trainings for senior leaders and management staff and launched its first road safety programmes in 2013<sup>1</sup>. It also began sending a report to the executive team on every fatality within 24 hours of its occurrence. This improved the visibility of incidents.

By 2017, fatalities had fallen significantly across all categories. Notable progress was made on road traffic-related deaths, which fell from 21 in 2012 to seven in 2019 due to improved vehicle management and training, while workplace fatalities fell from 14 in 2012 to four in 2019. An improvement in the lost time incidence rate, from 8.5 in 2015 to 5.7 in 2019, was driven by progress in specific high-risk regions.



Read our engagement case studies in full at [www.hermes-investment.com/ukw/stewardship/eos-insights](http://www.hermes-investment.com/ukw/stewardship/eos-insights)



**Claire Gavini**  
Theme lead: Human Rights

## Q&A: AI ETHICS AND DATA GOVERNANCE



With Christine Chow  
Sector lead: Technology  
Software, Technology  
Hardware

Concerns about social media companies' failure to regulate themselves reached new heights in 2019 with the live-streaming of a terrorist attack on two mosques in Christchurch, New Zealand. This added to existing concerns about tech firms harvesting individuals' data without their knowledge, seeking to influence them for political ends, as in the Cambridge Analytica/Facebook scandal. Other fears relate to loss of human autonomy, consumer manipulation, and discrimination.

Recognising the importance of these wide-ranging and complex issues, we published our investor expectations white paper on responsible artificial intelligence and data governance in April 2019 and stepped up our engagement. In December we co-published a paper on AI in financial services, and in 2020 we are developing this new theme for other sectors including healthcare.

This is already paying dividends. For example, after we shared our AI white paper, one automotive company identified risks in its use of third-party facial recognition analytics within its approval process for car financing plans. Any biases in the data used to develop this software could have a business impact – in terms of inappropriate approvals – or lay the company open to charges of discrimination.

### Q. How did we engage with companies on AI ethics in 2019?

**A.** We engaged with Facebook on a number of material governance and business model issues, in light of the furore around how its platform works. As a result of our concerns about the board and its response to the crisis at the company, we recommended a vote against the lead director and the chair of the audit and risk committee at the 2019 shareholder meeting.

We also co-signed a letter to Facebook as part of a collaborative engagement with over 90 investment organisations and their representatives in response to the mass shootings in Christchurch. We asked if Facebook would do more to strengthen controls to prevent live-streaming of objectionable content.

We followed up with a call during which we repeated this request and delved into wider issues arising from its business model. While Facebook is providing much more information on its activity, it is hard to see a strategic plan to resolve all the issues that it faces. We will continue to push for greater clarity.

<sup>1</sup> <https://www.g4s.com/social-responsibility/securing-our-people/health-and-safety>

\* Since 2013, G4S has not incorporated suicides into its published figures, in line with health and safety reporting norms.



At the Alphabet shareholder meeting we spoke in support of a shareholder proposal asking the company to strengthen board oversight of the company's use of AI and of human rights issues in the data supply chain. Disappointingly, Alphabet's CEO Larry Page and its president Sergey Brin did not attend, even though as co-founders of Google they hold 51.3% of the votes. With Alphabet opposing the proposal, it did not pass, but we believe more investors will step up engagement with the company on this issue in 2020.

#### Q. What did we ask Alphabet to do?

A. We asked the company to take a leadership role in three key areas: to establish a board Societal Risk Oversight Committee; to make improvements to the internal governance structure overseeing AI technologies; and to regularly report on and monitor the impact on content reviewers, and ensure sufficient support is given to staff and contractors.

#### Q. How did the company respond?

A. Alphabet said its directors attended all board meetings, although no evidence of this was provided. It published a library of tools and testing components online to help developers become more aware of AI biases and manage them. So there are bottom-up efforts, but the problem is really at the top.

**We also see the need for a public policy response. These companies have evolved in a very under-regulated environment and are now too big in different parts of the chain.**

#### Q. What were our next steps?

A. We reached out to the Investor Alliance for Human Rights to build support for a collaborative engagement on broad-based issues. This led to the drafting of a private letter to Alphabet's chair, signed by 80 institutional investors and shareholder representatives with collective assets of US\$10tn. We will consider ramping up our public campaign and filing a shareholder resolution if the company is not responsive and open to a dialogue.

**We reached out to the Investor Alliance for Human Rights to build support for a collaborative engagement on broad-based issues.**

We also see the need for a public policy response. These companies have evolved in a very under-regulated environment and are now too big in different parts of the chain, presenting huge conflicts of interests that require investors' attention. But it is difficult to drive change through company engagement alone.

#### Q. How will we address this in 2020?

A. We will look at focusing more on anti-competitive practices in the US, to make a fairer, more transparent platform for investors. We will also consider calling for certain conditions to be met if companies want to continue with dual-class share structures – such as founders providing evidence of active involvement in the company in order to maintain an executive position.

