Responsible Investment Annual Report 2015

BMO Global Asset Management

Contents

Introduction

Society's expectations of investment institutions are changing. Short-term maximisation of returns is no longer the only metric we are judged on; increasingly, regulators and our clients are looking to us to take a longer-term view. Protecting our clients' financial security means ensuring we have a full understanding of the risks and opportunities that may impact long-term performance, including those presented by environmental, social and governance issues. We also believe that as investors we have a responsibility to play our role as corporate citizens in helping to promote a more sustainable financial system.

Over the thirty years that BMO Global Asset Management has worked on responsible investment, we have seen it shift from a niche product to an approach which is fast becoming a key part of investment practice.

At a market level, we saw the emergence of new regulatory guidance on environmental, social and governance (ESG) for corporations and investors. This included the development and implementation of Stewardship codes in Asia; new requirements for asset owners in Ontario; and stronger corporate governance standards in Japan. 30% of global assets under management are now covered by some form of ESG approach[1] and the Principles for Responsible Investment (PRI) initiative has almost 1,500 signatories[2].

A more subtle shift has been a growing expectation that investors have a responsibility to consider how their own activities impact on our wider economy and society, including their role in relation to global challenges such as climate change and international development.

At BMO Global Asset Management, we are committed to integrating the consideration of ESG factors within our investment activities. We also offer a number of specialist ESG solutions, including €1.6bn[3] in our Responsible Funds range; an engagement and voting service, ***reo***®, representing over €70bn in third-party assets[4]; and mandates with clients that include ESG sovereign bonds, smart beta approaches, green bonds and private equity climate solutions.

Our capabilities include a London-based Governance and Sustainable Investment team, which conducts responsible ownership activities on behalf of the assets managed in Europe by BMO Global Asset Management, as well as on behalf of clients of our engagement service, ***reo***®[5]. These ownership activities are the focus of this report.

Key themes of our ownership programme for 2015 included:

- **Climate change.** In the run-up to the critical Paris negotiations, investors came together to engage with policymakers, calling for a robust deal which offers a clear trajectory to transition to a low-carbon economy. Company engagement focused on encouraging strategic thinking about how to stress test business models against a lower-carbon future.
- **Corporate governance.** There remains huge regional divergence in the quality and effectiveness of governance standards. Positive shifts in some markets, notably Japan, were offset by backward steps elsewhere, with France in particular presenting challenges.
- **Sustainable sourcing.** Companies in the electronics, retail and clothing industries can have, through their complex supply chains, exposure to markets where worker protection is weak. Our engagement included a trip to Bangladesh to assess how standards are enforced on the ground.

We expect the momentum behind responsible investment to continue through 2016, driven by both increased attention from regulators and growing public interest in knowing whether their money is being invested in a responsible way. BMO Global Asset Management looks forward to being an active participant in the debate.

[1] "2014 Global Sustainable Investment Review", Global Sustainable Investment Association
[2] Principles for Responsible Investment, as at February 2016
[3] As at 31 December 2015
[4] As at 31 December 2015
[5] There are certain exceptions: separate ownership policies currently apply to some assets managed by LGM Investments, Pyrford International, Thames River (Thames River Capital LLP and Thames River Multi-Capital LLP), F&C Portugal, Gestão de Patrimónios, S.A. and BMO Real Estate Partners. In some cases clients may not mandate us to vote or engage within a segregated account.

Our Responsible Engagement Overlay (***reo***®) service represents 26 institutions including those named below (all participate in the engagement programme; we also execute proxy voting for some of these institutions): Bayerische Versorgungskammer (BVK), Paedagogrnes Pensionskasse (PBU), Berliner Ärzteversorgung, SEI Holdings, Catholic Superannuation Fund, Shropshire County Council Pension Fund, European Bank for Reconstruction and Development (EBRD), Carl Spaengler kapitalanlagegesellschaft MBH, Evangelische Kirche in Hessen und Nassau, Stichting Bewaarder Beleggingen Menzis, Evangelische Landeskirche in Baden, Stichting Nedlloyd Pensionfonds, John Lewis Partnership Pensions Trust Ltd, Stichting Pensioenfonds Medisch Specialisten, Lloyd's, Stichting Pensioenfonds voor Huisartsen (SPH), Metzler Investment GMBH, Stichting Pensioenfonds Werk (Re-) Integratiem, OPSEU Pension Plan Trust Fund, New Zealand Superannuation Fund, The Accident Compensation Corporation, The Government Superannuation Fund

2015 in review

2015 saw responsible investment move further into the mainstream of investment practice. Across regions, asset classes and investment styles, the principle of considering ESG factors as financially material risks and opportunities is becoming increasingly relevant. At BMO Global Asset Management – one of the pioneers of responsible investment – we see the consideration of ESG factors as part of our approach to protecting long-term investments, as well as part of being a good corporate citizen.

