CASE STUDY

Kuala Lumpur Kepong (KLK)

Malaysia's KLK focuses on the production and processing of palm oil products and natural rubber. It sources primarily from its own plantations in Indonesia, Malaysia and Liberia, but also takes a proportion from suppliers.

We began our engagement in 2012 following the company's lack of response to NGO and media reports alleging its involvement in deforestation in Indonesia, and poor labour conditions and wages. In our first meeting, the company was quite defensive and denied the allegations.

In 2013 further allegations were made about poor labour conditions in the company's supply chain, and we urged KLK to provide clarity on how it was investigating. While KLK was gradually more willing to discuss labour issues, details on policy implementation were still lacking. We continued to raise our concerns in calls and correspondence over the next few years.

Since our initial engagement, KLK has strengthened its labour standards and disclosure, training suppliers on labour standards compliance as part of its commercial contracts, and commissioning external audits of its supply chain. KLK also partnered with a reputable consultant for a human rights impact assessment of its Liberian operations.

The disclosure of the audit findings and action plans have provided greater clarity for investors and other stakeholders. In 2014, the company also achieved 100% Roundtable on Sustainable Palm Oil (RSPO) certification of its Malaysia operation.

In a September 2021 call, we heard that the company had made good progress in tracing mill and refinery third-party supply chains back to plantations. It was open about the challenge of getting to 100% due to the lack of visibility regarding smallholders and challenges in visiting sites due to Covid-19.

We sought more information about how the company ensures that its commitments to no deforestation, no peat and no exploitation (NDPE) are met, especially at third-party plantations. KLK said it has teams based at operating centres (estates) to monitor this. It is also working with a satellite imaging company to monitor plantations and any contravention of its no deforestation, no peat commitment.

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KLK has carried out a third-party assessment of labour standards at some key sites, has published the results and is working on an action plan. It has also implemented improvements for migrant workers. Passports are not retained by the company and workers do not pay recruitment agency fees. It has monitored prevailing wages while waiting for the RSPO to complete the living wages benchmark.

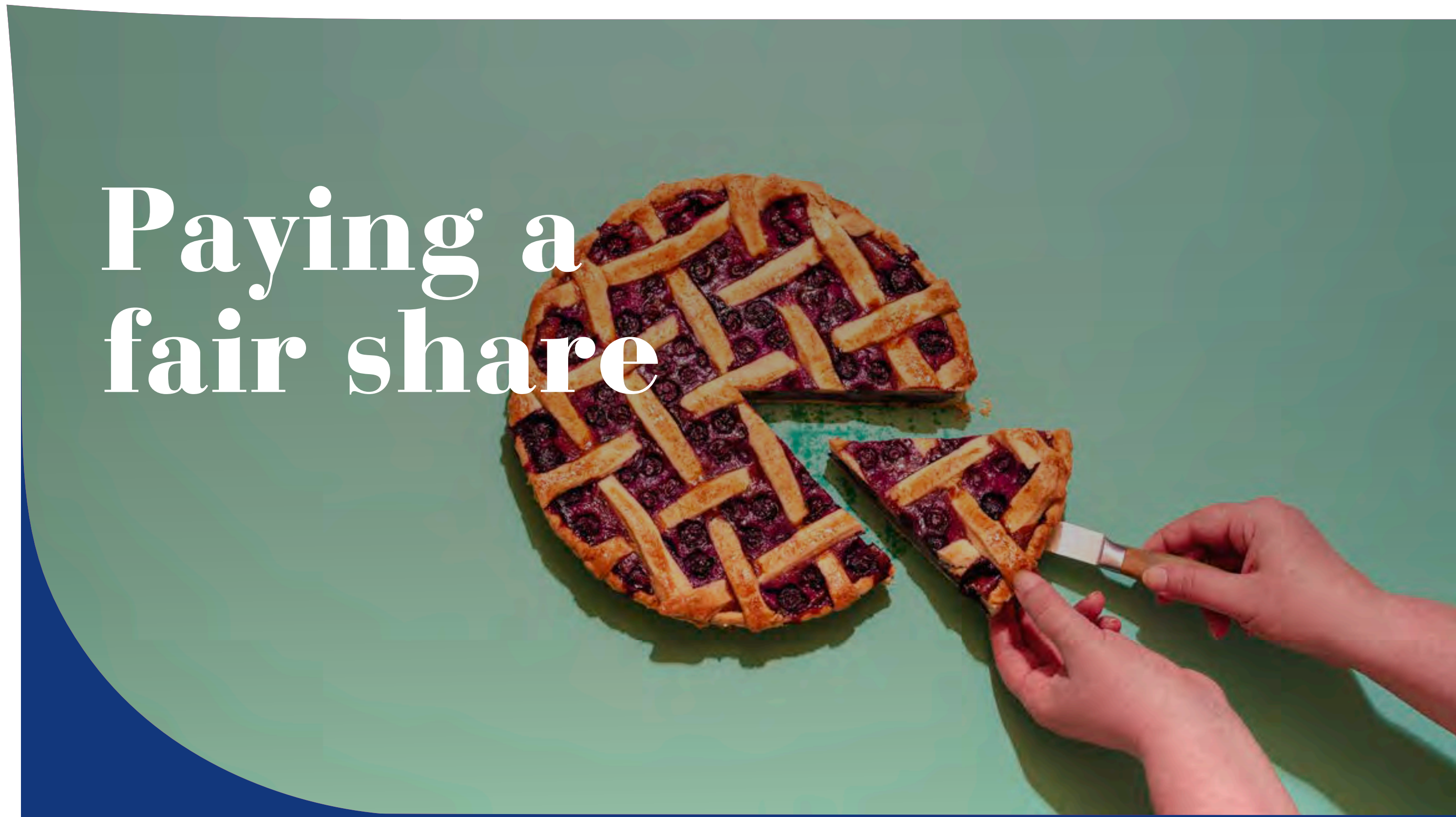
In addition, we are part of the Global Canopy Aligned Accountability project, which seeks to bring together existing data sets on deforestation and package this in a more usable way for financial market participants. The aim is to develop a comprehensive, collaborative and open database on company performance on deforestation, aligned with the Accountability Framework, which will provide standardised data. We are supporting this project to refine the development of the database and ensure its relevance for end users.

The aim is to develop a comprehensive, collaborative and open database on company performance on deforestation.

Outlook

Globally, sustaining efforts to halt and reverse deforestation will be critical over the next few years. For EOS, this will mean stepping up our engagement on deforestation and continuing to focus on this topic within our vote policy, escalating where necessary. This systemic issue requires extensive collaboration and political will, so we will continue to conduct advocacy on climate and nature-related topics. From 2023, FHL will disclose its assessment of deforestation risk in its portfolios and its mitigation activities, which will include ongoing engagement.

Paying a fair share



Companies that seek to aggressively minimise their tax payments will face increasing legal, financial and reputational risks as regulation tightens. Joanne Beatty explains why tax revenues are vital for cash-strapped public services, and how we engage with companies to ensure they pay a fair share.

Setting the scene

Tax payments underpin the functioning of vital societal services in developed countries and emerging economies. These include emergency services, health, education, infrastructure, welfare, justice, and environmental protection, including climate mitigation and ensuring a just transition. As a result, tax revenues represent the single largest source of funding for the UN Sustainable Development Goals.[1]

Investors need sufficient information to gauge a company's tax position and governance approach and anticipate any future risks to their holdings. Aggressive tax practices can lead to investigations by regulators, resulting in fines or retrospective clawback of underpaid tax. A company's reputation and social licence to operate can also be damaged if it is thought not to be paying its fair share.