#### CASE STUDY

### Ping An Insurance Group Co of China

In early 2019, we presented to Ping An's chief innovation officer and chief strategist at the insurer's Shenzhen headquarters on the need for responsible AI practices that met investors' expectations.



We shared industry examples of emerging best practices in AI governance and AI ethical principles, including the work behind our responsible AI paper.

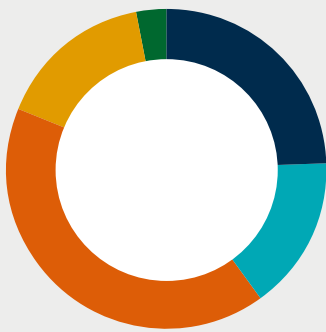
In August it became one of the first major financial institutions globally to publish a set of AI ethical principles. Ping An's co-CEO highlighted the positive impacts of its AI applications and the company's emphasis on information security and AI governance in its interim results announcement.



GOVERNANCE

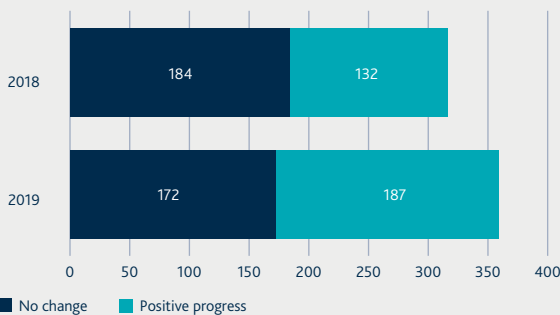
# VOTING SEASON ROUND-UP

Governance topics comprised 31% of our engagements in 2019.



- Board diversity, skills and experience 24.6%
- Board independence 15.4%
- Executive remuneration 41.2%
- Shareholder protection and rights 15.7%
- Succession planning 3.0%

### Progress against governance objectives



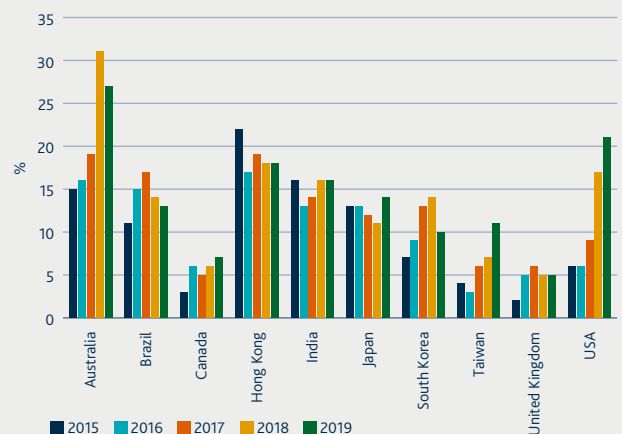
Source: EOS data

In 2019, we recommended votes for 10,584 meetings, covering almost 110,000 proposed resolutions. This compared with 10,358 meetings in 2018 and just under 105,500 resolutions. We attended nine shareholder meetings and broke our record for the highest number of votes against management that cited poor diversity as the rationale, with 1,496 recommendations to vote against, up from 795 in 2018.

Overall, we made at least one voting recommendation against management at 60% of meetings, with particular increases in the United States, Taiwan and Japan. Climate change, gender diversity and executive remuneration remained at the forefront of investors' concerns.

Some significant shareholder resolutions were filed focusing on the extent to which companies provide evidence of strategic alignment with the goals of the Paris Agreement, or demonstrate resilience to climate change. For more on this, please see the section detailing our activities with Climate Action 100+ on page 12. In total, we recommended votes on 2,850 shareholder resolutions in 2019. Some 450 of these were in the US, where we opposed management on 64% of resolutions.

### Percentage of proposals voted against management per key market



Source: EOS data



## Executive compensation

Executive compensation remained a contentious issue across the globe in 2019. In our view, some compensation structures and practices are not fit for purpose, failing to serve long-term investors or align properly with the core long-term objectives of companies.

Markets where pay practices are more restrained are at risk of importing poor practices from others. Some of these practices, such as introducing structures to gear the majority of pay towards 'performance-based' pay, may have been well-intentioned but have proved ineffective. They may have unintended consequences such as escalating quantum, and encourage short-termism or financial engineering.

Our voting recommendations on pay reflected these concerns, with an overall 33.3% recommended vote against rate in 2019, versus 33.15% in 2018. In the UK we opposed 28% of remuneration reports based on concerns such as excessive quantum and pay outcomes not aligned with performance. For example, we opposed the report at Royal Dutch Shell, where the policy paid out at near maximum.

