

# Pensions Committee

**2pm, Tuesday, 18 December 2012**

## Environmental Social and Governance Activity Update

Item number	5.4
Report number	
Wards	All

### Links

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Coalition pledges

Council outcomes [CO26](#)

Single Outcome Agreement

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# Executive summary

## Environmental Social and Governance Activity Update

### Summary

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This report provides an update on the pension funds' activity on environmental, social and governance (ESG) issues which can affect the financial performance of companies in which the funds invest. The funds pursue a policy of constructive engagement on issues, which is consistent with fiduciary duties.

### Voting and Engagement

The voting and engagement arrangements on the funds' direct equity holdings are shown in the tables below.

Mandate	Voting and Engagement Arrangement
Baillie Gifford (Pacific & Lothian Buses)	Baillie Gifford
Aberdeen (Emerging markets)	Aberdeen
All other listed equities	Hermes Equity Ownership Services

Details of voting and engagement activity are provided quarterly on the Funds' website. This includes both the total number of companies where the Funds have voted and details of votes against company management. The Hermes' report for the quarter to 30 September 2012 is included as Appendix 1.

Last year Committee was informed that work was underway to expand and improve the information available on the Funds' website. The website has been updated throughout the year with information on current issues, such as the Barclays Bank LIBOR fine. The main change is the inclusion of voting and engagement activity for Lothian Pension Fund's 10 largest equity holdings (Appendix 2).

### Local Authority Pension Fund Forum (LAPFF)

The Lothian Pension Fund is a member of the LAPFF. LAPFF provides an opportunity for focused discussion and the sharing of ideas and working practices.

In addition to a newsletter, LAPFF now publishes a Quarterly Engagement Report (Appendix 3). The latest issue highlights LAPFF activity on Lonmin, Rolls Royce, NewsCorp and also covers the effect of accounting standards on UK banks.

Councillor Cameron Rose is currently Vice Chair of the Executive Committee of the LAPFF. Committee is asked to endorse Councillor Rose's nomination to stand for re-election to the Executive and for the position of Chair at the AGM in January 2013. If successful, Council's endorsement of the appointment will be sought. Councillor Rose will provide a verbal update to Committee on his role on the Executive.

### **United Nations Principles for Responsible Investment (UN PRI)**

Lothian Pension Fund signed the UN PRI in 2008. Signatories complete a self assessment each year. This year, after consultation with signatories, changes were made to the reporting framework. Signatories were asked to complete a pilot assessment on a voluntary (non-public) basis, prior to reporting becoming mandatory again in 2013. Lothian Pension Fund participated in the pilot and submitted feedback to UN PRI on the new framework. UN PRI aim to deliver a report to signatories on their assessments by end 2012.

### **Recommendations**

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It is recommended that the Pensions Committee:-

1. note the contents of this report.
2. endorse Councillor Cameron Rose's nomination to stand for re-election to the LAPFF Executive and for the position of Chair.

### **Measures of success**

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Success of engagement with companies is very difficult to measure. Hermes measure their success by setting and measuring 'milestones' in engagements.

### **Financial impact**

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There are no direct financial implications of this report. Arguably, ESG issues affect the financial performance of companies and the performance of the Funds.

### **Equalities impact**

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There are no adverse equalities impacts arising from this report.

### **Sustainability impact**

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ESG activity is expected to contribute to the sustainability of the Funds' investments.

## Consultation and engagement

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The Funds' policy on ESG issues is included in Statement of Investment Principles which was agreed after consultation with stakeholders. Stakeholders are kept informed of ESG activity via the Funds' website.

## Background reading / external references

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Not applicable.

## Links

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### Coalition pledges

**Council outcomes** CO26 – The Council engages with stakeholders and works in partnerships to improve services and deliver agreed objectives.

### Single Outcome Agreement

### Appendices

[Appendix 1 - Hermes Q3 Public Engagement report](#)

[Appendix 2 - LPF engagement with top 10 holdings](#)

[Appendix 3 - LAPFF Quarterly Engagement report July to September 2012](#)

# Public engagement report

Q3  
2012

# Q3

This report contains a summary of the responsible ownership activities undertaken by EOS on behalf of its clients. It covers significant themes that have informed some of our intensive engagements with companies in Q3 2012. The report also provides information on our voting decisions and the steps we have taken to promote global best practice, improvements in public policy and collaborative work with other shareholders.

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## What is EOS?

Hermes Equity Ownership Services (EOS) helps institutional shareowners around the world to meet their fiduciary responsibilities and become active owners of public companies. EOS' team of engagement and voting specialists monitors its clients' investments in companies and intervenes where necessary with the aim of improving performance. EOS' activities are based on the premise that companies with informed and involved shareholders are more likely to achieve superior long-term performance than those without. Through pooling resource with other like-minded funds to create a stronger and more representative shareholder voice, our joint company engagements can be more effective. We currently act on behalf of 24 investors with roughly 143 bn. USD\* in Assets under stewardship.

Hermes has the largest stewardship resource of any fund manager in the world. Our 28 person team includes former CEOs and other board members of public companies, as well as senior strategists, corporate governance experts, investment bankers, fund managers, lawyers and accountants.

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

Hermes has extensive experience of implementing the United Nations' Principles for Responsible Investment (UN PRI). EOS' Chief Executive Colin Melvin chaired the committee that drew up the original principles and we are actively engaged in a variety of work-streams, through the clearinghouse and in the revision of the PRI reporting framework. This insight enables EOS to help signatories to meet the challenges of effective PRI implementation.

\*as at 31st of December 2011



## How does EOS work?

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

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

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

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

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

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

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

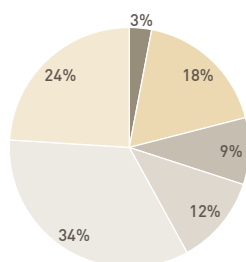
**For further information please contact Colin Melvin on +44(0)207 680 2251.**

## Engagement by region

Over the last quarter we engaged with 151 companies on a range of 327 social, environmental and governance issues. EOS' holistic approach to engagement means that we will typically engage with companies on more than one issue simultaneously. The engagements included in these figures are in addition to our discussions with companies around voting matters.

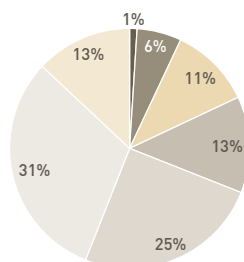
### North America

We engaged with 17 companies on a range of 33 issues over the last quarter.



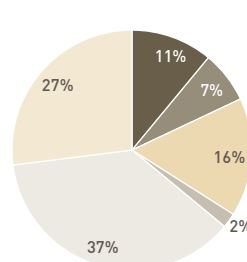
### Asia

We engaged with 33 companies on a range of 80 issues over the last quarter.



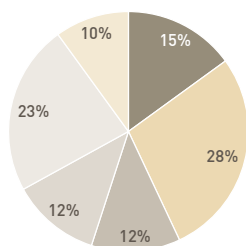
### Australia & New Zealand

We engaged with 17 companies on a range of 45 issues over the last quarter.



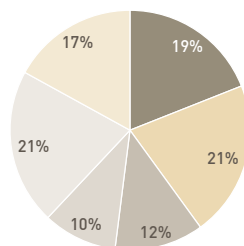
### Emerging & Frontier Markets

We engaged with 26 companies on a range of 52 issues over the last quarter.



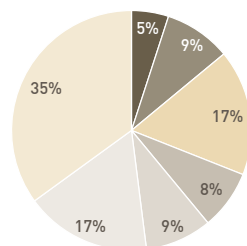
### Europe

We engaged with 25 companies on a range of 42 issues over the last quarter.



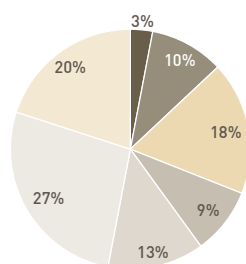
### UK

We engaged with 33 companies on a range of 75 issues over the last quarter.



### Global

We engaged with 151 companies on a range of 327 issues over the last quarter.

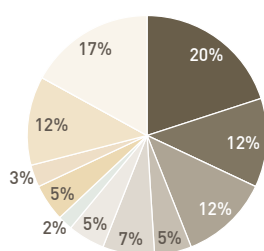


## Engagement by issue

A summary of the 327 issues on which we engaged with companies over the last quarter is shown below.

### Social and ethical

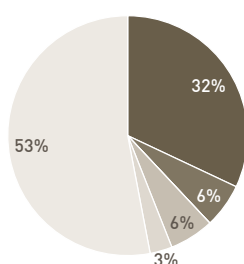
Social and ethical issues featured in 18% of our global engagements over the last quarter.



- Employee relations
- Community relations
- Health and safety
- Supply chain (inc child/other labour issues)
- Operations in troubled regions
- Corporate culture
- Munitions manufacture
- Access to medicines/clinical trials
- Political risk management
- Bribery and corruption
- Other social & ethical

### Environmental

Environmental issues featured in 10% of our global engagements over the last quarter.



- Climate change/carbon intensity
- Water stress
- Forestry
- Biodiversity
- Other environmental

### Other engagement

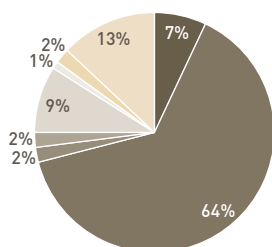
Remuneration featured in 20% of our engagements over the last quarter.