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Public services are under immense strain in many countries in the wake of the pandemic, with soaring inflation adding to the pressure. Against this backdrop, it is vital that tax burdens are distributed proportionately, rather than falling on the most vulnerable segments of the population. However, some multinational companies employ aggressive tax practices to minimise their tax payments, meaning that governments must make up the revenue shortfall by increasing the burden on individuals, or borrowing more.

Aggressive tax planning and practices are those where companies reduce their tax liability through arrangements that may be legal but are not in keeping with the intent of the law, and are often not transparent. These practices may increase profits in the short term, but pose significant risks that undermine investment returns in the medium and long term.[2] There are many ways that companies may seek to exploit tax loopholes and avoid paying their fair share of tax owed. The key strategies and practices deployed include:[3,4]

- Host country incentives to companies to locate in a low tax jurisdiction (eg tax havens, shell companies and other incentives)

[1] hermes-eos-public-engagement-report-q3-2019.pdf (hermes-investment.com)
[2] Microsoft Word – Exempt Solicitation Amazon 2022-04-14 (cictar.org)
[3] UNPRI Engagement guidance on corporate tax responsibility
[4] hermes-eos-public-engagement-report-q3-2019.pdf (hermes-investment.com)

- Exploitation of tax loopholes, for example transferring assets such as intellectual property from a subsidiary in a high-tax jurisdiction to a low-tax jurisdiction
- Base erosion of the national tax base through profit shifting. This is when multinational companies shift profits generated in the country into other jurisdictions, such as offshore financial centres with lower or zero tax rates, to minimise their tax burden. This can include the use of marketing services and trading company structures to shift profits.

Aggressive tax practices have wider financial impacts. Data from the Organisation for Economic Co-operation and Development (OECD) shows that tax avoidance costs between $100-$200bn in lost revenue annually.[5] This is significant when you consider the contribution this revenue makes to a government's ability to fund vital services. On average, corporate income tax is estimated to contribute 9% of government tax revenues in OECD countries, and over 15% in emerging markets.[6]

At the company level, aggressive tax practices can result in reputational damage and the loss of a company's social licence to operate. Over time companies avoiding tax may become increasingly vulnerable to changes in tax regulations. Aggressive tax practices attract the attention of tax authorities leading to non-compliance investigations. These practices also distort macroeconomic conditions (the avoidance of a tax is effectively a form of unintended subsidy), raising portfolio and systemic risks that undermine long-term value creation. From a portfolio perspective, aggressive tax practices undermine fair competition at the sector level and reduce the money available for government spending on necessary services and infrastructure.

Globally, regulatory changes to tax transparency rules are requiring companies and governments to disclose more financial and tax information at a country-by-country level.

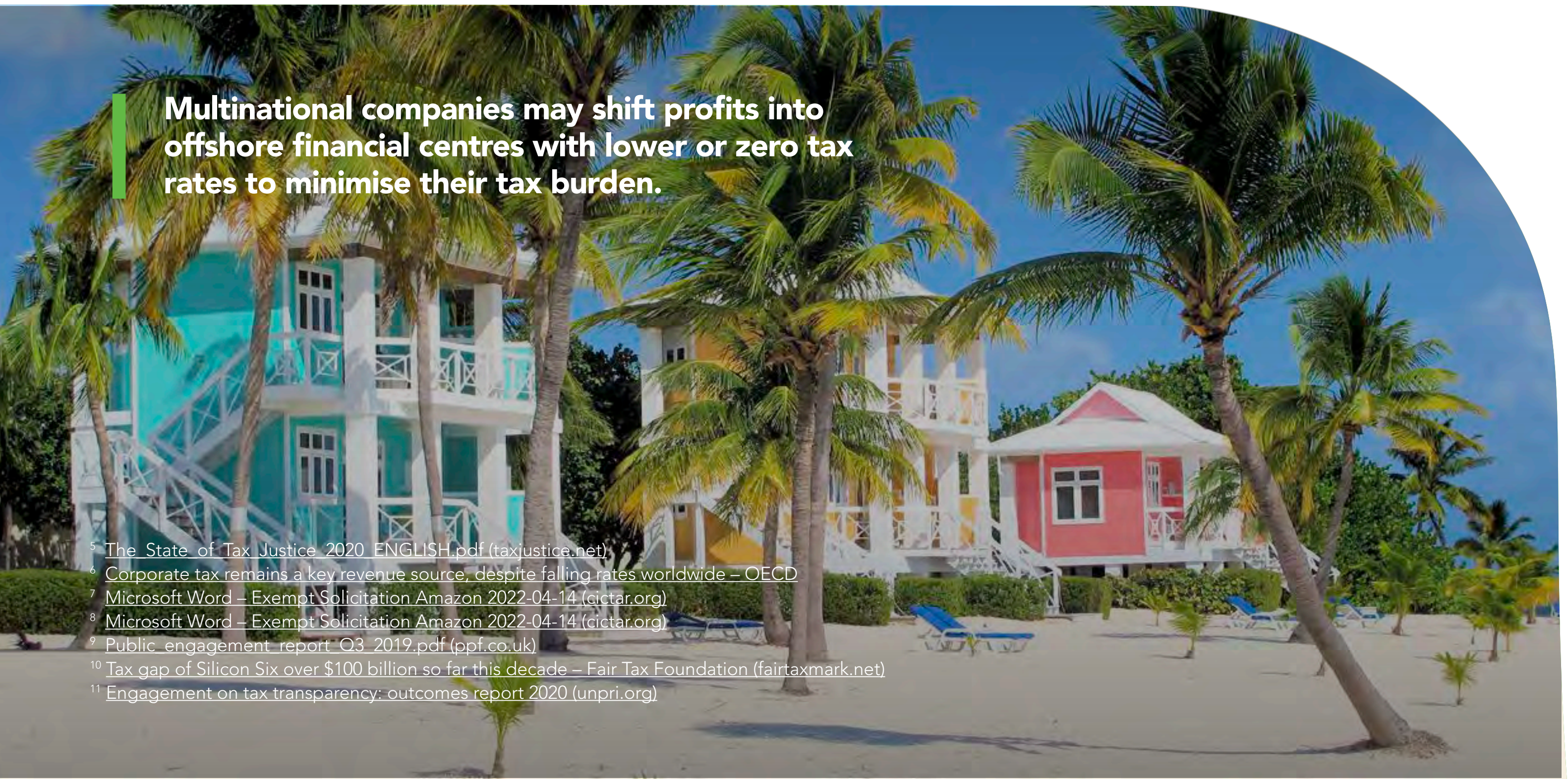
These regulatory changes in the EU and US will lead to legal, reputational and financial risks for those companies that seek to aggressively minimise and avoid their tax payments.

Tax burdens: size matters

Generally, small-to-medium-sized businesses (SMEs) have little choice but to pay corporate taxes in their home jurisdiction. But many high-profile multinational companies use aggressive tax practices to avoid paying their fair share.

The digitalisation of the economy has made it easier for multinationals to hold intangible assets such as patents, trademarks and copyrights in overseas affiliates in countries with a lower tax rate than the home country. Revenues are transferred into group companies where there is no or minimal physical presence, yet little ability to tax offshore income.[7] As a result, brick and mortar businesses, often SMEs, must shoulder an increased tax burden. This is at a time when inflationary pressures globally are impacting the viability of many SMEs.