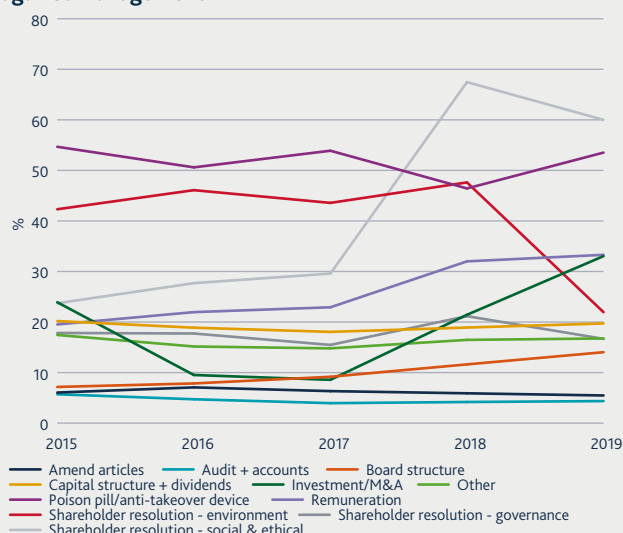
In the US, we recommended voting against over 82% of say-on-pay proposals in 2019 due to concerns about quantum and insufficient long-term alignment. Targeting CEO pay in the top quartile of peers is one of the ways we seek to address quantum, a critical issue in the US following many years of pay ratcheting up.

For example, we opposed pay proposals at Best Buy, Target and Walmart where CEO pay was in the top quartile of peers. Walmart also had an insufficiently strong anti-pledging policy, although we secured assurances from the company that this would be reviewed and improved before the next annual meeting.

We continued our work with the Council of Institutional Investors to influence its guidance on executive compensation and were pleased to secure some incremental improvements that brought greater alignment with our principles.

In Asian markets, executive pay tends to be lower but is less transparent than in Europe and the US. We continued our engagement with companies to encourage them to link incentive plans to performance criteria, including sustainability metrics.

### Proportion of resolution type with recommended votes against management



## Q&A: UK REMUNERATION



With Amy Wilson  
Theme lead: Executive Remuneration;  
Business Purpose & Strategy  
Sector lead: Retail

### Q. What was our main area of focus in 2019?

**A.** Around 75% of FTSE 350 companies will propose new three-year remuneration policies in 2020 for shareholder approval. So in 2019 we encouraged UK companies to make fundamental, rather than incremental, changes when they review these policies.

We have participated in a number of remuneration policy consultations for our engagement programme companies and others, and in July we hosted a closed door senior-level event on this topic. For this we convened a 70-strong audience of remuneration committee chairs, company chairs, senior representatives from HR and reward teams, remuneration consultants and investors. The discussion was focused on whether we need a different approach to executive pay.

### Q. What contributions have we made in the public policy sphere?

**A.** In October Saker Nusseibeh, CEO, International at Federated Hermes, spoke at the UK All-Party Parliamentary Corporate Governance Group breakfast, sharing our views on the need for greater simplicity in executive pay. He discussed issues around quantum and a lack of trust in business leaders. This followed a contribution by Bruce Duguid, head of stewardship at EOS, to the Business, Energy and Industrial Strategy Select Committee on fair pay in late 2018. The Committee's report, released in March 2019, substantially agreed with our submissions, including the need for far simpler pay policies with lower variable pay and lower overall quantum.

We also refreshed our Corporate Governance Principles, which we distribute to the chairs of all FTSE 350 companies. We reiterated our calls for simplicity, alignment, management shareholdings and accountability. We argued that pay outcomes should be communicated to all stakeholders, including employees and the public.

### Q. What progress have we seen?

**A.** Most UK companies are still consulting on their proposals. We called for a reduction in quantum and the size of variable pay, and an increase in executive shareholdings. Ultimately, we want to see far simpler pay schemes based on fixed pay as a majority of the total, combined with long-term share ownership. But we are not yet taking the position of automatically opposing all pay models that do not align to our principles. While we may not endorse many typical current practice models, we have set a number of pragmatic guidelines and thresholds in our voting policies to improve market practice and encourage closer alignment with our principles.

### Q. What will we focus on in 2020?

**A.** We will continue to press for changes to executive pay practices, in line with our remuneration principles. We want to see far simpler schemes based on fixed pay as a majority of the total, with a significant portion of this delivered through long-term shares. We will also continue to tighten our voting guidelines in areas such as shareholding requirements and the amount of variable pay relative to fixed pay.