Risk management featured in 9% of our engagements over the last quarter.

Shareholder communications featured in 3% of our engagements over the last quarter.

### Governance

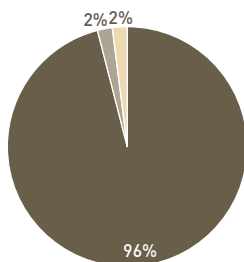
Governance issues featured in 27% of our global engagements over the last quarter.



- Accounting or auditing issues
- Board structure
- Committee structure
- Related party transactions
- Succession planning
- Poison pill
- Separation chair/CEO
- Other governance

### Business strategy

Business strategy issues featured in 13% of our global engagements over the last quarter.



- Business strategy
- Returns to shareholders
- Capital structure

## Business strategy and board structure

### Strategic engagements

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

#### Statistics

Number of companies engaged with on strategic matters this quarter:	40
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North America	4
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Asia	19
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Australia and New Zealand	0
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Emerging and Frontier Markets	6
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Europe	4
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UK	7
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Number of significant steps forward in strategic/governance engagements this quarter:	37
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North America	10
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Asia	4
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Australia and New Zealand	0
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Emerging and Frontier Markets	13
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Europe	5
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UK	5
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#### Overview

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

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

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

#### Examples of successful engagements

We spoke with executives from a **North American conglomerate** to test the effectiveness of its governance structures. We tested the company on two new recent additions to its board in order to gain a better understanding of the skill-set and anticipated contribution they will bring. We have previously encouraged the company to consider enhancing both the financial and international expertise on its board and are pleased that the two newly appointed directors bring extensive such experience. Despite this positive step, we questioned the size of the board, which has swelled to 18 directors, and discussed a process for shrinking it over time. We pressed for details about the newly formed board risk committee which has been tasked with enhancing oversight of a particular area of the business and welcomed the board's stronger approach to this business. We challenged the company to demonstrate how its board operates in practice in order to examine the effectiveness of the current leadership structure in providing appropriate



independent oversight and accountability. We had previously expressed our desire to see the roles of CEO and chair separated, although we agreed that the shift could occur gradually provided a sufficiently robust independent lead director and board is in place in the interim. Despite some positive insights into the current workings and dynamics of the board, we continued to advocate that the board remain open to splitting the roles upon the succession of the current CEO.

We met with the chair of the remuneration committee of a **Japanese electronics company** at the firm's Tokyo headquarters in order to progress our discussion on corporate governance and strategy. It is exceptional for a shareholder to be able to access an independent director in Japan so this marks a major step forward in our engagement. We queried the company's rationale for retaining its former CEO as chair and expressed concerns that this might limit the scope of the new CEO to implement critical reforms to the business. We gained insight into the former CEO's ongoing importance to the entertainment business, but won assurances that he no longer has any executive functions so that the new CEO is not hampered. We gained further reassurances that the speed of decision-making has improved since the change of management and that there are signs of positive momentum in the business. While we were pleased to have gained further assurances on remuneration structures, we pressed the remuneration committee chair to enhance the level and quality of disclosure so as to be more accountable to shareholders.

We met with the chair of the minority shareholder committee at a **bank in the Emerging Markets** and were invited to become a member of the committee, in order to represent international investors and to make recommendations to the board. The committee meets on a monthly basis and is currently composed of six members. The committee's most important project over the coming months will be to present a list of independent candidates for election to the board at the May AGM. As well as proposing potential candidates, EOS was also asked to lead international minority shareholders in this endeavour and help garner support for the election of independent candidates among other institutional investors. Directors in the country are elected by cumulative voting and in order to ensure the election of an independent director, around 6% of the votes are needed.

We met with the chair of the governance and nomination committee of a **European financial institution**. We discussed the composition and functioning of the board and challenged what in our view is the chair's excessive satisfaction with current structures and processes given the performance of the bank and specific dysfunctions, such as that in the management of human resources. We gained reassurance on the quality of the board but pressed for more formal nomination and evaluation processes. We also questioned the need for the presence of a non-voting director who is systematically absent from board

meetings and nominated for historical reasons that could not be specified. Despite previous commitments to us from the chair, vice-chair and secretary of the board that the governance structure would be thoroughly reviewed by 2015, the chair of the governance committee strongly argued in favour of continuing to combine the roles of chair and CEO. He first dismissed a recent related shareholders' resolution which gained 25% support, but then acknowledged our strong concerns. We agreed to continue our dialogue to arrive at an unbiased assessment of the governance structure.

We met with the new chair of a **UK insurance company** to discuss a number of his priorities on the board, in particular the qualities he will be looking for in forthcoming non-executive appointments. We queried the challenges in finding the right candidates given the clear difficulties the company faced when looking for its chair and received some assurances that due to these roles being both less demanding on time and requiring a different skill-set the pool of candidates remains high calibre. He agreed with us that, due to a number of recent incidents at the company including the failure of a deal, the board needs to make substantial efforts to improve communications with shareholders and thus trust. This will include more regular interactions with him and the board's committee chairs in the future and we pressed that his communication with investors will be key to how the company's shareholders will judge his performance as chair.

## Investing responsibly in sovereign bonds

Dealing with the challenges of responsible investment in a major asset class

Best practices in responsible investment in the sovereign fixed income asset class are still developing. This article sets out our current understanding of best in class approaches in the area.

‘The nature of the issuers essentially means that the difference between engagement and policy work disappears. There is thus a much reduced set of tools available for responsible investors to use, and most of the focus is placed on exclusions and integration.’

### Overview

“Blood bonds: Investments in corruption and oppression” is an arresting but unattractive title for a paper, a particularly unattractive one when that paper alleges that a number of funds have made investments of precisely that nature. The paper was published in May by DanWatch, a Non-Governmental Organisation (NGO) which seeks to promote its view of more responsible investment by Danish funds, and local newspaper Berlingske. But the questions which the paper raises are, deliberately, universal. Only some institutional investors with an interest in responsible investment are yet beginning to have answers to those questions.

As ever, institutional investors will not wish to be prey to every issue raised by every NGO. However, when criticisms strike home with beneficiaries and clients, or when (as it has occurred in Denmark) the government has encouraged greater attention to the issues raised, then inevitably funds will need to work to develop approaches to those issues.

This article attempts to set out a possible approach to responsible investment in government bonds. Inevitably, in an asset class where best practice is still developing and in many ways is still in its infancy, this cannot represent a finalised approach, and certainly does not purport to be definitive. However, this is what ‘in our experience’ currently amounts to best practice. It benefits from, among other things, our active and ongoing participation in the United Nations (UN) backed Principles for Responsible Investment (PRI) sovereign fixed income working group, whose face to face meeting we were pleased to host in July 2012.

Readers will be familiar with the standard toolkit available to the responsible investor: exclusions, investment integration, voting, engagement and policy work. One of these - voting - is irrelevant in the context of sovereign bonds, and given the nature of the issuers of bonds many assume that engagement is impossible. This is not necessarily the case, as we discuss below, but the nature of the issuers does essentially mean that the difference between engagement and policy work disappears. There is thus a much reduced set of tools available for investors to use, and most of the focus is therefore placed on exclusions and integration, with the former the furthest advanced.







There are a number of reports and considerations which might form a basis for exclusions. The DanWatch report identified eight problematic African countries using only two criteria, which some have suggested were somewhat arbitrary: the Transparency International corruption perception index, and the Freedom House freedom index, targeting, so DanWatch puts it, investments in regimes which are potentially corrupt and abusive of human rights. It is not apparent why the study focused solely on Africa nor on these eight countries, ignoring lower-rated states.

Interestingly, we had in place a simple screening tool for a client, identifying those countries subject to UN and/or European Union sanctions where the sanctions regimes were not merely historic artefacts and where we believed that the client should formally consider whether it wanted exposure to those regimes. We applied intelligence and judgement to this list, including regimes with questionable human rights and corruption records even where the sanctions were largely in relation to historic leadership. This screening tool captured some of the eight countries which DanWatch identified as problematic, as well as the four countries which their report notes have lower scores than any of the eight it does focus on.

We recognise that, though it applies appropriate judgement, this approach is not yet as broad and robust as it might be. The developing best in class approach would be to combine this intelligent understanding of sanctions with a broader set of assessments based on broader norms. Different clients will have different concerns acting as drivers within such a framework, with some emphasising indiscriminate weapons, some with greater concerns about human rights or corruption, and some with more bespoke concerns such as press freedom. In some cases the framing provided by the banner issues of the UN Global Compact may assist by linking their approach to sovereign bonds with that for corporate risks. We are seeking to assist in the development of such tools.

Integration essentially relies on developing considerations of which Environmental, Social and Governance (ESG) factors will have an impact on sovereign bond returns over the long run, understanding these factors at the level of the nation-state. This is an area where considerable work is going on, and so far has been the major focus for the PRI's working group – which has worked to develop case studies and statistical analyses that identify where key ESG risks have had important influences on the sustainability of regimes and of their ability to continue to fund their financial commitments.