Non-disclosure presents challenges to investors in terms of evaluating the risks to the company with respect to taxation reforms. It can be hard to assess whether a company is engaged in responsible tax practices that ensure long-term value creation for the company and the communities in which it operates.[8] Three years ago, we highlighted Starbucks, Apple and Vodafone as among those criticised for their tax practices. In 2019, research by Fair Tax Mark found that Amazon, Apple, Facebook (Meta), Google, Netflix and Microsoft had the poorest tax conduct.[9,10] Amazon, Alphabet and Facebook were also among eight companies considered 'unresponsive' by lead investors in the UNPRI's collaborative engagement on corporate tax transparency, which ran between 2017 and 2019.[11]



Multinational companies may shift profits into offshore financial centres with lower or zero tax rates to minimise their tax burden.

[5] The_State_of_Tax_Justice_2020_ENGLISH.pdf (taxjustice.net)
[6] Corporate tax remains a key revenue source, despite falling rates worldwide – OECD
[7] Microsoft Word – Exempt Solicitation Amazon 2022-04-14 (cictar.org)
[8] Microsoft Word – Exempt Solicitation Amazon 2022-04-14 (cictar.org)
[9] Public_engagement_report_Q3_2019.pdf (ppf.co.uk)
[10] Tax gap of Silicon Six over $100 billion so far this decade – Fair Tax Foundation (fairtaxmark.net)
[11] Engagement on tax transparency: outcomes report 2020 (unpri.org)

Tax loopholes are tightening globally

Since our 2019 tax article we have seen increased regulatory and legislative momentum globally to improve the mandatory disclosure of company financial and tax information. A key recommendation of the UN FACTI high level panel on Financial Accountability, Transparency and Integrity was to introduce requirements that "all private multinational entities publish accounting and financial information on a country-by-country basis".[12] The Covid-19 pandemic has increased the urgency, as tax policy is a key mechanism through which governments can rebuild the economy and mitigate the economic effects of the pandemic.

Since 2020, G20 leaders and governments have enacted a sweeping range of reforms focused on companies paying a fair share of tax and improving transparency in tax reporting:

- In 2021 the European Union (EU) adopted legislation to require a degree of public country-by-country reporting.[13] This legislation was supported by investors representing over US$5.6trn in assets under management.[14]
- The US House of Representatives in 2021 passed the Disclosure of Tax Havens and Offshoring Act, which proposed amendments to the Securities Act of 1934 to require country-by-country reporting. In 2020, we wrote to the US House Committee chairs and ranking members in support of the bill. The Act requires certain US companies to publicly disclose information related to the tax jurisdiction, income, and assets of their subsidiaries as well as country-by-country financial information annually.[15] This Act had wide support.[16]
- In 2021 the OECD-led reform of the international tax system was finalised ensuring that multinational enterprises will be subject to a minimum 15% tax rate from 2023. Unprecedented agreement was reached with more than 130 countries and jurisdictions representing more than 90% of global GDP.[17] This significant reform is focused on addressing the tax challenges arising from the digitalisation of the economy.[18]

The landmark deal to reform the international tax system is the first fundamental change in over 100 years and increases tax transparency. The agreement adopted a two-pillar solution, with both pillars being implemented concurrently by 2023.[19]

- **Pillar One** aims to ensure a fairer distribution of profits and taxing rights among countries with respect to the largest multinationals.[20]
- **Pillar Two** introduces a global minimum corporate tax rate set at 15% that countries can use to protect their tax base.[21,22] It does not eliminate tax competition, but it does set multilaterally agreed limitations on it. There are mechanisms to protect the right of developing countries to tax certain base-eroding payments such as interest and royalties.[23]

If implemented successfully the two pillars are expected to have a significant impact on profit shifting by multinationals as well as the role of tax havens.[24] The 15% tax rate will give countries a share of taxes on profits earned in their territory. Initially, it is expected to apply to the top 100 or so companies and is targeted at the most aggressive users of tax-reducing domiciles including many tech companies.

In keeping with this momentum, on 16 August 2022, US President Joe Biden signed the Inflation Reduction Act (IRA) into law.[25] This 15% minimum tax on the corporate profits of the largest most profitable companies creates a corporate alternative minimum tax or floor on the percentage of taxes that a filer must pay to the government regardless of how many deductions and credits are claimed.[26]

The landmark deal to reform the international tax system is the first fundamental change in over 100 years and increases tax transparency.

[12] https://www.factipanel.org/news/facti-panel-report-has-been-published
[13] https://www.europarl.europa.eu/news/en/press-room/20211108IPR16839/corporate-tax-transparency-meps-okay-new-country-by-country-reporting-rules
[14] https://dwtyzx6upklss.cloudfront.net/Uploads/u/m/t/investorsignonletteronpubliccbcr_signatories_final_758353.pdf
[15] The U.S. House Passes Two Axne Bills | The Iowa Torch
[16] https://thefactcoalition.org/64-investors-with-nearly-2-9-trillion-in-assets-under-management-show-support-for-the-disclosure-of-tax-havens-and-offshoring-act/
[17] International community strikes a ground-breaking tax deal for the digital age – OECD
[18] International community strikes a ground-breaking tax deal for the digital age – OECD
[19] Brochure: Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy, October 2021 (oecd.org)
[20] Which include a mandatory and binding dispute resolution process for Pillar One but with the caveat that developing countries will be able to benefit from an elective mechanism in certain cases, ensuring that the rules are not too onerous for low-capacity countries
[21] International community strikes a ground-breaking tax deal for the digital age – OECD
[22] Brochure: Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy, October 2021 (oecd.org)
[23] Brochure: Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy, October 2021 (oecd.org)
[24] New International Tax Reform: The end of tax havens? – The Oxford Strategy Review
[25] BY THE NUMBERS: The Inflation Reduction Act – The White House
[26] What Is the 15% Minimum Corporate Tax Senate Democrats Are Proposing? – Bloomberg

Investors seek increased transparency

Increased transparency is also being driven by investors and stakeholders seeking more disclosure on tax through voluntary reporting. Effective from 1 January 2021, companies are encouraged to report their tax strategy, governance and tax payments on a country-by-country basis under the Global Reporting Initiative (GRI), one of the world's most used voluntary sustainability reporting standards.[27]

The GRI 207 tax criteria recognises the role that tax contributions have on sustainable development. The standard was developed in response to growing investor concerns and stakeholder demands for tax transparency, and sets expectations for increased disclosure of tax payments on a country-by-country basis, alongside tax strategy and governance.

Reporting against the GRI 207 tax criteria will improve transparency and comparability of tax information. It also paves the way for a more informed public debate as well as better policy and investment decisions. The development of the tax standard followed consultation with multinationals, accounting firms, academics, politicians, investors, and other stakeholders. It is the first global reporting standard to combine management approach disclosures on tax strategy with public country-by-country reporting of business activities, revenues, profit and tax.[28]

Companies claiming to report in accordance with the GRI standards are required to make disclosures on all material topics. Investors consider a company's tax practices as financially material, that is, reflecting the organisation's significant economic, environmental and social impacts and capable of substantially influencing the assessments and decisions of stakeholders.[29] A number of companies are already reporting in line with the GRI 207 tax standard, including Anglo American, Apple, Philips, Randstad, Vodafone, Royal Dutch Shell, and Ørsted.[30]

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For certain sectors, additional tax disclosure that goes beyond country-by-country reporting may be required, such as reporting at the state or municipal level. This has been a practice for companies in the extractives industry due to intensive community impacts and corruption issues.