## Board composition and diversity

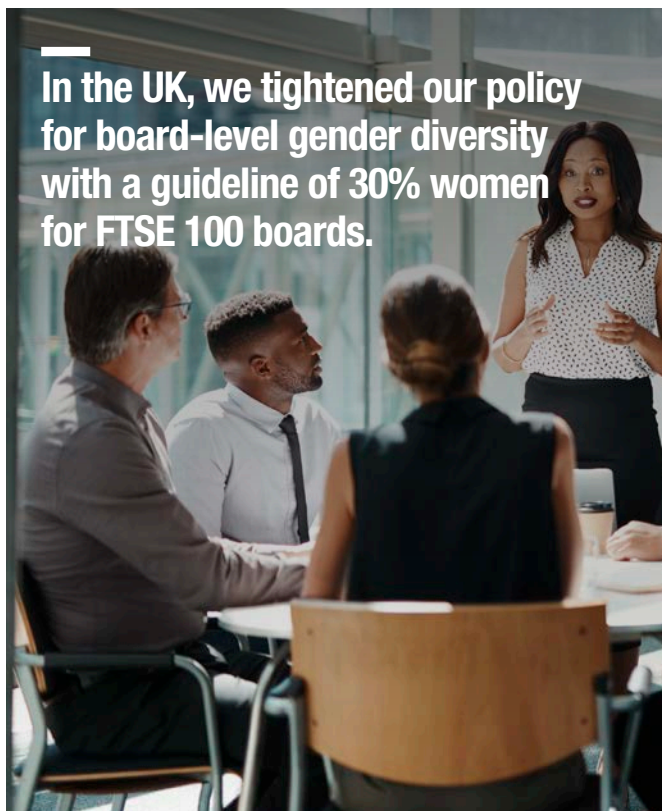
Board composition is critical to the good management of companies, and one of the most important shareholder powers is the ability to elect board directors. A diverse board is vital to good decision-making, so we stepped up our expectations on gender diversity this year.

In the UK, we tightened our policy for board-level gender diversity with a guideline of 30% women for FTSE 100 boards and 25% for FTSE 250. We also introduced a policy on below-board diversity, with the guideline that we would consider recommending a vote against the chair of FTSE 100 companies with no women on their executive committee.

In the US, we also continued to push our expectations on board diversity across a number of dimensions, recommending opposition to 916 proposals in 2019, compared with 618 proposals in 2018.

In Germany, we released our new German Corporate Governance principles, which set out our expectations for 2020 and beyond, including that companies achieve 30% female representation on executive boards. Currently, only 8% of German companies have more than one woman on the executive board. Two-thirds still have no female board members. We raised the issue of diversity at German car manufacturer Daimler's AGM, along with concerns about audit tenure that led us to oppose the ratification of the auditors.

At Dutch financial services group ING we opposed the discharge of directors – in effect a vote against management performance over the previous year – along with 63% of shareholders. This followed collective engagement with the board, and concerns that the executive and supervisory board had failed in their duties to safeguard the bank's reputation and ensure full compliance with legal and regulatory frameworks.



## Q&A: CORPORATE GOVERNANCE IN JAPAN



With Sachi Suzuki  
Theme lead: Shareholder Protection & Rights  
Sector lead: Transportation

2019 was an important year for Japanese corporate governance, with investors flexing their muscles during voting season. More companies received shareholder proposals than ever before, and there was intensive engagement behind the scenes, bringing some notable successes.

The shift has been driven by an increase in dialogue between companies and shareholders, following the introduction of the Stewardship Code in 2014 and the Corporate Governance Code in 2015.

However, the year ended on a less positive note after the government proposed amendments to the Foreign Exchange and Foreign Trade Act that would enforce "national security" screening of foreign investors who want to hold more than 1% of a company's shares. This reduces the current threshold from 10%, and would apply to a wide range of businesses. The move could significantly curtail shareholder rights to nominate directors and file shareholder proposals on business strategy. We have therefore been engaging with the Japanese government and other stakeholders to help protect minority shareholder rights.

### Q. How have we responded to this development?

A. We wrote to Japan's Ministry of Finance in early November to set out our concerns about the proposed changes. We broadly supported the collective position of the Asian Corporate Governance Association and pointed out that the proposal to lower the threshold at which investors are required to give pre-notification of their buying intentions from 10% to 1% could deter foreign investments in Japanese companies, with negative consequences for the market.

Foreign asset management companies are exempt from the prior-notification requirement only if they give up the right to make director nominations or file shareholder proposals. But these are important shareholder rights and an attempt to limit these is contradictory to the promotion of effective investor stewardship. We continue to monitor developments.

Kirin Holdings sold strategic holdings worth

**¥36BN**

in the first three quarters of

**2019**



**Q. Up until now the government has been pushing for improved investor stewardship and corporate governance. What significant developments have we seen?**

**A.** The 2017 revision of the Stewardship Code encouraged the disclosure of voting results at the individual company and proposal levels. This meant that institutional investors became accountable for their own voting decisions and were expected to vote against the management of companies whose governance practices needed improvement, or if there were issues with minority shareholder protection. We have since seen an increase in the number of votes against management. In response to this, as well as the requirements of the Corporate Governance Code, companies are engaging more with investors. For example, more Japanese companies are visiting us in London, often with senior executives, including CEOs.