Amongst the factors that we believe may be relevant to integrate are the following, in no particular order. Under the Environmental banner: climate change sensitivity and adaptability; water intensity and potential shortages; carbon intensity of the economy; general environmental pollution; and land use intensity and flexibility. Regarding Social issues: human rights protections and abuse; labour rights and protections; business integrity and corruption. And with respect to Governance issues: rule of law; ease of doing business; consistency and reliability of regulation; and property rights protections. All of these (and other) factors seem likely to us to impact a country's long-term capacity to finance its liabilities.

There are a number of research houses which provide ESG ratings for countries using these sorts of metrics. The challenge for asset owners then is to encourage their fund managers to consider and where relevant integrate these factors into their decision-making, whether on an 'all-other-things-being-equal' basis or by requiring a more active integration. Developing benchmarks which reflect some of these issues would assist in encouraging this integration or at least allow a richer assessment of fund manager performance.

A further way to bolster integration strays into the area of engagement, for one main route to ensure that longer-term factors are included in sovereign bond assessments would be for the ratings agencies to build them into their models. We have had some conversations with ratings agencies along these lines and a forthcoming task of the PRI working group is to take this forwards collectively. There is also, in spite of the obvious challenges, some scope for engagement with the issuers of sovereign bonds. For example, many responsible investors already look to engage with governments on their climate change policies. Typically this is done from their perspective as investors in companies and assets in that country, but it is only a small extension to make the link to the overall sustainability of government finances and concerns as investors in sovereign bonds. Leading countries already have processes to tap the views of the key buyers of their bonds, and so are seeking to be open to appropriate influence. Of all the emerging areas in the field of responsible investment in sovereign bonds, this in particular is an area of developing practice, but there is much less difficulty in carrying this work forwards than many tend to assume.

## Conflict Minerals

Smart phones and crimes against humanity: Addressing the use of conflict minerals in the electronics industry.

For more than a century, the Democratic Republic of the Congo has been plagued by regional conflict and a deadly scramble for its vast natural resources. The majority of these minerals eventually wind up in electronic devices such as cell phones, portable music players, and computers.

‘Clearly any link in a company’s supply chain which has the potential to facilitate the breach of fundamental human rights is not only unacceptable as a matter of policy and principle but also is damaging to a company’s reputation and the value of our clients’ investment.’

### Overview

Over the past several years Hermes Equity Ownership Services (EOS) has undertaken a programme of engagement with electronics companies on the issue of minerals sourcing from the eastern regions of the Democratic Republic of Congo (DRC).

This engagement was prompted by concerns over the continuing link between multinational corporations which source minerals mined in the war-torn DRC and armed rebel groups responsible for human rights violations.

So called ‘conflict minerals’ can turn up in a wide array of electronic products such as smart phones, MP3 players, and laptop computers amongst others. Consumers in the United States, Europe and Asia are the ultimate end-users of these conflict minerals and are inadvertently fuelling the war in the DRC through the purchase of these electronics products. We believe that the use of conflict minerals in these products can result in significant reputational risks. EOS has engaged with global consumer electronics companies to ensure that their policies on supply chains are transparent and sufficiently robust to address these risks.

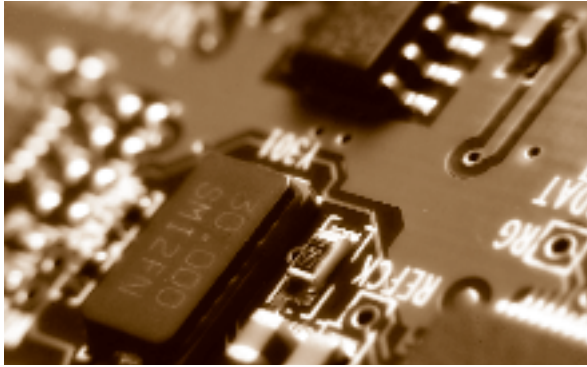
Since 2009 EOS has led a collaborative engagement effort along with members of the United Nations (UN) backed Principles for Responsible Investment (PRI) targeting major electronics companies in North America, Europe, and Japan on the issue of minerals sourcing from the DRC.

The three main minerals in question are tin, tantalum, and tungsten, which are used in nearly all types of electronics products including mobile phones, MP3 players and laptop computers.

The DRC has been the scene of some of the deadliest conflict since World War II. It remains amongst the most dangerous places in the world to live, in significant part because of the international demand for minerals found in the eastern Congo. Whilst eastern Congo is a complex crisis — fuelled by tensions over land, rights, identity, regional power struggles and the fundamental weaknesses of Congo as a state — the trade in conflict minerals remains one of the key drivers of the conflict. The same armed groups that reap enormous profits from the mineral trade in eastern Congo regularly commit human rights abuses as they jockey to control the region’s most valuable mines, transportation routes, and opportunities to impose







extortionary 'taxes' on those involved in this trade. This violence is also hampering the establishment of civil society in the region and ensures local people remain in poverty. While it is difficult to determine the full extent to which militia groups profit from these minerals it has been estimated that in 2008 alone armed groups in the Congo earned approximately US\$185 million from the trade.

The link between armed groups and the mineral trade has been well documented by numerous international organisations, including the UN. The UN panel recommended due diligence in the international minerals supply chain as an effective strategy to cut off support to the Congolese rebels derived from these mining activities.

Since the launch of this initiative, EOS has encouraged electronics companies to play a significant role in combating the trade in conflict minerals in eastern Congo. Initiatives include publicly disclosing their supply chains for components containing tin, tantalum and tungsten and by working with relevant organisation and industry peers. This collaboration would encourage the development of robust and internationally accepted mechanisms to verify the origin of these minerals and promote responsible and sustainable mining practices.

Our efforts received a significant positive boost in August 2012. The United States Securities and Exchange Commission (SEC) adopted a final rule implementing disclosure and reporting requirements regarding the use of conflict minerals from the DRC. This rule is part of reforms introduced under the Dodd-Frank Wall Street Reform and Consumer Protection Act. The legislation requires disclosure by companies that use gold, tin, tantalum and tungsten in their products to determine whether such metals originate from particular mines in the DRC or adjoining countries.

Throughout the rule-making process we have worked with the SEC as part of a multi-stakeholder network. This network comprised of a diverse mix of organisations, including issuers from several industrial sectors, socially responsible, and faith-based investors, and non-governmental organisations.

The issuance of this new rule is a significant milestone in our collective efforts to eliminate the link between violence and human rights abuses and the mineral trade in the DRC and surrounding countries. This rule will also allow investors to evaluate the efforts of companies in other industries ranging from auto parts to retailers and jewellers, to identify and eliminate the use of conflict minerals in their supply chains as well.

Clearly any link in a company's supply chain which has the potential to facilitate the breach of fundamental human rights is not only unacceptable as a matter of policy and principle but is also damaging to a company's reputation and the value of our clients' investment. We commend the significant positive steps taken by industry, governments and investors alike to address this serious issue and will continue to support collaborative efforts aimed at furthering the elimination of conflict minerals from global supply chains.

## Health and Safety in the mining industry

### Enhancing measures and transparency

Hermes Equity Ownership Services (EOS) engages with mining companies across the world to ensure the efficient management of health and safety and other sustainability risks. It seeks to encourage a corporate culture where employees' safety is protected, to minimize overall health and safety risks, and to enhance shareholder value.

#### Statistics

Number of companies engaged with:	22
Number of companies where substantive change sought:	22
Number of these showing progress so far:	5

#### Overview

Health and safety risks are a global challenge for mining companies. Despite the implementation of comprehensive health and safety management systems by companies across the mining and metals industry, actual and potentially fatal events continue to occur with unacceptable frequency. As a result, EOS engages with mining companies globally to encourage the improvement of safety performance and to minimize health risks throughout operations.

EOS understands that, given various level of enforcement and the consequences of the regulations and laws, the severity of the health and safety problems vary by region. Mines in certain regions receive greater attention on health and safety risk management from their investors and from regulators than others. For example, the Chinese coal mining industry's record on accidents and deaths is well documented, reported and discussed. Tragic accidents constantly appear in the headlines of global and local press. Two explosions at the Rospodskaya coal mine, which killed 67 miners, injured 134 and left 23 missing, meanwhile indicate that the health and safety risks in Russia are potentially also severe.

EOS's engagement with mining companies aims to help reduce such events and to encourage the continuous improvement of existing safety and risk management systems. Through efficient management systems, EOS encourages companies to foster a safe and healthy working environment as well as to reduce fatalities, injury rates, occupational illnesses and the number of accidents.

EOS has categorised engagement on health and safety risks with mining companies into the following three issues: fatalities, injuries and occupational illness; board oversight and corporate governance culture; and health and environmental impacts on the local community. We engage with mining companies across the world, including in Australia, Canada, China, Germany, India, Indonesia, Poland, Russia, South Africa and the United States of America.





The objective of our engagement is to encourage mining companies to do 'Zero Harm' to their personnel or the environment and to give appropriate consideration to health and safety in the design, operation and maintenance of project facilities. Mining companies should provide a safe workplace and should strive for the elimination of incidents. We believe the greatest gains can be made by preventing accidents and occupational illnesses through encouraging workers and supervisors to work together in an atmosphere where safety is the highest priority.