[27] https://assets.kpmg/content/dam/kpmg/xx/pdf/2020/11/the-time-has-come.pdf
[28] https://www.globalreporting.org/about-gri/news-center/backing-for-gri-s-tax-standard/
[29] GRI 207:TAX 2019, Global Reporting Initiative, 2019 (PDF 250 KB)
[30] https://www.angloamerican.com/~/media/Files/A/Anglo-American-Group/PLC/investors/annual-reporting/2021/anglo-american-country-by-country-report-2020.pdf, p.2; https://www.results.philips.com/publications/ar20/downloads/pdf/en/PhilipsCountryActivityAndTaxReport2020.pdf, p. 6; https://www.randstad.com/s3fs-media/rscom/public/2021-02/randstad-annual-report-2020.pdf, p. 238; https://www.vodafone.com/sites/default/files/2021-10/vodafone-tax-report-19-20.pdf, p. 11; https://reports.shell.com/sustainability-report/2020/servicepages/downloads/files/gri-index-shell-sr20.pdf, p. 11; https://via.ritzau.dk/ir-files/13560592/4751/6293/Annual%20report%202021.pdf, p. 123

Our expectations

Companies should operate not only for their shareholders, but also for a wider purpose that benefits society. Ultimately, this will support savers and pensioners, who rely on sustainable returns in an economy and a society that is capable of providing them and their families with a secure future.

Our engagement expectations are focused on four critical areas: tax policy, governance, stakeholder engagement and transparency.

Policy

We expect to see a clear set of principles on tax responsibility that include paying tax in line with the location of economic value generation and with the legislative intention of tax law. We look for policies that cover the company's tax-related approach to corporate structuring, transfer pricing, use of debt, due diligence, lower tax jurisdictions, tax havens and use of incentives. The company's tax policy and tax governance framework should be disclosed and should reference GRI tax standards. The disclosure should include the company's approach to tax risks, including how risks are identified, managed, and monitored; and how compliance with the tax governance framework is evaluated, including incidents of non-compliance.

Governance

We believe that a company's tax strategy and practices are the responsibility of the board. We expect the board to oversee risk management and compliance, including in relation to tax. In particular, the audit or other risk committee should have oversight of tax risks and the implementation of tax policy. We will look for evidence that the remuneration committee has considered tax behaviour in the structuring of executive remuneration policies to ensure that remuneration does not incentivise overly aggressive corporate tax practices and personal income tax/capital gains behaviours.

Stakeholder Engagement

We believe a company should be aware that its tax practices are of interest to various stakeholders and that by engaging with them, it has the potential to influence its reputation and position of trust. We believe that an organisation's approach to stakeholder engagement on tax can enable it to understand the evolving expectations related to tax, including potential future regulatory changes, enabling it to better manage its risks and impacts.

Transparency

We seek clear disclosure of the company's approach to tax and the consideration of tax in corporate activities. This should accompany a clear explanation of taxes paid on a country-by-country reporting basis. The company's description of its tax approach and results should be aligned with its purpose, its reporting disclosures and our engagement.

Our engagement approach

We have been engaging with companies on tax transparency and fairness in line with our engagement plan since 2016. These include companies in the technology, mining, consumer staples and pharmaceuticals sectors. We assess company tax practices and disclosure in our engagement research and look for tax transparency, including reporting under GRI's 207 tax criteria. We urged the Danish healthcare company, GN Store Nord, to improve its tax reporting, including providing country-by-country reporting. We expect to see improvements in its disclosure in 2023.

Rio Tinto is an example of a mining company publishing reports on annual taxes paid with lump sums at the country level as well as aggregated disclosure. Such information is key to ensuring that companies demonstrate their long-term social licence to operate, empowering communities to make informed decisions about resource extraction in their backyards. In our engagement with Marathon Oil, we encouraged the company to publish the taxes it pays in Equatorial Guinea in line with the standards of the Extractive Industries Transparency Initiative (EITI).

In 2022, ahead of the company's annual meeting, we engaged with Amazon on a shareholder proposal that publicly highlighted the company's tax avoidance strategies. An exempt solicitation filed with the Securities and Exchange Commission by co-filers Pensions & Investment Research Consultants (PIRC), OIP Trust and Greater Manchester Pension Fund, stated that Amazon does not disclose revenues, profits, or tax payments in non-US markets in its standard reporting and has faced increased attention from tax authorities.[31] With management opposing the proposal it was defeated, although according to our calculations it gained 17.5% of the dissident vote.[32] It is worth noting that the last tax transparency shareholder proposal at a major multinational (Google in 2014) received support of only 1%.[33,34]

[31] Microsoft Word – Exempt Solicitation Amazon 2022-04-14 (cictar.org)
[32] 0001104659-22-065872 (d18rn0p25nwr6d.cloudfront.net)
[33] Microsoft And Cisco Face Shareholder Pressure Over Public Disclosures (forbes.com)
[34] Form 8-K (sec.gov)

Microsoft and Cisco are expected to face similar shareholder proposals later this year. Nordea Bank and several Danish pension funds filed a shareholder proposal with Microsoft urging the company to disclose its public country-by-country tax information in line with the GRI tax transparency standard. Cisco faces an identical proposal filed by three shareholders. The proposal references the fact that the company's 2021 annual report is silent on whether it had conducted any intra-entity transfers of intellectual property to the US despite an increase in US profits.[35]

As we found in 2019, although tax transparency has improved in some sectors and geographies, in others it remains limited. Engagement on tax transparency and fairness can be challenging. Companies cite commercial sensitivity, the potential implications for competitiveness, or the prospect of misinterpretation by media or the public, for example in relation to legacy corporate structures in tax havens. In addition to our expectations, we reflect our concerns about a company's tax transparency in our vote recommendations – for example where a company has been unresponsive to investor concerns, or in support of certain shareholder proposals.

Outlook

We have developed a watchlist of high priority companies that will be the focus of our engagement efforts for the remainder of 2022 and into 2023. The list was developed based on our engagement with companies, research conducted by PIRC and the Centre for International Corporate Tax Accountability and Research (CICTAR), plus companies that have been named in the press for aggressive tax practices and/or tax avoidance.[36] We will engage based on our responsible tax principles to:

- Seek commitments from companies to pay fair tax on a country-by-country basis in line with the location of economic value generation and the spirit and intention of the law.
- Strengthen company global tax policies and principles particularly in relation to tax management, good governance and transparency.
- Ensure companies are balancing the interests of various stakeholders.
- Increase tax reporting and disclosure in accordance with GRI tax criteria 207.
- Consider vote recommendations in accordance with our Corporate Governance Principles where expectations fall short.

We will also continue to support the development of market best tax practices and advocate with public policymakers at an international level and individual country levels to achieve greater tax transparency.

[35] Microsoft And Cisco Face Shareholder Pressure Over Public Disclosures (forbes.com)
[36] Why 55 U.S. Companies Paid No Taxes Last Year (marketrealist.com); Big Companies Like FedEx and Nike Paid No Federal Taxes – The New York Times (nytimes.com); 15 Biggest Companies That Don't Pay Taxes (yahoo.com)

Key voting season trends from Asia and the emerging markets

Shoa Hirosato
Themes: Board Composition and Effectiveness, Natural Resource Stewardship

Judi Tseng
Themes: Corporate Reporting, Human Capital

The voting season in developed Asia and global emerging markets saw renewed attempts to improve board diversity and independence – as well as some surprising and positive shareholder action in Japan and Brazil. Shoa Hirosato and Judi Tseng identify the key trends.