**Q. What sort of impact has this had?**

**A.** Previously, shareholder proposals had a limited chance of succeeding, as institutional investors tended to support management. However, shareholder proposals now have a better chance of gaining support if they are considered beneficial for minority shareholders. Companies have also become more receptive to shareholder demands, even if shareholder proposals do not pass. This may have given shareholders more incentive to file proposals.

In 2019 we supported the shareholder proposals at housing materials manufacturer Lixil Group filed by former CEO Kinya Seto. He was seeking to elect himself back to the board, along with seven other candidates, after Seto was effectively removed by the chair. All the shareholder proposals passed at the 2019 meeting and Seto was reappointed as CEO.

**Q. What are the key governance challenges at Japanese companies?**

**A.** There are a number of challenges. One is capital management – Japanese companies tend to hold cash and cross-shareholdings for an extended period of time, often without sufficient explanation. The 2018 revision of the Corporate Governance Code added stronger wording around the reduction of strategic shareholdings, requiring boards to examine the purpose of these holdings and their benefit. However, some companies have used the new guidelines to justify the benefits of cross-shareholdings and so we continue to see some entrenched positions.

Board composition is another issue – until the early 2010s the appointment of outside directors was uncommon, and many companies had no independent directors at all. The new Corporate Governance Code requires two independent directors, but this is low compared with other markets. Board diversity is also poor despite the sharp increase in the number of companies appointing female directors in the recent years.

**Q. What improvements would we like to see in 2020?**

**A.** Board effectiveness would be improved by the appointment of directors offering diverse perspectives, including women and individuals with expertise from other industries and international experience. We will also urge companies to fundamentally rethink the purpose of strategic and cross-shareholdings and accelerate their efforts to eliminate them. We have engaged systematically on this issue and are now seeing some success.



**Shareholder proposals now have a better chance of gaining support if they are considered beneficial for minority shareholders.**

For example, Kirin Holdings sold strategic holdings worth ¥36bn in the first three quarters of 2019, planning to use the funds for share buybacks. And following a number of interactions with steel and engineering company JFE Holdings during which we raised this topic, it said it would reduce its strategic holdings by over ¥100bn the end of the next fiscal year, nearly half the total amount. We will continue to engage on this and encourage other companies to follow suit.

Finally, while there are now more opportunities for direct dialogue with executive directors in Japan, opportunities to meet independent directors are still limited. In the UK, investors can discuss board composition with the chair of the nomination committee and executive remuneration with the chair of the remuneration committee, for example. Such opportunities would enable more technical and effective discussions, which would benefit Japanese companies and investors.

*This Q&A builds on a Japanese language article written by Sachi Suzuki for the Japanese consultancy Brain Center and first published on its website in 2019.*

<sup>1</sup> <https://www.clsa.com/wp-content/uploads/2018/12/CG-Watch-2018-Short-version-181205-L.pdf>

<sup>2</sup> <https://www.bbc.co.uk/news/world-asia-43666134>



# SPOTLIGHT ON STEWARDSHIP IN SOUTH KOREA

South Korean stocks are generally undervalued relative to those of Asian peers – the so-called Korea discount. Can stewardship help to improve corporate governance in the country, boosting shareholder returns? By engager *Hannah Shoemith*.

In 2019 we joined an Asian Corporate Governance Association (ACGA) delegation to South Korea to engage with regulators, government departments and businesses on ways to improve corporate governance there. South Korea is a significant country for our engagement activities, home to a number of big companies, including Samsung, the eighth largest in our current engagement programme by holdings.

During the trip we urged stakeholders to do more to stimulate the economy and encourage entrepreneurialism, without diluting corporate governance standards. For example, we argued against the proposed introduction of dual-class share structures, which may threaten minority shareholder rights. We also expressed the need for clearer guidance on the so-called 5% rule, whereby shareholders with a 5% stake in a company must state if they plan to influence management. The law was conceived as an anti-takeover measure but there are concerns it could make some asset owners reluctant to adopt the country's stewardship code due to uncertainty about the legitimacy of engaging with companies on corporate governance.

We also met with company representatives including the chair of Samsung, directors from Hyundai and investor relations teams from SK Hynix, SK Holdings, SK Telecom and Hana Financial. We engaged with these companies on topics such as the role and composition of the board, capital management and shareholder protection.

During these discussions we reiterated our support for the stewardship code, launched in December 2016, and commended its adoption by key asset owners such as the National Pension Service and the Korea Investment Corporation.