In our focus on fatalities, injuries and occupational illness, EOS believes that companies demonstrating an outstanding safety record should have good risk management procedures, well trained crews and robust safety empowerment. These are integrated into both the workers' and the supervisors' internal responsibility systems. We believe that the first defensive measure against fatal accidents is to prevent them. This means ensuring that a company's personnel receive sufficient training and comply with controls identified to manage potential fatal risk. Competency assessment and continuous education of personnel are crucial to consistently enforce the understanding of these controls for the prevention of fatal incidents as well as enforcing the responsibility within the programme. Individuals at all levels should be held accountable for the implementation of fatal risk controls.

Companies should also adopt an effective methodology to prevent fatal and accidental risks. We encourage companies to involve operational expertise from different levels within the organisation in the analyses of fatal and accidental risk. The preventative actions should be able to identify potential fatal incidents. Assessments should be made to track the completion of the actions, to review their effectiveness, to evaluate critical controls for fatal and accidental risks and to set appropriate performance standards. Planning and budgeting processes should also be considered when implementing engineering controls.

Whilst accidents occur, it is important to conduct investigations to understand and analyse the root cause of fatal incidents, and the potential root cause for potential high risk incidents. The findings of such investigations should be promptly and appropriately fed back into the fatality prevention program. Importantly, companies should facilitate an open reporting culture on their operations and accidents. Some mining companies in the Asian emerging markets tend to have relatively poor disclosure. We believe that committing to the open and transparent sharing of information and collective actions on health and safety issues could assist those companies striving to do 'Zero Harm'.

EOS does not only encourage companies to have effective health and safety programmes in place, we also encourage company boards to be aware of the actual and the potential risks. Board leadership in health and safety issues does matter to a company's safety performance. We believe that a board's active and direct participation, underpinned by rigorous oversight of health and safety risk management, is vital in achieving a company's goal of a 'Zero Harm' working environment. Safety leadership must be evidenced and instilled at all levels, from the chief executive officer to the broader workforce, in order to change human behaviour. A board's commitment to safety performance will motivate and empower workers to drive a sustained safety culture within the company.

Lastly, environmental and health impacts are intertwined with a local community. We believe companies should carry out health and environmental impact assessments on local and nearby communities when designing mining projects. Mining companies should undertake appropriate measures to mitigate potential negative impacts on local and nearby communities and to protect the environment, local bio-diversity and broader public health. In the event that damage is caused, it could lead to financial consequences for companies, which could include huge compensation liabilities and could potentially halt the operations. For example, EOS had an intensive engagement with a major Chinese gold mining company that had an incident where waste water leaked into the local ecosystem. The toxic elements caused damage to the local ecosystem, which in turn caused damage to fishery businesses and to public health, due to the presence of toxic elements in drinking water.

EOS continues to engage with mining and metals companies to highlight major risks and to encourage them to pursue appropriate health and safety programs. The programs should be implemented effectively through bottom-up behavioural change as well as top-down management. We also continue to observe regulatory development in different markets and, where necessary, proactively engage with relevant regulators on the enhancement of health and safety risk management measures for mining operations.

## Ethics in pharmaceutical companies

Mitigating the exploitation of vulnerable groups during drug development and approval processes.

Hermes Equity Ownership Services (EOS) engages with pharmaceutical companies to encourage a greater focus on ethical standards during the pre-research and development stages and during the subsequent clinical trials stage of drug development. In order to protect the rights and welfare of clinical trial participants, we seek to engage with the boards of pharmaceutical companies to ensure that sustainability risks are appropriately overseen.

‘To ensure that population groups and communities continue to benefit from new drugs and that business needs are appropriately managed, pharmaceutical companies should ensure appropriate board level oversight of pre-research and development processes as well as clinical trials.’



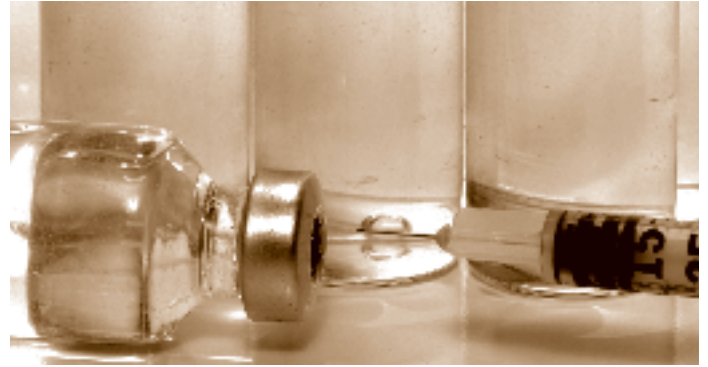
### Overview

There is a trend among multi-national pharmaceutical companies to undertake clinical research in developing markets. Given the poor levels of healthcare available in these regions EOS is concerned about the potential exploitation of vulnerable groups, including the financially vulnerable and the illiterate. Such groups may be participating in clinical trials as their only means of receiving health care. We have conducted engagements on this theme which included a site visit to a government hospital in India. During this visit we met with clinical trial physicians to gain an understanding of how pharmaceutical company policies on pre-research and development and clinical trials are implemented in practice. EOS has engaged with pharmaceutical companies throughout the research and development process, since we are concerned that the incentives for clinical trial physicians could be misaligned. Added to these concerns is the issue of ensuring the integrity of data in the recording of clinical trial results to regulators and the disclosure of negative findings.

Through engagement, EOS aims to ensure that companies in the pharmaceutical industry have the necessary monitoring responsibilities in place and that they adhere to international standards to facilitate a reduction of inappropriate practices. EOS impresses on pharmaceutical companies the importance of providing additional safeguards when conducting clinical trials amongst vulnerable groups. Such safeguards are essential to avoid the dangers of exploitation and of compromised consent, both of which have been areas of controversy in developing markets.

Whilst some pharmaceutical companies have assured us that they adhere to all applicable international standards as well as the guidelines of the local drug approval authority, we are not convinced that these companies are aware of the specific risks and oversight measures that need to be in place. On the other hand some companies have well developed processes in place which attempt to safeguard against key risks in the pre-research and development stages. To underline our engagement on these issues, we have focused on the recruitment stage of clinical trials, encouraging pharmaceutical companies to provide assurance of the correct board level oversight.





A lack of affordable health care in many countries around the world means that patients may be expected to pay for drugs, tests and medical procedures that they cannot afford. The impact of such medical expenses can force patients to sell assets, go into debt or even stop essential treatment.

Clinical data submitted to the European drug regulators to secure market approval for new drugs includes data obtained from trials in low and middle income countries. Some operators of clinical trials in developing countries have faced the criticism that they have exploited individuals who do not have access to good quality and affordable care, and who may therefore may accept offers of clinical trials that potentially provide better quality and free treatment. In some developing countries there may be a weaker regulatory system that protects clinical trial participants. In addition patient consent could be compromised by factors such as their medical condition, education levels and poverty. These factors could influence patients' ability to understand the risks involved in the clinical trial and could also influence their desire to participate. In developing countries patients may not question their doctor's judgement and may be easily influenced by their advice. They may also think that refusal to follow the doctor's advice to participate in a trial would affect their access to healthcare. We encourage companies to train doctors to avoid undue influence and the potential misunderstanding that clinical trials are an individual's only treatment option. Instead, the risks involved in being recruited for various phases of clinical trials should be explained to patients. Doctors should be clear about the varying risks, limitations and strengths of different treatment options.

During our engagements, EOS therefore stresses the importance of ensuring appropriate training is provided to the physicians running the clinical trials so that factors influencing a patient's judgement can be taken into account. Another important risk is the acknowledgement that conflict of interests may arise through doctors being given substantial incentives to recruit their own patients into clinical trials, such as fees and all-expenses paid conferences abroad. This is particularly acute when the clinical trial physician is also the patient's primary doctor. Our engagements on this issue have encouraged pharmaceutical companies to identify, manage and mitigate such conflicts of interest, especially when developing incentives to recruit clinical trial participants.

Since the application of ethical codes can vary across geographies, we encourage companies to ensure that clinical trials are conducted according to the principles of the declaration of Helsinki, local good clinical practice guidelines and the assurance that patients are giving prior and informed consent before enrolment into a clinical trial. In line with this guidance, we expect companies to justify that research is responsive to the health needs and priorities of the specific population group or community and that there is a reasonable likelihood that the specific population group or community could benefit from the outcome of the research. Within the clinical trial recruitment process we seek to ensure that no payments are made to participants which could potentially influence their judgement on whether to participate in a clinical trial. Furthermore, we seek to ensure that the incentives for recruiters of clinical trial participants drive the right type of behaviours and do not focus only on the number of participants recruited. In the event that the pharmaceutical company operates its trials through a subsidiary, we encourage the group wide values, ethics and compliance processes to be integrated into the subsidiary and for the group's strategic priorities to be implemented.

During our engagement with pharmaceutical companies on the research and development processes as well as the testing of new drugs, we also consider the existence of whistle blowing policies. Such policies guide the procedure around highlighting issues that undermine the integrity of the data to the appropriate management level. We have assisted one particular company in its investigation of our findings around clinical trials, it has been open about the biggest challenges it faces during the research phase and implementation. This is an issue faced by many companies in the industry and EOS has been impressed at the speed with which certain pharmaceutical companies have responded to our concerns. We believe this is a reflection of improvements within the corporate culture at those companies.

Clinical trials have helped to develop and improve drugs from which many people have benefitted. To ensure that population groups and communities continue to benefit from new drugs and that business needs are appropriately managed, pharmaceutical companies should ensure appropriate board level oversight of pre-research and development processes as well as clinical trials.