Climate change

A disproportionately high number of companies in the region fell below the minimum requirements of our climate change vote policy, resulting in recommendations to vote against the most relevant responsible director due to climate-related risks. For example, concerns about coal expansion plans, or slow timelines for phasing out coal-fired power, led us to recommend voting against the chairs at Nippon Steel, Itochu, Marubeni, Sumitomo and Mitsubishi.

We recommended votes against relevant directors at Kikkoman and WH Group because of concerns about their exposure to deforestation risks. We also included financial institutions in our policy for the first time. This led us to recommend votes against directors at Malaysia's Public Bank and Industrial and Commercial Bank of China due to deforestation concerns.

> **We recommended votes against relevant directors at Kikkoman and WH Group because of concerns about their exposure to deforestation risks.**

However, progress at some companies, including Geely Automobile, meant that we were able to recommend support for directors there. In some cases where companies were captured by our climate vote policy, we recognised improvements to targets and strategies following engagement. This led us to recommend voting for the chair at companies such as CLP Holdings.

Generally, say-on-climate resolutions have not yet reached companies in developed Asia and emerging markets, but a say-on-climate vote featured at asset manager Ninety One's annual shareholder meeting in South Africa. We recommended voting against this proposal because of the lack of clarity on the company's coal financing and science-based targets approach, but it is encouraging to see the adoption of say-on-climate votes in new markets.

Climate resolutions in Japan

This year, NGOs such as Market Forces and international investors flexed their muscle on climate action at Japanese companies. Climate-related shareholder proposals were filed at three power utilities and two financial groups. These received strong support, topping 20% in some cases, and were the first of their kind filed by institutional investors in Japan – a significant development.

We were active in engagement in the lead-up to the voting in each case, expressing our views on the importance of aligning business strategies with the goals of the Paris Agreement and of meeting our expectations on coal policy improvements.

At J-Power, we recommended support for all three climate-related shareholder proposals. These included aligning the 2050 business plan with the goals of the Paris Agreement, which received almost 26% support.

Climate-related shareholder proposals were filed at three power utilities and two financial groups.

There were also calls for the company to align its capital expenditure and remuneration policies with its emissions reduction strategy, both attracting support of over 18%. At Tepco and Chubu Electric, we recommended support for proposals asking the companies to disclose how their energy assets would be affected by a net zero by 2050 pathway, with the Chubu proposal winning almost 20% support.

Shareholder proposals brought in previous years have subsequently influenced commitments by major Japanese banks and trading houses to pull back from financing new coal projects. Mizuho attracted the first in 2020, followed by Mitsubishi UFJ and Sumitomo Corp in 2021. This summer, Japan suffered through its worst heatwave since records began, spurring impetus for change.[1]

At Sumitomo Mitsui Financial Group this year, we recommended support for one shareholder proposal asking the bank to disclose short- and medium-term emissions reduction targets and set an appropriate strategy in line with the goals of the Paris Agreement. This attracted 27% support. We did not support the second climate-related proposal on aligning the bank's financing policy with the International Energy Agency's net-zero emissions by 2050 scenario, as shareholder proposals in Japan are legally binding and we believed this was too prescriptive.

Finally, we recommended support for both climate-related shareholder proposals at Mitsubishi Corp this year. The first was a proposal for setting and disclosing short- and medium-term emissions reduction targets aligned with the Paris Agreement goals, which won over 20% support. The other called on the trading house to disclose its capital expenditure alignment with a 2050 net-zero emissions reduction target.

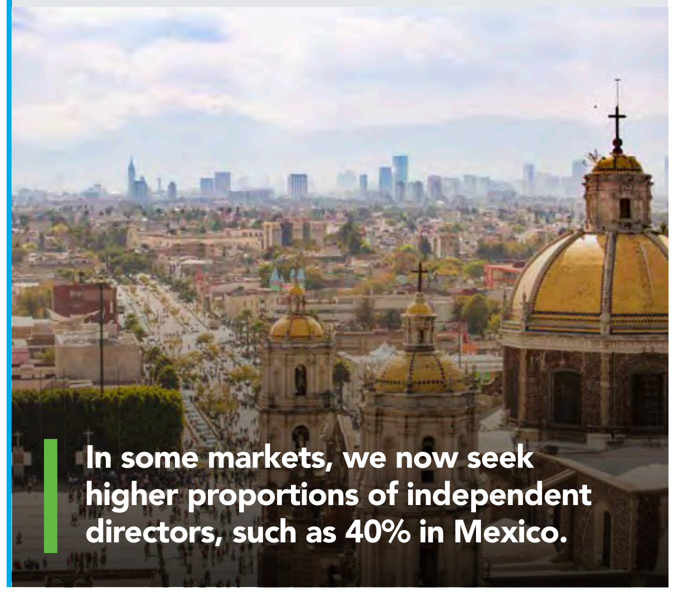
Independence

We continued to push for improved board independence this year. In some markets, we now seek higher proportions of independent directors, such as 40% in Mexico and 50% in Brazil for the Novo Mercado listing segment, where corporate governance requirements are more stringent. Through our engagements, we are able to consider not just the proportion of independent members but also how they function in practice. Some boards fulfil the independence criteria at a technical level, but this does not always result in sufficient genuinely independent thought on the board.

In the case of South Korea's Hyundai Steel, we recommended voting against a new executive director despite an independent majority. As two fatal industrial accidents[2,3] occurred in March at two separate plants, we raised our concerns about the board's effectiveness in overseeing management performance on critical issues. This highlights the importance of having more independent directors with diverse expertise on the board to hold management to account.

However, there are times when engagement remains the best way forward, even if there are some concerns about independence. For example, at Samsung Electronics, nearly half the board are executives, reducing the proportion of independence directors. However, we ultimately supported the election of proposed executive board members, given a range of recent positive governance developments, including the implementation of a new compliance framework. We will continue to engage for an increase in the proportion of independent directors.

We recommended opposing directors at companies in India and Hong Kong where their long tenure weakened board independence. For example, at Hong Kong's Power Assets, we recommended voting against the chair, who had been in place for 37 years.



In some markets, we now seek higher proportions of independent directors, such as 40% in Mexico.

[1] https://www.bbc.co.uk/news/world-asia-61976937
[2] https://www.koreatimes.co.kr/www/tech/2022/07/129_324820.html
[3] https://en.yna.co.kr/view/AEN20220305003700320

In Japan, we were pleased to see progress on gender diversity in companies such as Chubu Electric Power and retailer Seven & i.

Gender diversity

The slow progress in board and senior management gender diversity in Brazil led B3, the Brazilian Stock Exchange, to propose the introduction of a new listing rule, on a comply or explain basis. This requires companies to have at least one woman and one ethnically diverse member on the board or the executive committee from 2025. This remains below our expectations, which are reflected in our voting policy.

Legal requirements are also tightening in South Korea, Malaysia and Hong Kong. In the latter, we were pleased to see progress at companies such as Geely Automobile, where board gender diversity reached 30% after several years of engagement on this topic. At AIA Group and Ping An Insurance, we recommended support for directors by exception to our policy to recognise their progress in reaching a level of diversity that is just below our minimum expectations. However, we recommended votes against at Beijing Enterprises, China Mengniu Dairy, and China Resources Beer. More focus is needed to raise female board membership far above our current 20% minimum threshold.