Performance with principles

Since its origins over 30 years ago, one of the most frequently asked questions in responsible investment has been: is there is a trade-off between principles and performance. The fear that taking ESG into account could risk a breach in fiduciary duty has acted as an obstacle to the progression of responsible investment practices.

A report by the UN Principles for Responsible Investment[6] reviewed international law and practice, and concluded that, far from being at odds with fiduciary duty, there may be a positive duty to consider financially relevant ESG factors.

Alongside this, further evidence from the academic and investment community demonstrated that the incorporation of ESG factors is at worst neutral, and at best can support outperformance. One recent study[7] reviewed over 200 pieces of research, and found that 88% of studies concluded that companies with robust sustainability practices demonstrated better operational performance, and 80% indicated that prudent sustainability practices can have a positive influence on investment performance.

These developments reinforce BMO Global Asset Management's commitment to the robust incorporation of ESG factors into relevant investment processes. We believe that prudent consideration of ESG issues can have an important impact on the creation of long-term investor value. Companies that successfully manage their ESG risks and proactively follow best practices may demonstrate risk-adjusted outperformance over the longer term.

ESG integration at BMO Global Asset Management

Monitoring and analysis of ESG data is now a core part of relevant investment processes across the BMO Global Asset Management business. We make use of 'red flag' markers, drawn from third-party ESG data, to identify companies that may have elevated levels of risk arising from ESG factors. This risk is then analysed, and incorporated into investment analysis, where judged to be material.

Approaches include:

- The US Disciplined Equity Group has developed an exclusion list based on ESG ratings from a third-party data provider, considers ratings as part of all buy and sell decisions, and monitors each portfolio's overall ESG exposures.
- In the UK, the Global Equity team incorporates ESG analysis into every stock note. As well as analysing risk factors, the team also views strong company ESG performance as a signal that can help them identify good quality companies for investment.
- Research analysts within the Fundamental Equity Group in Canada are required to review any poor ESG ratings when considering their buy and sell recommendations for individual companies and to document the relevance to the investment thesis.

6 Fiduciary Duty in the 21st Century, UN Principles for Responsible Investment, 2015
7 "From the Stockholder to the Stakeholder: How Sustainability Can Drive Financial Outperformance", Smith School of Enterprise and the Environment, Oxford University, 2015

Responsible investment crosses asset class boundaries

Whilst fundamental equities remain the most common asset class to have an ESG approach applied, the past few years have seen a rapid development of best practice development across asset classes.

Controversies such as the Volkswagen emissions scandal, which prompted downgrades in the company's credit rating, serve as a reminder of the relevance of ESG factors to fixed income analysis. BMO Global Asset Management's UK-based credit team integrates ESG factors into its credit portal, and runs a strategy with specific ESG exclusions, the Responsible Sterling Bond strategy.

At a country level there are also investment-relevant ESG risks that can undermine creditworthiness, including corruption, poor governance and environmental vulnerability. Our Global Rates and Emerging Market Debt teams regularly monitor a range of country-level ESG scores on these issues as a part of their investment processes. We have also developed an ESG-tilted sovereign bonds strategy, where these scores form an integral part of the benchmark construction.

Improvements in the quality and coverage of ESG data have also facilitated the development of quantitative approaches to ESG investing. We have developed an approach that takes a diversified global equity benchmark and tilts positively to companies with strong ESG performance and negatively to companies with weak ESG performance. This strategy has demonstrated that it is possible to get a noteworthy increase in portfolio-level ESG performance compared to the benchmark for a very low realised tracking error.

Think positive

For investors wanting to take a responsible approach to the way their money is managed, there is a growing interest not only in avoiding companies with poor ESG performance, but also investing in companies providing positive social and environmental benefits. 'Impact investing' – or investing in a way that has both financial and ESG outcomes – is one of the fastest-growing areas of responsible investment.