**Companies affected by these issues include:** AstraZeneca, Bayer, GlaxoSmithKline, Johnson & Johnson, Merck, Novartis, Pfizer, Roche, Sanofi, Takeda Pharmaceutical

## Public policy and best practice

Protecting and enhancing value by promoting better regulations

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

### Overview

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

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

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

### Highlighted sample activities

#### Enhanced Disclosure Task Force meetings

We participated in a number of meetings of the Enhanced Disclosure Task Force, established by the Financial Stability Board to promote better risk reporting by banks. We have the privilege of being one of only a handful of investors to be a member. While we believe that the bulk of what will be delivered will be a significant advance, we have worked to ensure that the co-chairs of the Task Force feel direct pressure (from all the investor participants as well as ourselves) about the need to deliver genuinely stretching standards which will reawaken trust in banks' accounting. We are also working with the other investors in the group and with other major institutions around the world to encourage direct engagement with the banks on the Task Force, such that they feel more fully the need to deliver something substantial through this process.

#### Investor Statement on Foreign Corrupt Practices Act

We co-signed an investor statement in support of the Foreign Corrupt Practices Act. This statement has been put out in reaction to the US Chamber of Commerce's call for changes or 'clarifications' to the Act, which we believe would weaken its effectiveness in fighting bribery and corruption globally. This investor action followed a meeting which one of the authors of the letter had with the Securities and Exchange Commission and the Department of Justice.





### Meeting with Tokyo Stock Exchange senior executives

We met with the Tokyo Stock Exchange to discuss recent changes in corporate governance rules and how we can continue working together to promote best practice further. We welcomed a number of recent amendments to the Company Act, in line with our persistent efforts and requests to date, such as strengthening the definitions of outside directors to enhance independent board representation, requiring a 'comply or explain' approach to board structure, and improved regulations on issuing new shares via third-party placement. We discussed additional guidance which we believe is critical for effective implementation of governance reform. In particular, we noted the need for clear guidance on the different roles and duties of independent board directors compared with those of outside statutory auditors when the new optional board structure includes an 'audit and supervisory committee', so that this new structure can be effective. We reiterated our strong belief in the need to develop a Corporate Governance Code with a practical framework and a 'comply or explain' approach to ensure that there is an open and constructive dialogue between companies and their shareholders. We also suggested that the TSE, with an active participation and support of investors, consider corporate governance awards for Japanese companies to encourage best practice to develop. We offered to work together to advance this.

### Presentation on necessary governance reforms in Taiwan

We gave a keynote speech on executive remuneration and wider corporate governance issues at the Taiwan Corporate Governance Association. We explained why executive remuneration matters, outlined the issues and problems associated with current practices and provided an overview of recent events and developments in Europe and the US. We also used the opportunity to present some of our ideas for reform of pay structures and our activities to promote these amongst companies, investors and regulators. Whilst the topic is not yet on top of the corporate governance agenda in Taiwan, there were many questions and a lively debate following our presentation. It became apparent that the role and influence of directors representing the state is a corporate governance issue of particular concern in Taiwan. As a first step to address apparent problems, the Association is keen to provide formal training to such directors, so that they better understand their proper role and legal obligations. We shared our experience with state shareholders in other markets and offered our help with regard to the director training programme. We used the presentation and the subsequent debate to make a number of proposals regarding corporate governance in Taiwan, focusing in particular on board nominations and composition as well as transparency and the role of shareholders with regard to major corporate transactions.

### Consultation on executive remuneration in France

We responded to a government consultation on remuneration which will inform legislative changes. We strongly promoted the concept of a vote on a special report on remuneration and set out precisely the information this report should provide. In our view, such a vote would significantly enhance the dialogue between companies and shareholders. We also argued in favour of an investor stewardship code, regrettably absent from the consultation and which we believe is the missing cornerstone of the 'comply or explain' principle currently applied in France on governance matters. As the use of share-based incentives was questioned in the consultation, we made a clear case in favour of a significant part of top executive remuneration being paid in shares, paid in instalments with performance criteria being applied, and there being a requirement to hold the shares over a long period of time. We see this as the most efficient tool to align company and shareholder interests over the long term. We will further contribute to the debate via discussions with stakeholders and articles.

### Other public policy work this quarter included:

#### Promoting best practice

- As part of our ongoing work through the PRI on sustainability in the palm oil industry we spoke with representatives from Mars and M&S to discuss the challenges in securing supplies of certified sustainable palm oil.
- We spoke with the Carbon Disclosure Project and some consultants on the possibilities of examining discrepancies between corporate carbon reduction initiatives and policy lobbying.
- We actively participated in a lengthy meeting of the Canadian Coalition for Good Governance's pay subcommittee, which is working to enhance its policy guidance. Our specific recommendations included removing language endorsing the contention that there is a highly competitive market for executives as this may be seen as supporting high pay.
- We met with the Keidanren, Japan's dominant and influential business federation, which represents over 1200 companies and other organisations and which has conservative views about corporate governance. We discussed the lessons to be learned from the recent corporate scandals in Japan and their implications for the business sector generally.
- We met with the executive director of the Association of Capital Markets Investors to discuss governance and shareholder rights. The association is a non-profit organisation that aims to protect minority shareholders' rights in listed companies in Brazil.
- We met the local director of the Carbon Disclosure Project in China to discuss developments in the CDP's work in the country and progress by Chinese companies in their 2012

## Public policy and best practice continued

responses. We discussed the challenges that CDP China faces when encouraging companies to participate.

- We met with the chair of the CityUK Russia Working Group to discuss its work alongside Moscow to create an international financial hub, the Moscow Financial Centre Initiative. The Russian government has identified TheCityUK as a leading partner in its work to develop Moscow in this way and we were invited to join the Russia & CIS advisory group and become part of one of their workstreams focusing on long-term sustainable investing.
- We spoke at the first ever Russian forum on ESG and responsible investment. We called for better disclosure and transparency on sustainability issues and stressed the need for Russian companies to integrate ESG as a core part of their strategy.
- We participated in the inaugural meeting of the Centre for Audit Committee and Investor Dialogue, a group we have initiated alongside other investors and one of the mid-tier audit firms to encourage dialogue between those who manage the relationship with companies' auditors and shareholders.
- In advance of our response to the Department of Business on its consultation on revised remuneration reporting regulations we met members of the GC100, a representative group of FTSE 100 general counsels, to discuss ideas on the consultation.

### Public Policy

- We met with the chair and deputy chair of the International Auditing and Assurance Standards Board regarding their proposed reforms to the audit reporting standard. We welcomed the proposals as a first proper reflection by the Board of what we and other users have been calling for over the past several years – more informative audit reporting – and the Board acknowledged the role which our meetings have had in encouraging the standard-setter to make these proposals. We provided the first and the leading investor commentary at the IAASB's Brussels roundtable on its proposals for enhanced audit reports.
- We co-signed an investor statement in support of issuing a final rule on conflict minerals due diligence and reporting under section 1502 of the Wall Street Reform and Consumer Protection Act (usually known as the Dodd-Frank Act). The issuance of this rule is a significant milestone in our collective efforts to eliminate the link between violence and human rights abuse and the mineral trade in the Democratic Republic of Congo and surrounding countries.
- We had a group meeting with senior officials at Japan's Financial Services Agency responsible for corporate disclosure and securities exchange surveillance. We welcomed the recent introduction of a new regulation regarding capital raising, which is in line with the recommendations of a coalition of institutional investors including EOS.
- We met with the outgoing chair of the Comissão de Valores Mobiliários, the Brazilian Securities & Exchange Commission. We discussed the next steps to enhance regulation in Brazil, including the possible need to change company law to embed corporate governance requirements, provisions for related-party transactions and further requirements for board members and audit committees.
- We met with senior managers of the Taiwanese exchange's listing department to discuss its rules regarding audit committees, nomination processes and shareholder approval of transactions.

- We met with senior executives of the Brazilian Securities, Commodities and Futures Exchange to discuss financial regulations and listing rules. The different listing segments of the Exchange, the Novo Mercado in particular, have undoubtedly helped push companies to improve their corporate governance but there are still many areas where improvement is needed.
- We met with an MEP who is rapporteur for one of the key parliamentary committees responding to the EU Commission's proposals for enhanced audit rules. This means she is charged with developing the response which will shape the negotiation between the parties that will lead to compromise legislation.
- Following our response to a French securities regulator consultation on the dialogue between shareholders and companies, we are pleased that our views were quoted extensively in the final synthesis document which has recently been published.
- We were invited to speak at the Spanish Institute of Directors' conference on corporate governance developments in Spain, as well as the increased activism at shareholder meetings in Europe and Spain during the 2012 voting season.
- We responded to the Financial Reporting Council's consultation on the Stewardship Code. We welcomed the bulk of the proposals – many of which reflect our recommendations in an informal pre-consultation which preceded the formal process – as well as highlighting a few areas where we believe more work is needed.
- We attended the launch of the Kay Review final report. While there are elements of this that we are not wholly in agreement with and sections that we believe could go further, we agree with the overall focus and thrust of the document, much of which reflects our input over the review process.