In Japan, we were pleased to see progress on gender diversity in companies such as Chubu Electric Power and retailer Seven & i. However, other companies are lagging, including Shin-Etsu Chemical, Canon, Toyota Industries and Toray Industries, which led us to recommend votes against the responsible directors.

Since 2016, Japan's gender gap performance has declined in terms of economic participation and opportunity, according to the World Economic Forum.[4] This led us to step up engagement on gender diversity. At Chugoku Electric Power, we recommended voting for a non-executive female director, despite her long tenure, in order to achieve improved gender diversity.

Stewardship in Brazil

Investors in Brazil are increasingly using voting as a tool for stewardship. This year we saw several shareholder candidates proposed for board elections, in response to a lack of independence and diversity.

Interference by the Brazilian government, the controlling shareholder of Petrobras, resulted in two board elections in four months at the oil company. We opposed the proposed slate due to the deterioration in independence and diversity. We used the cumulative voting system to recommend support for the election of an independent director at Klabin, in addition to the independent director elected at the 2021 annual shareholder meeting under the separate election system.

The legislation allowing candidates to be nominated by minority shareholders has been in place for a long time but was rarely used. It is a positive sign that domestic, as well as international, investors are prepared to act because they see the value of diverse and independent boards.

The lack of a structured process for board succession and the action taken by minority shareholders to nominate candidates in parallel with the controlling shareholder nomination does not always lead to good outcomes in terms of independence and diversity of skills. However, the market is going through a learning curve, and we expect stewardship to lead to better boards.

Progress report

We were pleased to see some companies performing well this year. The board of India's Tech Mahindra, for example, is now 60% independent and 40% female. Developments in shareholder activism in Brazil are positive signs that this could spread to other emerging markets.

However, there is still room for improvement on independence, diversity, and climate commitments. At a national level there has been progress on gender diversity requirements, but some backsliding in other areas. For example, the Indian regulator has revoked a requirement to separate the roles of CEO and chair, after pressure from major companies.

Through voting and engagement, we will continue to scrutinise board effectiveness and translate this into voting recommendations. We have recently tightened expectations on independence and diversity in some markets, such as Brazil. We will now focus on enforcing these tighter expectations.

[4] https://www3.weforum.org/docs/WEF_GGGR_2022.pdf

Company engagement highlights

A selection of short company case studies highlighting areas where we have completed objectives or can demonstrate significant progress.

Overview

Our approach to engagement is holistic and wide-ranging. Discussions range across many key areas, including business strategy and risk management, which includes environmental, social, and ethical risks. Structural governance issues are a priority too. In many cases, there is minimal external pressure on the business to change. Much of our work, therefore, is focused on encouraging management to make necessary improvements.

The majority of our successes stem from our ability to see things from the perspective of the business with which we are engaging. Presenting ESG issues such as climate change or board effectiveness as risks to the company's strategic positioning puts things solidly into context for management. These short company engagement updates highlight areas where we have recently completed objectives or can demonstrate significant progress, following several years of engagement.

Volvo

Engagement theme: TCFD-aligned reporting

Lead engager: Amy Wilson

As part of our ongoing engagement on climate change with Volvo, we pressed for better disclosure of the risks and opportunities relating to the low carbon transition, given the materiality of this issue for the company, which manufactures commercial vehicles including trucks, buses and construction equipment. In a meeting with a corporate social responsibility representative (CSR) in Q1 2018, we asked for reporting aligned with the recommendations of the Task Force on Climate-related Financial Disclosures (TCFD).

We reiterated our request in a letter to the chair in Q1 2019, along with concerns about the company's low score on the Transition Pathway Initiative (TPI). In its response, the company clarified some inaccuracies in its TPI assessment and confirmed that it had begun implementing some TCFD recommendations. We sought a progress update in a call with the CSR representative in Q2 2019 and at the company's capital markets day in Q3 2020. We were pleased to hear a formal commitment to align its reporting with the TCFD recommendations.

Outcomes and next steps

We welcomed the company's first TCFD-aligned section in its 2020/21 annual report, which includes risks and opportunities along with a corporate strategy explicitly aligned to decarbonisation targets. Climate change remains a material issue for the company, and we continue to engage on the progress of its electrification strategy, as well as its anticipated circular economy strategy.

Gilead Sciences

Engagement theme: Pricing strategy

Lead engager: Laura Jernegan

Following an update in Q2 2020 from the chair and CEO on remdesivir, a medicine for treating Covid-19, we emailed this US biopharmaceutical company. We urged it to provide more clarity on its Covid-19 response and to demonstrate its willingness to act more in the public interest. Shortly after our initial communication, the CEO wrote a public letter outlining the company's pricing strategy for remdesivir in the US and developing markets, including its plans to enter into agreements with generic manufacturers, which would substantially reduce costs in the developing world.

In a Q4 2020 call, we pushed for greater disclosure on its pricing and access strategy for remdesivir in the US and global markets. The company said that setting a single developed market price helped to ensure fair distribution. It added that it determined generic version eligibility for countries based on their gross national income per capita.

Outcomes and next steps

In its 2020 year-in-review report, published in Q2 2021, we were pleased by the disclosure around its expanded production for remdesivir and non-exclusive voluntary licensing agreements with generic manufacturers. This further expanded the supply of remdesivir in 127 countries, nearly all of which are resource limited. In its report, Gilead noted that the licences, which were royalty-free, reflected its commitment to enabling broad patient access to the medicine.

In Q4 2021 we again encouraged more transparency on drug pricing combined with the value it provides to patients, especially for Covid-19 treatments. The company continued to donate remdesivir in regions hard hit by the Covid-19 crisis, such as Indonesia and Armenia. These efforts, supported by increased transparency, substantially demonstrate Gilead's willingness to act in the public interest. While we will monitor its pricing of remdesivir and other drugs going forward, we are satisfied with Gilead's communication on remdesivir.

E.ON

Engagement theme: Business strategy

Lead engager: Lisa Lange

We first encouraged this German energy utility company to develop a compelling consumer-focused retail strategy in 2016. We continued to engage on this issue in subsequent years in discussions with the chair of the supervisory board, including questioning how this was being incentivised through executive remuneration schemes.

The company has undergone fundamental changes over this period including a major asset swap in 2019 between RWE and E.ON, leaving E.ON to concentrate on a combination of energy networks and customer solutions. E.ON now clearly articulates its customer focus in its corporate communications.

Outcomes and next steps

In its fiscal year reporting in March 2021, the company communicated its strategy for the customer solutions business and its targets for related earnings before interest and tax. Its Q3 2021 reporting provided further updates on the implementation of its customer-focused retail strategy, which now appears to be on course.

At its capital markets day in November 2021, E.ON announced that it will invest €27bn in the energy transition until 2026, of which around €22bn will go towards expanding its energy networks and €5bn towards accelerating the growth of its customer solutions business.

In Q4 2020, we engaged with the CFO and corporate counsel on low board diversity. The board had two female directors and 22% overall board diversity, below our best practice threshold of 30% gender, racial and ethnic diversity. While the board did not have an explicit diversity policy at the time, we were encouraged that it was discussing this subject and that the board's nominating and governance committee considered gender, race, and ethnicity among other director qualifications. In January 2021, we re-emphasised the importance of board diversity when we sent our 2021 US Corporate Governance Principles.

PetroChina

Engagement theme:
Methane emissions disclosure

Lead engager:
Haonan Wu

We first raised our expectations for methane emissions disclosure, reduction targets and adaptation in 2017 as part of our ongoing dialogue with PetroChina on climate change. We were concerned by the lack of targets or any clear disclosure by the company on methane emissions and we encouraged it to attend the UN Principles for Responsible Investment methane collaboration group.