This attitude is particularly prevalent amongst younger generations, with a recent YouGov survey showing that 58% of 18-24 year olds in the UK wanted to invest their money in companies that achieve positive social outcomes[8].

Our Responsible Global Equity and Responsible Emerging Market Equity ESG strategies both look at ESG factors for stock-level idea generation, focusing on companies meeting positive themes such as responsible finance, sustainable mobility and infrastructure for development.

Climate change drives financial innovation

In the run-up to the Paris climate summit, investors worked to influence the policy debate, calling for long-term clarity on the speed and direction of climate policies. But policymakers also sought to influence investors, asking them to play a supportive role in financing the $1 trillion per year that the International Energy Agency estimates is needed to fund the shift to cleaner energy systems[9]. The year saw a growth in the willingness of investors to allocate capital to climate solutions, underpinned both by the desire to be part of the global response to the challenge, as well as the belief that this is a long-term macroeconomic trend offering opportunities for outperformance.

BMO Global Asset Management's Climate Opportunity Partners fund, a climate change themed private equity fund of funds, made its final commitments of capital in 2015. We also became involved in the fast-growing green bonds market. We engaged with issuers, contributed to the debate on green bonds standards, and now run dedicated green bonds mandates on behalf of two clients, as well as investing in green bonds within our existing Responsible Sterling Bond strategy.

> Controversies such as the Volkswagen emissions scandal, which prompted downgrades in the company's credit rating, serve as a reminder of the relevance of ESG factors to core fixed income analysis.

[8] "Make our money count" – UK Sustainable Investment and Finance Association/YouGov survey, October 2015
[9] "Energy Technology Perspectives 2012" – International Energy Agency
Note: the Climate Opportunity Partners fund closed to new investors on 6 April 2013.

Green bonds make an impact[10]

Green bonds are a type of fixed income instrument where the proceeds raised are used to finance clearly defined projects which have environmental benefits. Projects financed include renewable energy, water conservation, energy efficiency, green buildings, clean transport and sustainable land use. The history of green bonds is short, with the first issuance in 2007, but the market has grown and diversified. In 2015, there were $41 billion of green bond issuances which was the highest recorded.

A key question in the market is how to ensure that there is a clear understanding of exactly what constitutes a green bond. This led to the establishment of the Green Bond Principles in early 2014, which provide guidelines for issuers and underwriters to follow; BMO Global Asset Management and BMO Capital Markets are both members.

Whilst the development of the Principles was an important step forward in the maturation of the market, there remain some concerns that their voluntary nature could mean that green bond issuances which fall short of the desired quality and integrity will be placed to the market. Areas under debate include the definition of the "green-ness" of the underlying projects; how impact is measured; and whether a bond can be genuinely "green" if the parent issuer has environmentally damaging activities elsewhere in its business.

BMO Global Asset Management's Governance and Sustainable Investment (GSI) team conducts its own due diligence before investing, and has met leading issuers including the European Investment Bank, World Bank, Nordic Investment Bank, EDF and Société Générale as well as investment banks and service providers to discuss the nature of projects financed, the assessment of projects, quality of reporting and standards in the market.

> Although the history of green bonds is short, with the first issuance in 2007, in 2015, there were $41 billion of green bond issuances which was the highest recorded.

Stewardship goes global

A key principle of responsible investment is stewardship – the active monitoring of, and engagement with, the companies we as investors own. The UK's Stewardship Code, established in 2010, was the first time that regulators have clarified in detail their expectations of investors in this area. The Code has substantially increased the momentum behind engagement and voting activities in the UK, which in 2013 covered over £1.4 trillion in assets, from just over £800 million in 2011[11].

These developments have been closely watched by regulators elsewhere and we have seen an acceleration in efforts to encourage stewardship activities by investors in other parts of the world. In Europe, the revisions planned to the Shareholder Rights Directive also give strong support to the principle. Meanwhile in Asia, Stewardship Codes are now in place in Japan and Malaysia.

BMO Global Asset Management's London-based GSI team has had a formal stewardship programme in place since 2000, covering both the assets managed in the EMEA region as well as those by third-party ***reo***® clients. This report details this activity over 2015, as part of our commitment to transparency about our activities.