### Working with other shareholders

- We hosted a conference call with UNPRI members participating in the project on conflict minerals to present recent developments in the collaborative engagement effort we are leading focused on the sourcing of minerals from the Democratic Republic of Congo by electronics companies, and to coordinate the group's future activities.
- Following our meeting with the OECD's group of Middle East and North African heads of stock exchanges and securities regulators, we have held discussions with the OECD on our focus and priorities for the region. We recommended that it would be useful to develop a network of Middle East institutional investors who can meet to discuss corporate governance.
- We spoke with the director of the Russian Investor Protection Association to discuss corporate governance and shareholder rights. The Association is an independent, non-profit organisation and the only body in Russia established by investors to seek to enhance corporate governance in the country and to protect the rights of investors.
- We co-hosted a conference call with the other principal author of a set of guidance on South Africa's acting in concert rules, which have acted as a significant block on cooperation and collaboration between investors in the country.
- With a group of other UK investors we met representatives of the Investment Management Association and the Financial Reporting Council to discuss the proposed questionnaire for their 2012 Stewardship Code survey.



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



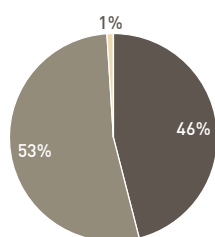
Hermes votes at company meetings all over the world, wherever its clients own shares.

## Overview

Over the last quarter, we voted at a total of 1,164 meetings around the world, analysing 9,433 resolutions. At 438 of those meetings we opposed one or more resolutions and we abstained at 15 meetings. We voted with management by exception at 11 meetings, while we supported management on all resolutions at 700 meetings.

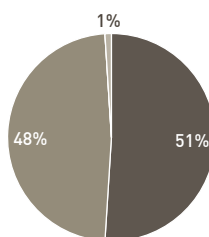
### North America

We voted at 397 meetings (2,914 resolutions) over the quarter.



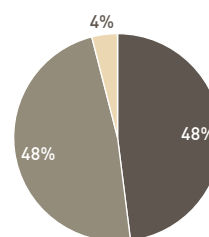
### Asia Pacific

We voted at 110 meetings (734 resolutions) over the quarter.



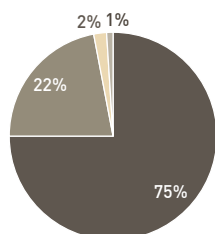
### Australia & New Zealand

We voted at 33 meetings (143 resolutions) over the quarter.



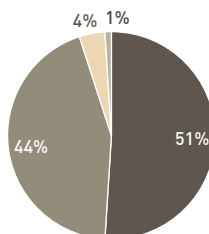
### Emerging & Frontier Markets

We voted at 281 meetings (2,031 resolutions) over the quarter.



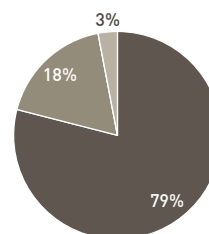
### Europe

We voted at 134 meetings (1,080 resolutions) over the quarter.



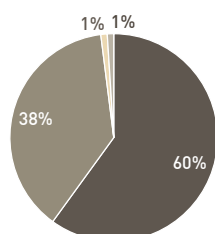
### UK

We voted at 209 meetings (2,531 resolutions) over the quarter.



### Global

We voted at 1,164 meetings (9,433 resolutions) over the quarter.



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

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## | Hermes Equity Ownership Services

Hermes Equity Ownership Services (HEOS) enables institutional shareholders around the world to meet their fiduciary responsibilities and become active owners of public companies. HEOS is based on the premise that companies with informed and involved shareholders are more likely to achieve superior long-term performance than those without.

## **Hermes EOS engagements with Lothian's top 10 holdings**

**Royal Dutch Shell** As one of the leading international oil companies and one of the largest UK and Dutch listed companies we have engaged with the company over the past few years, in particular on risk management. Oil companies face a number of health and safety, environmental and reputational risks. Oil and gas reserves are increasingly found in developing countries which present additional political, human rights and other issues. There are also environmental risks associated with unconventional methods of oil and gas extraction from oil sands, arctic drilling and shale. Effective management of these risks requires appropriate governance. We have therefore engaged with the company on these issues. We will continue to push for further progress on our engagements through further contact with the company where we have good contacts. We will request a meeting with the corporate responsibility committee chair and write to the chair to suggest that the company report publicly on how it is trying to encourage the other Nigerian stakeholders to work with it to implement the other recommendations of the United Nations Environmental Programme's report into Ogoniland in Nigeria.

**BHP Billiton** BHP Billiton is a global operator in the high risk extractives industry, and over the past few years has attempted unsuccessfully a number of large transactions. Our engagement has therefore focused on ensuring the company adopts a strategy that focuses more on organic opportunities. We have also focused on the health and safety of both employees and contractors. Our engagement with the company has also been on oversight of risk, in particular in non-managed joint ventures. As with other extractives companies, BHP Billiton is more highly exposed to operational, as well as environmental and social risks through its joint-ventures due to lower risk management standards. An example of this is the Cerejon Coal mine in Colombia, which is jointly-owned by Anglo American, BHP Billiton and Xstrata. The Cerrejon Coal mine appears to operate with much lower risk management standards than any of the three minority shareholders apply to their own controlled operations. The aim of our engagement is to ensure that joint-ventures operate to the same standards as the company's own operations

**HSBC Holdings** As this is a large international bank our engagement in the past few years has focused on governance in the wake of the start of the global financial crisis in 2008. We have engaged on appropriate remuneration structures, seeking better alignment with long-term shareholder interests. Another focus has been appropriate management of risk, including how remuneration policy and risk management are linked. Much of the engagement is now largely complete; the new chair and CEO seem to be appropriate candidates and the apparently divided board seems to be working effectively under the new leadership. The chair has intimated some new refreshment of the NED contingent, including a possible successor to him as chair. The remuneration policy has also been radically revised with much of its success dependent on the appropriate use of discretion and dialogue with shareholders by the remuneration committee chair.

**Vodafone** Given Vodafone's global footprint and its investment in joint ventures our engagement to date has focussed on the benefits of its conglomerate structure and the company's strategy to unlock value from the sum of the parts. We have also discussed whether the company is getting full value for its brand and whether pricing is appropriate. We have also examined operational performance, including that of the supply chain as well as governance issues.

**Rio Tinto** Rio Tinto's presence in some of the most challenging operating environments has prompted our engagement activities to focus on how it manages environmental and social risks, as well as bribery and corruption risks. The company's recent M&A activity has not been altogether successful and as a result, engagement has also focused on both management performance and the company's strategy. We have also engaged on risk management in its joint ventures. However the company faces a number of environmental and social risks which it does not appear at present to be managing sufficiently well. The company is particularly exposed to water risks. It has also suffered criticism over their minority interest in Grasberg copper JV with Freeport, which has poor operational record in terms of the environment and local communities. Grasberg is the most prominent example of how Rio Tinto is currently unable to ensure acceptable environmental and social risk management practices are employed in their non-managed joint ventures.

**BP** Post the Texas City explosion and the Prudhoe Bay oil spill we escalated our engagement and pushed for board refreshment, particularly at the chair, as we believed that this was the right way to ensure that the necessary cultural changes took place. We welcomed the appointment of the new CEO as we believed that he would focus closely on health & safety issues. The organisational changes he pushed through appeared to us as the right ones although, as time went on, we began to become concerned that the health & safety function within BP was becoming excessively decentralised and that no one was ensuring that lessons from one operation were learned across the entirety of the company's operations. We were obviously shocked and dismayed by the Macondo spill and explosion and stepped up our engagement again in the aftermath of this incident. Our recent engagement with the company has focused on its response to the accident in the Gulf of Mexico. We have held many meetings and participated in a number of telephone conversations with the company on both on how it has responded to the incident and also how it has reviewed and improved its risk management processes to minimise the likelihood of other incidents.

**British American Tobacco** The main focus of our discussions with the company have been on how it best navigates the difficulties presented by the tobacco industry. Additionally we have sought reassurance on the impact on the environment of its operations, in particular examining allegations of serious pollution, affecting the community local to its operations in one African country.

**Nestle** We have a long standing engagement with Nestle since 2005. Over the years we engaged on several issues such as Child labour in Africa, labour and bargaining right in emerging markets, unethical sourcing of palm oil and general governance issues. On the child labour issue, Nestlé has started to collaborate with local governments and producers to implement the Harkin Engel protocol. The aim being to complete a certification process by end 2010, effectively collecting data to assess the extent of the issue. Whilst Nestle has significantly improved its policies to deal with this issue, the lack of an effective monitoring of its supply chain creates a significant reputational risk for the company. Nestlé found itself also in disputes with unions over denial of bargaining rights and wages policy in several emerging markets. The most prominent dispute regards the workers who produce Nescafé products at the Panjang factory in Indonesia and it has been ongoing since 2008. On Governance, we have been engaging the company on governance issues since 2005. Over these years we have successfully encouraged, among other issues, the unbundled election of directors; the separation of the positions of chairman and CEO; the change of the terms of

board members from five to three years; the removal of voting rights limitations, which were increased from 3% to 5% in 2008.

**Unilever** We engaged with Unilever since 2008. Our aim hereby is to ensure Unilever has sufficient oversight of its supply chains and conducts an appropriate level of audit to satisfy itself of its understanding. Interlinked to this engagement is the desire to explore the company's strategy for sustainable palm and soy sourcing. In term of Governance we would like to improve the alignment of variable pay of the board and other executives with interests of shareholders.