But we pointed out that the country still lags behind its regional peers, with CG Watch 2018<sup>1</sup>, a report on corporate governance in the Asia-Pacific, ranking South Korea ninth out of 12 for corporate governance standards. This was due to low scores for minority shareholders' rights, the levels of corporate governance at listed companies, and the effectiveness of local asset owners' stewardship activities.

Arguably, some of these challenges have their roots in the 1950s. A visitor from the Seoul of 1953 would find today's bustling, skyscraper-dominated, high-tech capital unrecognisable. In 1953, the Korean War had just ended and much of the country was devastated. At that time businesses were often family-owned, so the 'chaebol' – a South Korean family-owned conglomerate – was born. In his book, *Korea, the Impossible Country*, Daniel Tudor argues that South Korea's rapid development was a result of a partnership between state and industry, a system that suited its time. The downside is that the chaebols' past advantage and continuing power today make them difficult to compete with, arguably stifling entrepreneurialism. Also, founder families can retain significant influence through circular shareholdings between group companies, plus a presence on company boards.

The country also faces other challenges – how to regain the public's trust after a political scandal, and an ageing population. In 2016, President Park Geun-hye was accused of involvement in a scheme to pressure large companies to make donations to the foundations of one of her closest advisers. This led to mass protests and Park's impeachment in 2017, followed by a lengthy jail sentence.<sup>2</sup> In his inaugural address, new President Moon Jae-in promised to reform the chaebols, but progress has been slow.

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**South Korea is a significant country for our engagement activities, home to a number of big companies, including Samsung, the eighth largest in our current engagement programme by holdings.**

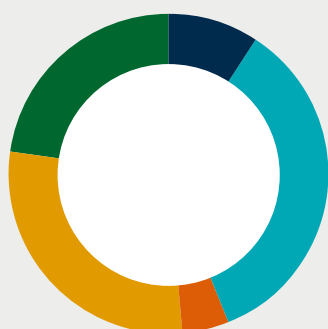
Local asset owners are also under greater scrutiny as many seek to implement the stewardship code. At the same time, international asset owners are increasing their engagement with South Korean companies on ESG performance for long-term value creation.

South Korean businesses must now build on the framework developed by the corporate governance and stewardship codes and address key governance weaknesses such as board composition and effectiveness, minority shareholder protection, capital management and executive remuneration. Asset owners and managers can play an effective role by strengthening their approach to stewardship and ESG engagement. Investors will also seek reassurance that regulatory enforcement of minority shareholder protections will occur when needed. Stewardship can help Korean business move towards better investor relations, more effective governance and higher returns, but it will take a concerted effort from all key stakeholders.

STRATEGY  
RISK AND  
COMMUNICATION

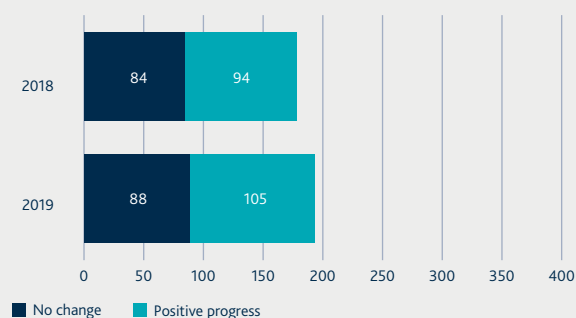
# A BREAKTHROUGH FOR BUSINESS PURPOSE?

Strategy, risk and communication topics comprised 17% of our engagements in 2019.



- Audit and accounting 9.2%
- Business strategy 34.9%
- Cyber security 4.6%
- Integrated reporting and other disclosure 28.7%
- Risk management 22.5%

## Progress against strategy, risk and communication objectives



Source: EOS data

In 2019, we saw two encouraging developments – the US Business Roundtable redefined the purpose of a corporation, moving away from shareholder primacy to include a commitment to all stakeholders, and France passed its PACTE law. This requires companies to consider social and environmental issues and invites them to incorporate societal objectives into their corporate purpose, or *raison d'être*. We understand from our engagements that some French companies are considering making such a statement and discussing how to define this.

The US Business Roundtable’s announcement was initially welcomed because it outlined a modern standard for corporate responsibility and was signed by 181 CEOs. It gave a commitment to investing in employees, dealing fairly and ethically with suppliers, supporting communities in which companies operate, and generating long-term value for shareholders. This indicated a shift from the rather shareholder-centric view that had dominated US boardrooms for decades. We believe this was overdue and consistent with existing fiduciary duties.

It is now our job as a representative of long-term investors to hold the signatories of the Business Roundtable’s statement to account, so that it is not just empty rhetoric. It is significant because it gives us this opportunity, and because the rhetoric marks a departure from the shareholder-centric view.