Outcomes and next steps

Following our meeting in 2019, the company established a greenhouse gas accounting and reporting information system for greenhouse gas emissions, covering fuel combustion and methane emissions. During our discussion with a senior engineer, the company acknowledged that controlling methane emissions was key to tackling climate change. PetroChina has been conducting on-site methane leakage investigations as a member of the Global Methane Initiative (GMI), working with Canada-based Clearstone Engineering to develop innovative technologies to combat emissions and air pollution.

We welcomed that the company disclosed its methane emissions reduction plan in its 2020 ESG report released in 2021. PetroChina has committed to a methane emissions control action plan and the goal of reducing methane emissions intensity by around 50% by 2025 versus the 2019 level. The China Oil and Gas Methane Alliance, of which PetroChina is a member, will incorporate methane emissions control into its carbon emissions reduction plan, aiming to reduce the average methane intensity in natural gas production to below 0.25% by 2025.

We continue to engage on other aspects of climate change such as setting intermediate targets, and for the company to adopt reporting aligned with the Task Force on Climate-related Financial Disclosures framework.

Ventas

Engagement theme:
Science-based targets

Lead engager: Joanne Beatty

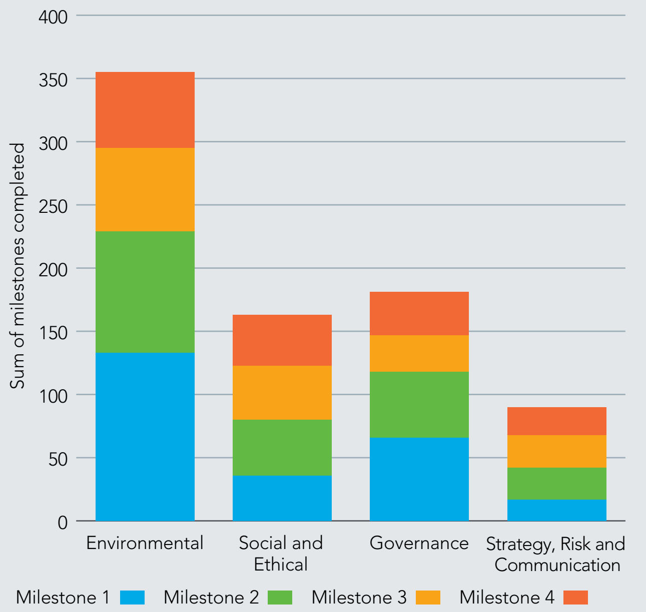
As part of our ongoing climate engagement with Ventas, a US healthcare real estate capital provider, we encouraged the company to increase the ambition of its greenhouse gas emissions reduction targets. At the time of the company's 2018/2019 report, these only covered Ventas-owned properties and were not science-based. In January 2020, the director of sustainability acknowledged our request to set a science-based target and anticipated setting such a target in the next two years.

Outcomes and next steps

In April 2021, we were pleased that the company's new target to reduce Scopes 1, 2 and 3 emissions on an absolute basis by 30% by 2030 from 2018 was approved by the Science-Based Targets initiative. In Q3 2021, Ventas confirmed that facilities outside its operational control were included in its Scope 3 emissions, so its new target covers both operated and owned assets as we had requested. The company announced its new science-based goal in its 2021 Corporate Sustainability Report published in September 2021.

In a Q4 2021 meeting with us, the chair of the compensation committee said that climate change is now a top ESG priority for the company. Going forward, we will continue to engage Ventas on climate change mitigation, asking for alignment with the Task Force on Climate-related Financial Disclosures.

Milestones completed by stage, Q1-Q3 2022



Source: EOS data

CASE STUDY

Delta Electronics

Taiwan's Delta Electronics has committed to net-zero emissions by 2050 and has improved board gender diversity from zero to 25%. When we first engaged with the company in 2020, it had not yet committed to a longer-term net-zero target. It also employed a significant proportion of migrant workers from Southeast Asian countries and we were concerned about the recruitment process.

Delta Electronics is a power electronics and automation provider, which is expanding rapidly in the electric vehicle charging market. We started engaging with the company on migrant workers, board gender diversity and long-term climate targets in May 2020.

We asked the company to conduct due diligence on indirect labour and the recruitment of direct employees, and how it ensured that workers were not being charged recruitment fees. We emphasised that the recruitment process for blue-collar workers could pose risks to labour and human rights.

In terms of climate action, Delta had already set science-based targets for 2025 but had yet to commit to a longer-term net-zero target. We encouraged the company to commit to such a target for its operations and value chain, and asked if there were any obstacles that prevented it from making this commitment. We suggested managing supply chain emissions as part of the Scope 3 emissions reduction targets.

In May 2020, we sent a letter to the chair stating our principles on corporate governance in Taiwan, stressing our concerns about the all-male board. We also asked the company to disclose the gender of nominated directors in the proxy materials, even though this is not yet a requirement in Taiwan. In 2022, we said that we had raised our expectations for board gender diversity to at least 20%, and that we wanted to see an improvement at Delta before the next election.

Outcomes and next steps

After our first engagement, the company stated in its August 2020 Corporate Social Responsibility report that foreign migrant workers in Taiwan were not required to pay fees incurred for agents, passports, visas or transportation. In the next report, published in August 2021, the company disclosed the care it provides to foreign migrant workers, such as training workers in their own language, providing religious venues or information, and hosting foreign worker forums and social events.

In response to our letter on gender diversity, the chair acknowledged the benefits of a diverse board and confirmed that from 2021, the board planned to include female candidates. The company added its first woman to the board in 2021 and two more female directors in 2022. Board gender diversity has increased from zero to 25% since we first engaged on this issue.

In June 2022 the company formally announced its commitment to net zero emissions by 2050. We will continue to engage with the company on supply chain human rights issues such as cobalt sourcing, as well as TCFD reporting and supply chain emissions reductions.

Engagement objectives:

Environmental:
- Net-zero emissions strategy

Social and Ethical:
- Supply chain human rights

Governance:
- Board gender diversity

Sustainable Development Goals:

Judi Tseng
Themes: Human Capital, Business Purpose & Strategy

Olivia Lankester
Responsible Investing & Sustainability, Federated Hermes Limited

BLOG SPOTLIGHT

The modern meal deal: a constant craving

In the sixth article in our Insights series on the social and environmental impacts of the global food system, Zoe de Spoelberch examines the supersized problem with ultra-processed and pre-packaged food.

Our global food systems are dysfunctional – obesity has nearly tripled since 1975, yet undernutrition and micronutrient deficiencies remain. In developed countries, unhealthy, ultra-processed food can be cheaper than healthy, raw ingredients, while Russia's invasion of Ukraine has sparked food price inflation that is squeezing household budgets around the globe. However, the growing demand for healthier and plant-based diets makes health and nutrition an area of opportunity for companies.

The problem with Western diets

People who eat a lot of ultra-processed food high in salt, sugar and saturated fats are never properly sated because their diet is low in vital nutrients. Foods with health risks may also have negative environmental impacts:

- **Processed foods and palm oil:** Processed foods contain preservatives, fats, sugar and salt to prolong shelf life. These ingredients have been linked to heart disease and cancer. Plus, the manufacturing of processed food generates carbon emissions, and it often uses more packaging than non-processed alternatives.
- **Red meat:** Eating red meat is associated with an increased risk of cancer. Raising livestock is also harmful to the climate, with 14% of global greenhouse gas emissions coming from meat and dairy production.
- **Fertilisers and pesticides:** Our food retains small amounts of the fertilisers and pesticides used in its production, making it less nutritious and potentially causing harm to those who consume it. The excessive use of pesticides can also lead to biodiversity loss.
- **Heavy metals:** Lead has been found in water and baby food, arsenic in rice, cadmium in cereals, vegetables, nuts and seafood, and mercury in fish. These are all metals that impair brain function (especially in children) and are linked to cardiovascular diseases.