**GlaxoSmithKline PLC** The recent focus of the engagement has been on structural changes that have been necessary to support the company's cultural changes following substantial issues with its sales practices in the US. We discussed how the company can outwardly communicate the cultural shifts in its organisation and pressed that one number that will be picked up is the number of disciplinary actions over the year. This number remains high and we debated whether a sign of success is this number increasing or decreasing. We ran through the breakdown of these numbers, in particular focussing on those relating to falsifying documents, which represent 10% of the total issues. We further expressed a desire to see some regional breakdown of the figures to understand better how the trends vary across the globe. On Governance we pressure the company to better align pay to the risks and long term nature of the business. The Company assured us to amend the pay scheme further but we pushed for longer holding period of shares for the CEO at least to be more aligned with shareholders' experience of product lifecycles and as a risk management tool.

# QUARTERLY ENGAGEMENT REPORT

JULY TO SEPTEMBER 2012



## Local Authority Pension Fund Forum

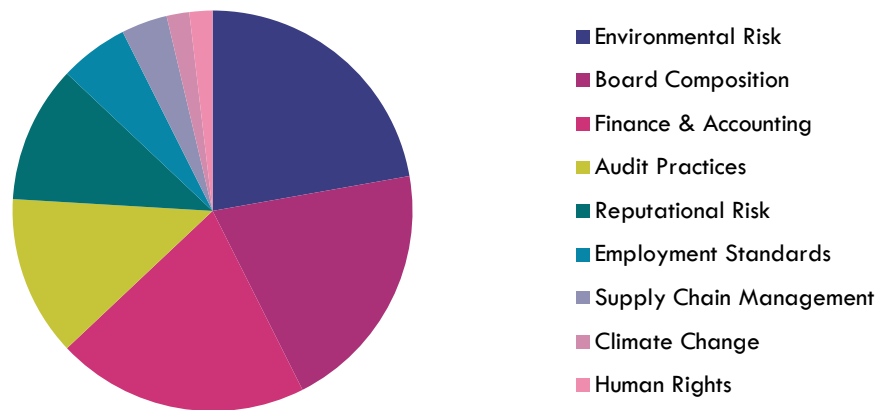
LAPFF exists to promote the investment interests of local authority pension funds, and to maximise their influence as shareholders whilst promoting social responsibility and corporate governance at the companies in which they invest. Formed in 1990, the Forum brings together a diverse range of 55 local authority pension funds in the UK with combined assets of over £115 billion.



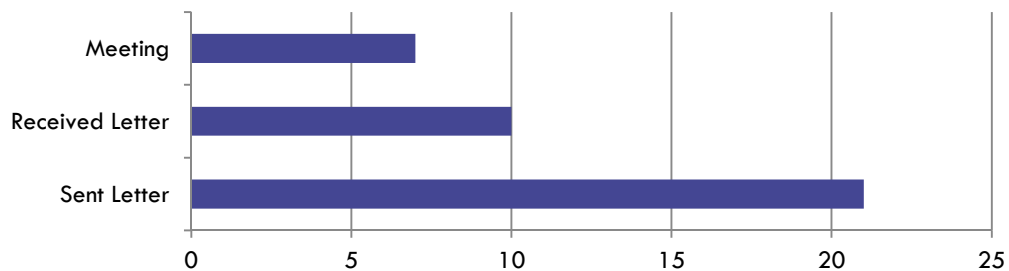
# ENGAGEMENT SUMMARY

JULY TO SEPTEMBER 2012

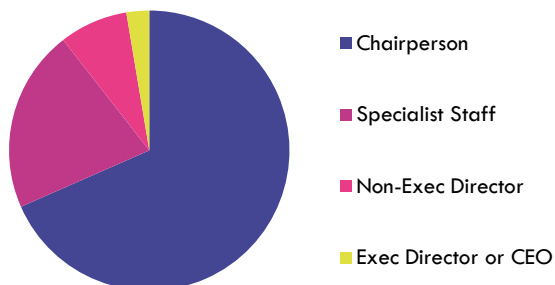
## Topics



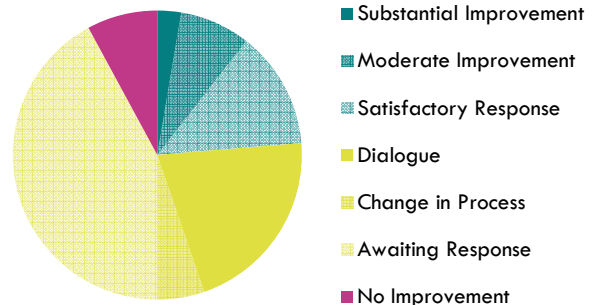
## Activities



## Company Contact



## Outcomes



# ACHIEVEMENTS

- Met with directors at **Barclays**, **Lloyds**, **HSBC** and **Standard Chartered** directors to discuss IFRS, 'true and fair view' accounting, as well as recent fines and reputational risk in the banking sector.
- LAPFF member funds signed an open letter to Rupert Murdoch from Class A shareholders asking the **News Corp** board to appoint an independent Chair at its successor companies.
- Wrote to the Chair of **Lonmin** to express deep concern regarding violence at the company's South African platinum mine and to encourage the board to implement best practice principles in its relationships with police and security forces.
- Discussed sustainability and responsible supply chain management with **Kingfisher**, the parent company of household name B&Q. Met with **Reckitt Benckiser** on labour standards and supply chain management.
- Met with **Rolls-Royce** to discuss the company's role in reducing airline greenhouse gas emissions through improved jet engine technologies.
- Received responses from **EOG Resources** and **Wal-Mart** to the request that they participate in the CDP Water questionnaire. Both companies have declined to participate again this year. LAPFF also wrote to ten companies requesting they provide a response to the **Forest Footprint Disclosure** project.
- Sent letters to 36 companies in the FTSE 350 encouraging them to meet the **board diversity** targets set out by the Davies Review. We received responses from 12 companies on their measures to consider diversity in the boardroom.

## THE FORUM IN THE NEWS

Investor calls for audit reform – [Professional Pensions, 25 Sept](#)

Local investment opportunities – [AICIO, 20 Sept](#)

News Corp shareholder resolution – [Institutional Investor, 4 September](#), [Telegraph, 5 September](#)

Independent Chair at News Corp - [BBC News, 18 July](#), [The Telegraph, 18 July 2012](#), [International Business Times, 19 July](#)

Bob Diamond's Remuneration - [The Guardian, 3 July](#)

View more press coverage: [http://www.lapfforum.org/press\\_coverage](http://www.lapfforum.org/press_coverage)

# COMPANY ENGAGEMENT

## LEADERSHIP ON KEY CAMPAIGNS

Upon hearing of the horrific violence at **Lonmin's** West Markiana mine, LAPFF wrote to the Chair, Roger Phillimore, to express deep concern regarding the violence, asking the board to take due care in its relationships with police and security forces. The letter encouraged the company to refrain from issuing back to work orders to striking workers, for fear it would lead to more violence. It also asked the company to review community and workplace grievance mechanisms in light of the social unrest. The company responded swiftly to LAPFF's letter outlining its position with regard to the conflict. LAPFF was pleased to hear that the company has softened its stance; however tensions at the mine remain high and the company faces real financial risk.

### PLATINUM FACTS

- 80% of world's platinum reserves are in South Africa
- 12% of global supply is produced by Lonmin mines
- 31% is used for catalytic converters
- 28% goes to producing jewellery

Members of LAPFF signed an open letter to **Rupert Murdoch** sent by 18 investors holding non-voting Class A shares and representing US \$1.6 trillion in assets. The letter expressed the investors' support of the shareholder resolution filed by Christian Brothers Investment Services and co-filed by two LAPFF member funds requesting that News Corp appoint an independent chair. Class A shareholders do not have the right to file shareholder proposals or vote at the company's annual meeting. The LAPF chair met with UK investors to build support for the shareholder resolution and a webinar was held for US and other overseas investors.

Finally, LAPFF wrote to 36 companies on the FTSE 350 encouraging them to consider **diversity** when making appointments to the boardroom. To date, 12 companies have responded to the letter, highlighting the steps they are taking to implement the recommendation of the Davies Review which asks companies to achieve 25% women on the board by 2015. Many companies that responded highlighted their strategies to address diversity generally within the organisation, but there continues to be a serious disconnect between diversity in the workforce and diversity at the senior executive and director level.

## PROMOTING GOOD GOVERNANCE

### Financial Reporting & Audit

Criticisms of IFRS appear to be gaining steam as more investors and companies raise concerns about the distortive effects IFRS has on company balance sheets. LAPFF has initiated a round of meetings with the board chair or audit committee chair of each of the large

UK banks to discuss the Forum's concerns about accounting standards and the risk the standards pose to shareholder capital. This quarter, the Chair of LAPFF met with board directors and the finance directors of **Barclays**, **Lloyds**, **HSBC** and **Standard Chartered** to highlight the deficiencies in IFRS accounting and seeking each company's perspective on the issue. LAPFF has also arranged a meeting with **RBS**.

The Forum co-signed an investor letter to the **European Commission** (EC) on mandatory auditor rotation and recommended that auditors should not receive fees for non-audit services equal to more than 50% of the statutory audit fee to help avoid problematic conflicts of interest. The investor group also called for an investigation as to whether IFRS could provide a 'true and fair' view.