[10] ESG Viewpoint: "Green bonds: financing the transition to a new economy". November 2015, BMO Global Asset Management.
[11] "European SRI Study", Eurosif, 2014

Investor engagement

2015 was a year when investors' approach to engagement developed a further sense of maturity. As pioneers in the field, we have witnessed at close hand how engagement activities have evolved over recent years. There is an increasing number and diversity of investors now involved in dialogue with companies on ESG issues. We have also seen the quality of engagement improving gradually. This is in part the result of the availability of better data on companies' sustainability performance, and on the progress in integrating ESG risk factors into mainstream investment analysis.

Engagement in 2015

Engaged **1,376** companies

Engaged companies in **58** countries

241 instances of change achieved

Travelled to **14** countries to engage local companies

We plan our annual engagement programme by identifying ESG issues that present the greatest threats to long-term investor value for both equity and corporate bond portfolios. Using a combination of quantitative databases and qualitative research, we analyse key issues within sectors and decide on a number of thematic projects around the most prominent risks. We also use the same approach to systematically identify a list of priority companies – companies with the most material ESG risks and where we have the highest investment exposure – for more focused in-depth engagement activities across the year. The engagement is conducted by sector and country experts.

In 2015, we actively engaged 1,376 companies in total which was an increase from 774 in 2014. This increase was due to several initiatives where we reached out to a large number of target companies. Engagements over the year involved 363 meetings, most of which were one-to-one interactions or, where we felt it would be more effective, by working with other investors through collaborative initiatives. Our dialogues included 66 discussions (meetings or calls) with senior executives and/or board directors. We travelled to 14 countries worldwide including the United States, Japan, Bangladesh, Malaysia and Indonesia.

Almost 40% of our activities in 2015 revolved around environmental themes, the majority of which focused on climate change. There was both appetite and momentum from all stakeholders to make progress on this issue ahead of the United Nations (UN) global climate change talks in Paris towards the end of the year. We held intensive engagement with companies in the extractives and energy sectors on the risks of "stranded assets". We pressed companies to stress-test the resilience of their business models to a low carbon scenario and disclose the results to investors.

Climate change was also a prominent theme in our fixed income engagement. BMO Global Asset Management became a signatory to the Green Bond Principles in 2015. This is a group of issuers, investors and underwriters that play a key role in shaping the rapidly growing market for bonds where the proceeds are used for environmental projects.

In relation to social themes, we built on our previous work on supply chain labour standards to conduct a project on living wage concerns in the textile industry supply chains – an area that many brands and retailers still find challenging to tackle. Other projects covered the implementation of enhanced human rights policies in the extractives sector, as well as engagements with pharmaceutical companies on their practices around access to medicines in low income countries.

Company: Novartis | **Issue:** Business ethics

Background

The marketing and sales practices of pharmaceutical companies have been under the spotlight in recent years following a series of high profile incidents. These have included cases in the United States resulting in settlements of more than a billion dollars and in China where GlaxoSmithKline was fined $490 million for bribery. In 2015, the Swiss pharmaceutical giant Novartis was investigated by the US authorities over claims that it orchestrated a scheme where it paid kickbacks to pharmacies to increase sales of its prescription drugs. The Department of Justice was seeking to fine the company $3.35 billion, the largest ever penalty for a pharmaceutical company. Eventually Novartis settled the allegations for $390 million.

Engagement action

We held a number of discussions with the company including with the Chief Compliance Officer. The company's reforms have been focused around a so-called "Step Change" programme to change its corporate culture and to strengthen the standard of its business ethics. We pressed the company on why it continued to be involved in high-profile regulatory breaches even after it had implemented rigorous compliance and internal control systems. Novartis said that these were legacy problems and the current senior executive team were committed to cleaning up the company's practices and culture. We urged it to report on metrics that captured culture change to reassure investors that the reform programmes were effective.

Verdict

Novartis is one of the largest pharmaceutical companies in the world and it has been involved in some notable bribery and corruption-related regulatory breaches. The company is making a concerted effort to address the underlying causes. However, we believe that implementing lasting reforms will be challenging considering its exposure to major risks, which include the fact that it operates in countries with high corruption risks and that many of its products face competition from generics. The Chief Compliance Officer highlighted that these were key factors in rules being broken by employees to boost sales. We plan to continue to engage the company on these issues through 2016.