How to address this through engagement

Transitioning to plant-based diets could cut food-related greenhouse gas emissions by 70% and reduce the risk of land use change, deforestation and biodiversity loss.

EOS engages companies and policymakers to promote good health and nutrition. We ask for protein diversification, the reformulation of product portfolios towards healthy alternatives, and a clear articulation of a health and nutrition strategy, with associated targets and metrics. We assess the governance behind a company's nutrition strategies, the accessibility and affordability of food, responsible marketing and product labelling, and consumer and government engagement.

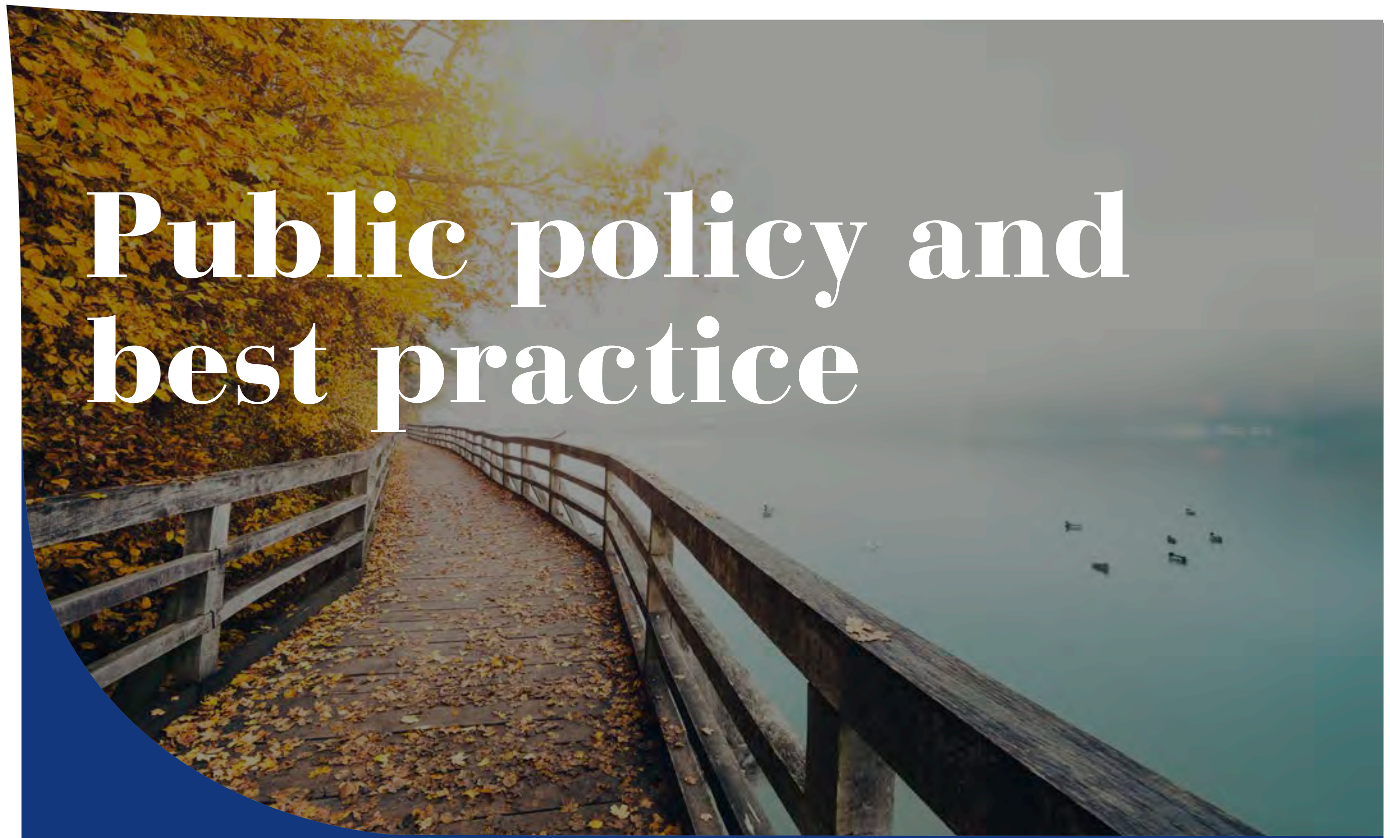
We also participate in collaborative engagements focusing on health and nutrition, and plant-based proteins. For example, we worked with ShareAction's Healthy Markets Initiative to send a letter to Nestlé asking it to articulate its long-term health strategy. We met UK supermarket Tesco to discuss its nutrient profiling methods. We were pleased to see it commit to selling 300% more plant-based products by 2025, versus a 2018 baseline, while encouraging other food and beverage companies to follow this lead.

We also engaged with contract food service company Compass Group, asking for more plant-based meals, and were pleased to see this included in its decarbonisation strategy as part of its meal reformulation plans. We met US food manufacturer General Mills to discuss sugar reduction in its products and support for organic farming, while through the Access to Nutrition Initiative we have engaged with Danone, Mondelez and others. We supported the Farm Animal Investment Risk & Return (FAIRR) Initiative by co-signing letters to companies seeking a transition to sustainable plant-based proteins, and we have engaged Sainsbury's on developing metrics to track healthy and plant-based food sales.

Read the EOS Insights article in full at:

https://www.hermes-investment.com/uk/en/intermediary/eos-insight/stewardship/the-modern-meal-deal-a-constant-craving/

Zoe de Spoelberch
Theme lead: Natural Resource Stewardship



Public policy and best practice

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

Overview

We participate in debates on public policy matters to protect and enhance value for our clients by improving 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 for shareholders; and codes of best practice for governance and the management of key risks, as well as disclosure.

In addition to this work on a country specific basis, we address regulations with a global remit. 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 instead of being moulded to the narrow interests of other market participants, which may differ markedly – particularly those of companies, lawyers and accounting firms, which tend to be more active than investors in these debates.

PRI working group on plastics

Lead engager: Zoe de Spoelberch

We participated in a Principles for Responsible Investment working group on plastics with the Ellen MacArthur Foundation (EMF). It was reassuring to hear that the use of virgin plastics has peaked for the companies that signed up to the Global Commitment and its 2025 targets.

The Global Commitment is an initiative led by the EMF in collaboration with the UN Environment Programme. This has united more than 500 organisations in a commitment to develop the circular economy by reusing, recycling and composting plastics. However, the progress to date towards eliminating plastic has been driven by recycling, with more effort needed in terms of redesign and reuse. The EMF explained that best practice in plastics reporting is to disclose the full scope of plastic packaging and the weight.

We discussed investor expectations in terms of corporate strategy and agreed that we should expect robust strategies to eliminate plastic. We also covered flexible packaging, a growing plastic type that is not easily recyclable and is a big source of ocean pollution. We asked the EMF if targets beyond the Global Commitment for 2025 had been developed and understood that it needs to do more work on this. We also asked about the impact of the forthcoming UN treaty on plastic pollution.