The US Business Roundtable’s announcement was signed by:

**181** CEOs





But how should companies approach corporate purpose? We began requesting that companies articulate their societal corporate purpose in different versions of our Corporate Governance Principles in 2016. The aim was to encourage businesses to think about how their strategies, values and capital allocation affected stakeholders beyond their investors. These other stakeholders might include their employees, local communities and wider society through their environmental impact.

Such an approach helps to protect the long-term interests of savers and pensioners invested in companies, who require sustainable financial returns and an economy, society and environment capable of providing a secure future.

We believe company boards should be responsible for articulating this, identifying the stakeholders most critical to long-term value creation and setting out a timeframe over which the purpose should guide the company's strategy, values and culture.

To this end, we have developed a guidance document for directors and are helping to lead the statement of purpose campaign in conjunction with others. We also serve on the advisory board of Chief Executives for Corporate Purpose's Strategic Investor Initiative, which focuses on helping companies to articulate their purpose and the long-term strategic plan to fulfil it.



## US public policy and the threat to shareholder proposals

Moves by the US Securities and Exchange Commission (SEC) to restrict rights relating to shareholder proposals and regulate proxy adviser activity put investors on the defensive later in 2019. The PRI strongly condemned the SEC's 'Proxy Advisor Rulemaking' proposed changes and the Council of Institutional Investors (CII) issued a factsheet with counter-arguments to the SEC's assertions.

We wrote to the SEC in late October to express our support for the CII's position on these developments and pointed out that proxy advisers are contractual agents of institutional investors, not of the companies who are the subjects of their research. We will continue to engage with the SEC in order to limit the damage to the interests of institutional investors that these proposals are likely to cause.

**We began requesting that companies articulate their societal corporate purpose in different versions of our Corporate Governance Principles in 2016.**

## Q&A: REFORMING UK AUDIT



With Roland Bosch  
Theme lead: Risk Management  
Sector lead: Financial Services

In recent years we have seen a spate of UK business failures partly linked to poor quality audits, ranging from high street cake seller Patisserie Valerie to contractor Carillion and retailer BHS.<sup>1</sup> Following the collapse of travel agency and airline Thomas Cook in 2019, the company's auditors were heavily criticised by the UK parliamentary select committee inquiry because the goodwill on its balance sheet had not been written down since 2012.<sup>2</sup> These high-profile cases have raised questions about the quality, relevance and independence of audits, and strengthened calls for reform.

Several reviews and consultations have considered ways to overhaul the UK audit sector, to which we have contributed. These include the Competition and Markets Authority's (CMA's) study, where we argued for less concentration and called for an improvement in audit quality and the independence of audit providers. The CMA recommended an operational split between the Big Four's audit and non-audit practices to reduce potential conflicts of interest.

Another is the Business, Energy and Industrial Strategy (BEIS) consultation on the recommendations made by Sir John Kingman in his review of the Financial Reporting Council (FRC). With a consensus behind Kingman's view that a stronger regulator was needed to help improve audit quality, the UK government agreed to back the proposal for a new Audit, Reporting & Governance Authority (ARGA). This will have a new mandate, enhanced powers and be accountable to parliament.

We also gave input to the Brydon Review, which looked at the scope, quality and effectiveness of audit, including whether auditors should try to prevent or detect fraud. We argued for more professional scepticism, with auditors prepared to challenge management, rather than taking a tick-box approach.

The FRC's 2019 Developments in Audit report found that only 75% of FTSE 350 audits met quality standards, below the target of at least 90% set by the FRC three years ago. Brydon proposed redefining the purpose of an audit, to "help establish and maintain deserved confidence in a company". He also recommended that ARGA help establish a corporate auditing profession based on a core set of principles.

### Q. Why is audit quality so important?

A. If a business collapses, it has a tremendous impact on its stakeholders, leading to job losses and destroying value. Sometimes the government has to step in. With Thomas Cook, we saw the largest peacetime repatriation in UK history. And when Carillion collapsed, some big construction projects – such as a new hospital in Liverpool – were put on hold.



### Q. What did we ask for in the consultations? What were some of our main concerns?

A. Audits should provide assurance to shareholders that the financial statements present a prudent, true and fair view of the results, cash flows and financial position of a company. To this end, in the consultations we expressed our concerns about audit quality. We believe the audit committee and the board should remain accountable for auditor selection and monitoring. We would also support the introduction of Sarbanes-Oxley type regulation in the UK, requiring senior company executives to attest to the accuracy of financial statements by signing them off. That would place appropriate accountability on management to ensure the quality of their financial reporting.

### Q. What else are we pushing for?

A. The UK parliamentary select committee was interested in the role shareholders can play in audit. We are supportive of more engagement, so we will seek to increase our dialogue with audit committee chairs. We have already strengthened our voting around audit, considering the composition of audit committees and audit tenure. In the US and Switzerland some audit firms have very long tenures and we would like to see regular rotation. Finally, we have set out some guidelines for audit tenders – we want investors to be involved in that process to ensure the auditor is independent.