Company: Ryanair | **Issue:** Employee management

Background

Ryanair is Europe's largest airline (by passenger numbers) but its approach to employee management has long been a focus of public criticism. Its pilots and cabin crew are employed under Irish contracts which have weaker employee protection than many other European jurisdictions. In 2015 the airline went head-to-head with trade unions in Denmark which demanded that Ryanair adapt to the country's generous working conditions. Ryanair lost a court ruling allowing unions to strike and blockade its aircrafts.

Engagement action

We travelled to the airline's headquarters in Dublin and met the Chief Executive Michael O'Leary. We expressed our concerns about controversies relating to the airline's anti-union strategies and the impact this has on its ability to recruit and to retain motivated, high quality staff.

Mr O'Leary strongly dismissed the view that Ryanair is "shopping" for the most favourable regulatory tax regime. He says that the company is in full compliance with European laws and new Ryanair recruits pay their social taxes in the country where they start and end their working day. He also cited the waiting list of more than 5000 people wanting to work for the airline which showed that Ryanair is an attractive employer. The company enters into collective labour agreements with all staff and does not see the value of trade unions getting involved.

Verdict

There is no doubt that Ryanair is a challenging company in respect to achieving change through investor engagement. However, we appreciated that the company allowed us the opportunity to meet the Chief Executive and to voice our concerns in person to him. We still believe that better management of employee relations – especially on the issue of working conditions – will allow it to sustain its success in the future. This is particularly significant given its future expansion plans and the need to recruit more pilots and cabin crews.

Company: BP | **Issue:** Climate change

Background

A shareholder resolution at BP's 2015 annual shareholder meeting asked the company for a stronger approach to managing climate change risks. This was supported by the management and by 98% of investors. This resolution provided unprecedented leverage to encourage the UK oil & gas major to address the challenge of stranded assets – an issue we have engaged on for the past two years. The main focus of investor engagement has centred around how the company should stress-test the resilience of its business model to a low carbon scenario and set out a strategy that takes account of the political agreement at the Paris climate meetings to limit global temperature rise to below two degrees Celsius.

Engagement action

We acted as a lead investor of the Institutional Investor Group on Climate Change (IIGCC) and collaborated intensively with the lead filers of the resolution from the 'Aiming for A' investor coalition. In 2015, we met BP 11 times, which included meeting the Chairman of the Board on two occasions. The discussions following the resolution prompted BP to map out its role in moving to a lower carbon economy. It has become vocal in highlighting the advantages of replacing coal with gas and has stepped up its advocacy for global carbon pricing mechanisms. At the same time, the continuing low oil price environment forced BP to cut costs and shelve capital-intensive investments. We encouraged enhancing board expertise on climate change economics and asked for clearer alignment of executive remuneration plans with energy transition goals.

Verdict

BP stands out in terms of the access that investors have to senior executives and board members, and in the seriousness in which it has engaged with us on stranded assets. Likewise, the company has stepped up its public policy work through the newly formed Oil and Gas Climate Initiative, which sent a strong signal to negotiators ahead of the UN climate change conference in Paris. Despite these positive steps, there has been little tangible success on the crucial question of developing stress-tests and business strategies that include the impact of a lower carbon economy. We remain confident that, as the economic implications of the Paris climate deal become clearer, our push for better business resilience disclosure will yield results.

Company: Pegatron | **Issue:** Supply chain standards

Background

The working conditions and practices of suppliers to world-leading consumer electronics companies face intense scrutiny by the media and non-profit organisations (NGOs). Pegatron, the Taiwanese electronics manufacturer, was unprepared for this spotlight when it was selected by Apple as an assembler of products such as the iPhone and iPad. The company has been accused by NGOs, such as China Labour Watch, and the media, such as the BBC, of unsafe working conditions, excessive overtime, the employment of underage workers and poor dormitory conditions at its factories in China.

Engagement action

Such allegations could be material for investors if they lead to fines, reduced productivity, increased employee turnover and potentially the loss of key contracts. Previous engagement with Foxconn (a subsidiary of Hon Hai Precision Industry) – another major supplier to Apple which had faced similar allegations – had given us experience of engaging on supply chain standards in China. Pegatron responded well to our engagement and allowed us to speak directly with staff responsible for corporate social responsibility. It has demonstrated a commitment to improving its working conditions. For example, it installed a facial recognition system to detect child workers on production lines, implemented a timesheet system to ensure workers did not work more than 60 hours per week (as required by Apple) and disclosed policies and performance data.