## MANAGING ENVIRONMENTAL ISSUES

### Environmental Risk Management

LAPFF is a long-term supporter of the **Forest Footprint Disclosure Project** and the **Water Disclosure Project**. This quarter the Forum wrote to 12 companies asking them to respond to these initiatives. Wal-Mart and EOG Resources replied to LAPFF's request stating that they did not intend to reply to the CDP Water questionnaire in 2012.

In March, LAPFF joined 35 other global funds, to write to **21 oil and gas companies** that are producing shale oil, asking for information about how much they are flaring and their plans to reduce flaring. Twelve of the 21 companies have responded, with a further three planning to do so. An investor webinar in September outlined potential follow-up investor engagement with these companies regarding flaring and other environmental risks related to shale oil.

30 investors with assets of **US \$2.5 trillion** signed up to the Forest Footprint Disclosure project in 2012

A meeting with **Rolls-Royce** was very informative in explaining the company's technological approach to meeting demanding carbon reductions and its investment in newer technologies such as tidal power. The Forum expressed the view that the company could reinvigorate its message from the board on the strategic importance of carbon management to the business.

## TARGETING SOCIAL ISSUES

### Employment Standards & Sustainable Supply Chains

Meetings were held with **Reckitt Benckiser** and **Kingfisher** on the issue of sustainable supply chains and labour standards. Kingfisher, the parent company to UK 'do it yourself' chain B&Q described its recent Net Positive sustainability strategy which sets out a vision to not only 'do no harm', but to have a net positive impact on the environment. Kingfisher has set stringent

Kingfisher sold **7.1 million m<sup>3</sup>** of timber products in 2011/12, roughly equivalent to the size of **Switzerland**.

*-Kingfisher 2012 Sustainability Report*

targets for sourcing sustainable timber, and for energy efficiency. The company has also recently improved its communication to shareholders about its sustainability initiatives and how they contribute to the bottom line.

The Forum's interest in meeting with Reckitt Benckiser was to learn from one of the market-leading companies on sustainability, how they integrate sustainability into the supply chain. LAPFF encouraged the company to continually improve its disclosure with regard to supply chain audit results and remediation practices.

In July, the Forum formally signed up to the **Access to Nutrition (ATN) Investor Statement**, following four years of engaging with UK companies on the investment risks posed by obesity. LAPFF's support for the initiative signifies the continued relevance of health and nutrition as an investor concern.

## CONSULTATIONS & PUBLIC POLICY

### ENGAGING POLICY MAKERS AND CONSULTATION RESPONSES

Following the publication of an SEC review of IFRS, LAPFF wrote to the **Office of the Chief Accountant at the SEC** to raise concerns about conflicts of interest within the IASB – the international body that sets accounting standards. The US has yet to adopt IFRS and is undertaking a review of the standards.

The Forum was represented in a meeting between several institutional investors and Senior Advisors at the **Bank of England** to discuss IFRS accounting at UK banks in July. The investors expressed serious reservations about the current accounting framework and advocated for a return to prudence and the 'true and fair view' in UK accounting. Representatives from LAPFF also met with the Department for Business Industry and Skills (BIS) and the Financial Reporting Council (FRC) to highlight concerns regarding inherent risks in IFRS accounting for institutional investors. The meeting was productive and LAPFF is working with other investors to further engage with key policy decision-makers on this issue.

LAPFF was also pleased to read that [consultation responses](#) submitted to regulators in Denmark have quoted the Forum's research into IFRS, highlighting the role the accounting standards played in the financial crisis.

No formal consultation responses were submitted by LAPFF this quarter. All consultation responses submitted by LAPFF to date can be viewed online at: <http://www.lapffforum.org/consultations>.

## NETWORKS & EVENTS

- **News Corp:** webinar on shareholder resolution to appoint an independent chair
- **Oil sands** webinar on environmental & social risks by Ceres
- **30% Club** celebrates reaching over 50 Chairmen supporters
- **Food Ethics Council** Roundtable 'Overcoming commercial and political short-termism'
- **Integrated Reporting** webinar by Paul Druckmann, CEO, IIRC
- **UKSIF** annual lecture: Big Society Capital
- **Green Investment Bank** webinar by UKSIF & Transform UK

The Forum chaired a webinar to highlight the rationale for the shareholder resolution for an independent chair, and to debate wider concerns about the governance of News Corp.

The **30% Club** celebrated reaching over 50 FTSE 100 Chairman supporters in July. Attendees were advised of the progress of the initiative to date and of plans to develop the momentum behind this business-led approach to better balanced boards. Many board appointments have been to non-executive roles so it is intended to have a greater focus on the executive pipeline at companies.

LAPFF also participated in a **Ceres** webinar highlighting key social and environmental risks in the oil sands. Oil sands operating companies have recently set up an industry association to examine sustainability in oil sands operations and accelerate the pace of environmental improvement. The webinar outlined some practical steps companies can take to address issues such as water management, reclamation, biodiversity and greenhouse gas emissions. It also suggested how investors can engage with companies to encourage prudent environmental management in the extraction of oil sands.

The issues of commercial, political and consumer short-termism were debated at a **Food Ethics Council Roundtable** which explored key challenges faced by food businesses in progressing towards a sustainable food system and how this can be influenced by relevant players in the investment chain.

# COMPANY PROGRESS REPORT

Company	Topic	Outcome
Archer-Daniels Midland	Environmental Risk	Awaiting Response
Ashtead Group	Board Composition	Moderate Improvement
Barclays	Finance & Accounting, Reputational Risk	Dialogue
Berendsen	Board Composition	Change in Process
Bunge Limited	Environmental Risk	Awaiting Response
Danone S.A.	Environmental Risk	Awaiting Response
EOG Resources	Environmental Risk	No Improvement
Fresnillo	Board Composition	Moderate Improvement
General Mills, Inc	Environmental Risk	Awaiting Response
Greggs	Board Composition	Satisfactory Response
Halfords Group	Board Composition	Satisfactory Response
Hikma Pharmaceuticals	Board Composition	Satisfactory Response
HSBC Holdings plc	Finance & Accounting, Reputational Risk	Dialogue
Intertek	Board Composition	Moderate Improvement
Kingfisher	Supply Chain, Employment Standards	Substantial Improvement
Kraft Foods Inc	Environmental Risk	Awaiting Response
Lloyds Banking Group	Finance & Accounting, Reputational Risk	Dialogue
Lonmin	Human Rights, Employment Standards	Awaiting Response
McDonald's Corporation	Environmental Risk	Awaiting Response
National Express	Employment Standards, Board Composition	Awaiting Response
News Corp	Board Composition, Reputational Risk	Dialogue
Olam International Limited	Environmental Risk	Awaiting Response
Reckitt Benckiser	Supply Chain Management	Satisfactory Response
Rolls-Royce	Climate Change	Satisfactory Response
Royal Bank of Scotland	Finance & Accounting, Audit Practices	Dialogue
Standard Chartered	Finance & Accounting, Audit Practices	Dialogue
Wal-Mart Stores Inc	Environmental Risk	Awaiting Response
Wilmar International	Environmental Risk	Awaiting Response
Xstrata	Board Composition	Change in Process
Yum! Brands Inc	Environmental Risk	Awaiting Response





**The Local Authority Pension Fund Forum** was established in 1991 and is a voluntary association of 55 local authority pension funds based in the UK. It exists to promote the investment interests of local authority pension funds, and to maximise their influence as shareholders to promote corporate social responsibility and high standards of corporate governance amongst the companies in which its members invest. The Forum's members currently have combined assets of over £115 billion.

Report prepared by PIRC Ltd. for the  
Local Authority Pension Fund Forum

**PIRC**

[www.lapfforum.org](http://www.lapfforum.org)

Aberdeen City Council  
Avon Pension Fund  
Bedfordshire Pension Fund  
Brent LB  
Camden LB  
Cheshire Pension Fund  
City of London Corporation  
Clwyd Pension Fund  
Croydon LB  
Derbyshire CC  
Devon CC  
Dorset County Pension Fund  
Dyfed Pension Fund  
Ealing LB  
East Riding of Yorkshire Council  
Enfield  
Falkirk CC  
Greater Gwent Fund  
Greater Manchester Pension Fund  
Gwynedd Pension Fund  
Hackney LB  
Haringey LB  
Harrow LB  
Hillingdon LB  
Hounslow LB  
Islington LB  
Lancashire County Pension Fund  
Lewisham LB  
Lincolnshire CC  
London Pension Fund Authority  
Lothian Pension Fund  
Merseyside Pension Fund  
Newham LB  
Norfolk Pension Fund  
North East Scotland Pension Fund  
North Yorkshire CC Pension Fund  
Northamptonshire CC  
NILGOSC  
Nottinghamshire CC  
Rhondda Cynon Taf  
Shropshire Council  
Somerset CC  
South Yorkshire Integrated Transport Authority  
South Yorkshire Pensions Authority  
Southwark LB  
Surrey CC  
Teesside Pension Fund  
Tower Hamlets LB  
Tyne and Wear Pension Fund  
Waltham Forest LB  
Warwickshire Pension Fund  
West Midlands Pension Fund  
West Yorkshire Pension Fund  
Wiltshire CC  
Worcestershire CC