### The FRC's 2019 Developments in Audit report found that only

**75%** of FTSE 350 audits met quality standards

### Q. Is widespread reform likely?

A. There is clearly a recognition that change is needed and some of the recommendations are quite significant, such as a UK version of Sarbanes-Oxley. I expect there will be quite substantial reform. We've already seen some progress on reforming the regulator, and ARGAs incoming board seems to recognise the concerns around audit. The chair has called on the UK government to break up the Big Four accounting firms.<sup>3</sup> That's the operational split that we have advocated for, to address conflicts of interest. We also hope industry reform will see auditors exercise more professional scepticism and judgement around accounting for goodwill, for example, which was significantly overstated in Carillion's case. We are supportive of more discursive disclosure in auditor reports.

### Q. What still needs to be addressed?

A. Engagement on the whole needs to improve, but some investors may lack stewardship resources. The strengthening of the UK Stewardship Code in 2019 will help – investors will need to beef up their audit and accounting skills and knowledge so they can challenge audit committee chairs effectively. There is also a question of whether audit firm culture needs to change, and more work is likely to be needed in this area. There are concerns that audit is often carried out by junior teams of only partially qualified accountants. This can compromise the technical quality of the work and the auditors' ability to challenge irregularities.

**We have strengthened our voting around audit, considering the composition of audit committees and audit tenure.**



<sup>1</sup> <https://www.theguardian.com/business/2019/feb/01/decline-in-quality-auditors-face-scrutiny-over-string-of-scandals>

<sup>2</sup> <https://www.parliament.uk/business/committees/committees-a-z/commons-select/business-energy-industrial-strategy/inquiries/parliament-2017/thomas-cook-17-19/>

<sup>3</sup> <https://www.ft.com/content/84d1b2c0-0077-11ea-b7bc-f3fa4e77dd47>

# EOS TEAM

## Engagement



**Dr Hans-Christoph Hirt**  
Executive Director,  
Head of EOS



**Dr Emma Berntman**  
Sectors: Retail,  
Pharmaceuticals  
& Healthcare



**Roland Bosch**  
Sector lead: Financial  
Services



**Dr Christine Chow**  
Team lead:  
Asia & Emerging Markets  
Sector lead: Technology



**George Clark**  
Voting and Engagement  
Support



**Bruce Duguid**  
Director, Head of  
Stewardship, EOS



**Katie Frame**  
Sectors: Retail,  
Pharmaceuticals &  
Healthcare,  
Technology Software



**Claire Gavini**  
Sector: Retail



**Diana Glassman**  
Sectors: Chemicals,  
Financial Services, Oil &  
Gas, Technology



**Tim Goodman**  
Sector lead:  
Oil & Gas



**Jaime Gornsztejn**  
Sector lead: Industrials  
& Capital Goods



**Bram Houtenbos**  
Voting and Engagement  
Support



**Andy Jones**  
Team lead: Europe  
Sector lead: Mining &  
Materials



**Lisa Lange**  
Sectors: Transportation,  
Financial Services,  
Consumer Goods



**Pauline Lecoursonnois**  
Sector lead: Consumer  
Goods



**Kimberley Lewis**  
Sector lead:  
Pharmaceuticals  
& Healthcare



**Sonya Likhtman**  
Sectors: Retail, Mining &  
Materials, Pharmaceuticals  
& Healthcare



**Claire Milhench**  
Communications  
& Content



**Ian Munroe**  
Voting and Engagement  
Support



**James O'Halloran**  
Director of Business  
Management, EOS



**Marija Rompani**  
Sector lead: Chemicals



**Hannah Shoesmith**  
Sectors: Transportation,  
Retail, Financial Services,  
Technology



**Nick Spooner**  
Sector lead:  
Utilities



**Sachi Suzuki**  
Sector lead: Transportation



**Velika Talyarkhan**  
Sectors: Consumer Goods, Retail,  
Industrial & Capital Goods,  
Technology Hardware, Utilities



**Marcus Wilert**  
Sectors: Transportation, Retail,  
Financial Services, Technology



**Amy Wilson**  
Sector lead: Retail



**Janet Wong**  
Sectors: Financial Services,  
Technology



**Tim Youmans**  
Team lead: North America  
Sectors: Financial Services,  
Industrials & Capital Goods,  
Technology



## Client Service and Business Development



**Amy D'Eugenio**  
Director, Head of Client  
Service and Business  
Development, EOS



**Marwa Curran**  
Client Service



**Alexandra Danielsson**  
Client Service



**Rochelle Giugni**  
Client Service and Business  
Development



**Charlotte Judge**  
Communications  
& Marketing



**Alice Musto**  
Client Service

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