Verdict

Pegatron still has a lot of progress to make in areas such as providing more assistance to employees, formulating a strategy to ensure its workers earn an appropriate wage, disclosing its health and safety management system and performance, and providing more transparency into the indicators measuring the quality of working conditions. We are cautiously optimistic as it has been open to investor engagement thus far. We will continue to engage with global electronics companies, such as Apple, to ensure that working rights within their supply chains are protected.

Country: Bangladesh | **Issue:** Supply chain standards

Background

In April 2013, the Rana Plaza clothing manufacturing factory collapsed in the Bangladeshi capital of Dhaka. The incident resulted in more than 1,100 fatalities and was a result of poor building structure. Many international apparel brands were supplied directly and indirectly from the factory. In 2014, we went to the world's second-largest exporter of clothing to engage local stakeholders on the pace and impact of the safety and worker rights reforms. We found that international brands had improved their programmes to ensure supply chain policies are adhered to. However, we continued to have concerns about the remaining underlying inducements for supplier non-compliance.

Engagement action

We revisited Bangladesh in 2015 to see for ourselves whether these programmes are working to force suppliers to alter their practices. We were invited as part of a multi-stakeholder delegation led by the Dutch government to promote sustainable supply chains in the textile sector. We met a wide range of local stakeholders. Global apparel companies have generally been open to engagement on the management of their supply chain risks in Bangladesh. Despite this the only company which invited us locally was Associated British Foods which sources products for its low-price clothing retail chain Primark. We discussed the challenges of increasing factory compliance with labour standards. We welcomed the company showing leadership in its approach to investor dialogue on sustainability issues by taking an open and transparent approach.

Verdict

A key finding emerged from our trip: fire and building safety is important in improving working conditions but it needs to go hand-in-hand with better protection of workers' rights. Low production cost and high volumes have always been the main considerations to source from Bangladesh. Our engagement highlighted how failures in the rule of law, government corruption and poor working standards fuel social unrest. This in turn severely impacts quality, productivity and security of supply. These costs cannot be offset against savings from cheap labour for much longer. International apparel companies are now more willing to bear higher costs in return for better factory standards in Bangladesh to reduce these risks.

Market: Hong Kong | **Issue:** ESG reporting

Background

The Hong Kong Stock Exchange (HKEx) introduced in 2012 a voluntary ESG reporting guide which encouraged companies to report more thoroughly on their ESG performance. However, only half of the listed companies on the index reported on ESG issues in 2015, according to HKEx. To address this issue, it proposed revising the reporting guidelines by bringing them in line with international standards, strengthening disclosure requirements, and standardising reporting across issuers.

Engagement action

We firmly support transparency in the markets and so, we welcomed HKEx's move to update the ESG reporting standards. We made a policy submission encouraging a "comply-or-explain" approach to ESG disclosures where issuers will either meet the standards expected or provided an explanation as to why they have chosen not to. We believe this will best drive improved ESG reporting. We also highlighted that increasing issuers' ESG disclosure obligations enhances the international reputation, quality and sustainability of the market in Hong Kong.

Separately, but with the same engagement objectives, we co-signed a joint investor letter to 62 stock exchanges worldwide. We urged the establishment of voluntary guidelines for issuers on ESG reporting by the end of 2016. The initiative is in concert with the recent release of the Sustainable Stock Exchange Model Reporting Guidance, which provides a resource that exchanges can use to help issuers report ESG information to investors.

Verdict

The new guide for ESG disclosure was brought into effect from the start of 2016. Under the new rules, general disclosure for each aspect of the guide will be under our favoured "comply-or-explain" approach. The key performance indicators for environmental performance will also be upgraded from "recommended disclosure" to "comply-or-explain". In terms of social issues, companies will now be asked to provide data on gender diversity, not just at the board level, but at all levels of the company. The new guide also clarifies that the board has overall responsibility for ESG strategy and reporting. This is a valuable move that puts the board where it should be, at the heart of discussions around ESG issues.

Public policy

We believe in the power of active collaboration with other investors and organisations to advocate reform in companies and in markets with the goal of a sustainable financial system. Given the scale and complexity of many of the issues facing industry and society, collaborative engagement continues to be particularly effective in the public policy arena. It can be difficult for any investor to individually bring about the macro-level changes necessary to tackle and ultimately to solve these problems.

With ever more active investors in the market, opportunities for collaborative initiatives have grown. These have been facilitated, for example, by the Principles for Responsible Investment. Other groups which we are involved with include the Investment Association (UK), Eumedion, Institutional Investors Group on Climate Change, Asian Corporate Governance Association, Ceres, and International Corporate Governance Network.

Climate change featured prominently in public policy engagement ahead of the UN global climate change negotiations in Paris. Elsewhere, we submitted a response to the Modern Slavery and Supply Chains consultation by the UK government. This led to the Modern Slavery Act which was passed in 2015 and which recognises the role businesses have in ensuring their supply chains are slavery free. We provided advice to the government on what level of disclosure companies should be expected to provide.

We also made comments to the European Union institutions on revisions to the Shareholder Rights Directive. The underlying policy objective to the proposed amendments is to enhance effectiveness of the financial system through promoting greater transparency and accountability of asset owners and managers, more meaningful interaction through the investment chain, and improved corporate governance. We voiced objection to multiple voting rights proposals – as seen in France and Italy. We pressed for a "comply-or-explain" approach to engagement reporting and called for shareholder approval of material related-party transactions.

Month	Issue	Initiative
January	Climate	Letter by the Institutional Investors Group on Climate Change supporting early adoption of the Market Stability Reserve (EU-ETS reform)
February	Governance	Submission on the Japan corporate governance code
March	Climate	Co-drafted document on aligning the Junker investment plan with EU climate objectives
March	Governance	Letter to the French state shareholding agency on double voting rights
March	Governance	Response to the proposed amendments to the German corporate governance code
May	Climate	Letter on climate change to the G7 and G20 finance ministers
May	Stewardship	Response to consultation on responsible ownership by the Hong Kong securities regulator
June	Climate	Co-drafted document to EU Commission on EU Emissions Trading Scheme reform
August	Labour	Submission to the Modern slavery and supply chains consultation by the UK government
August	Climate	Joint investor letter to the US Environmental Protection Agency (EPA) on climate change, air pollution and the Clean Air Act
September	ESG	Response to the consultation paper by the Hong Kong Stock Exchange on ESG disclosures by listed companies
September	Climate	Co-authored paper on Climate Finance describing the key barriers faced by institutional investors in deploying capital in developing countries
October	Shareholder rights	Submission to the EU Institutions on the Shareholder Rights Directive revisions
December	Climate	Signatory to the Paris Pledge for Action which supports action towards limiting global temperature rise to less than two degrees Celcius

Theme: The Paris global climate change deal
Issue: Environmental standards

Background

Following two weeks of intense negotiation, the 2015 UN Climate Summit in Paris delivered a deal that exceeded expectations. The event was the largest gathering of heads of state in history, and the final agreement was supported by 195 countries, with key points including:

- A long-term ambition to achieve 'a balance between sources and sinks of greenhouse gases in the second half of this century' while 'peaking emissions as soon as possible'. In other words, the world should become carbon-neutral.
- A commitment from every participating country to produce a national emissions reduction plan. All but six countries have already done so.
- A commitment to review these plans in 2018 and then every five years to ensure they are in line with the Agreement's aim to hold the global temperature rise to 'well below 2°C' and 'pursue efforts to limit the temperature increase to 1.5°C'. These targets cannot be weakened.
- The introduction of a monitoring and verification requirement for all countries.
- Developed countries have now agreed to fund in full the Green Climate Fund up to $100 billion per year from a 'variety of sources', which will also include private finance.

The agreement marks a clear milestone for the global energy sector, and will have a profound impact on both energy producers and users, and consequently also the financial sector.

Engagement action

The investment community played a critical role in creating the political conditions necessary for a global deal on climate change to be struck in Paris. Investors including BMO Global Asset Management (EMEA) were at the heart of this effort. We followed a two-pronged approach, engaging intensively with corporates to ensure they are integrating climate risks within their strategies, and engaging with policymakers to encourage the necessary regulatory and policy changes.

French President François Hollande praised the support of "businesses and investors" in the negotiating process. Non-state participants have shown their strong support: over 7,000 cities representing 32% of global gross domestic product (GDP) and 5,000 companies representing the majority of global market capitalisation had made low-carbon pledges.

Key activities in 2014-15 included co-authoring, with the IIGCC, the Global Investor Statement on Climate Change[12], which attracted 409 supporters with over $24 trillion in assets and was delivered to heads of state at the UN Secretary General's Climate Summit in September 2014. We had also co-authored an open letter to G7 and G20 finance ministers[13] expressing investors' concerns regarding the systematic nature of climate risks, which was signed by 120 investor CEOs and had the support of four regional investor groups on climate change as well as the Principles for Responsible Investment.

During the Paris meetings themselves, we were present at the climate summit in Paris as part of the IIGCC observer delegation, helping to represent the investor's voice during meetings with a number of country negotiating teams, including the US, EU, and G77.

[12] Global Investor Statement on Climate Change http://investorsonclimatechange.org/statement/
[13] Open letter to Finance Ministers in the Group of Seven .http://www.iigcc.org/publications/publication/open-letter-to-finance-ministers-in-the-group-of-seven-g-7

Verdict

The Paris deal makes climate change, and the energy transition, a mainstream investor issue. The focus now shifts to implementation. We also expect more investment opportunities to develop. We expect regulators' attention to climate change to continue to increase, both as a result of the deal itself and in the broader context of a trend toward encouraging investors to consider ESG issues – as seen in developments including the introduction of Stewardship codes in Asia, and the revisions to the EU Shareholder Rights Directive. Existing investor initiatives to improve the understanding of climate risks and opportunities, such as the 'Climate Change Investment Solutions: A Guide for Asset Owners' compiled by the Global Investor Coalition, provide a strong foundation for the discussions we expect to continue into 2016 and beyond.

"We urge you to support a long term global reductions goal in the Paris agreement and a submission of short to medium term national emission pledges and country level action plans."

Letter on climate change to G7 and G20 finance ministers, May 2015

Voting and Corporate Governance in 2015

We view the exercising of the right to vote as a central part of being an equity owner and as an opportunity to encourage change at companies. We engage companies before voting to explain our expectations and to invite comment, and post-vote to explain our reasons for any votes against management.

In 2015, we voted on nearly 70,000 resolutions at 6,307 company meetings in around 70 countries on behalf of our in-house holdings[14] and of our ***reo***® clients. We supported management in 75% of all proposals, which was slightly lower than in 2014 (78%). This is largely accounted for by our decrease in support for director elections in Europe and the United States which did not contribute to the formation of well balanced, diverse and effective boards. Our voting standards were strengthened in this area.

Executive remuneration continued to be the most contentious issue dividing investors and management. We voted against management at 44% of these resolutions around the world – exactly the same as the year before. In the US, we continued to be disappointed with the overall standard of executive remuneration packages proposed to shareholders, with the proportion of votes against management on this topic increasing slightly from 55% in 2014 to 56%. In the UK, votes against management on executive remuneration reduced from 21% in 2014 to 16%. This reflected a lower number of pay-related resolutions put forward to investors as most companies refrained from submitting amendments to their remuneration policies where these had been approved by shareholders in 2014. However, our main concerns with pay arrangements continued to be serious: weak links between corporate strategy and key performance indicators used in pay plans; weak performance targets and payouts inconsistent with achieved performance levels; and excessive focus on short-term outcomes.

Indonesia and Japan remained the major markets with the highest levels of votes against management proposals. Although we did not support 58.8% and 48.7% of resolutions respectively, these figures are a reduction on previous years due to governance standards improving in both markets. In Indonesia, there was more disclosure of information in advance of shareholder meetings. In Japan, where there have been widespread governance reform, companies increased the representation of outside directors on boards. This allowed us to support more directors standing for election. We were pleased to note an increase in support of five percentage points. In 2015, we travelled to both countries on engagement trips to press local companies and regulators for stronger governance practices and standards.

Throughout 2015, we used voting rights to send a clear message to the board and management of companies and therefore we maintained a very low use of abstentions. In the very small number of cases (0.3% of the total number of resolutions) where we abstained, this is aggregated into the "votes against management" column in the table below.

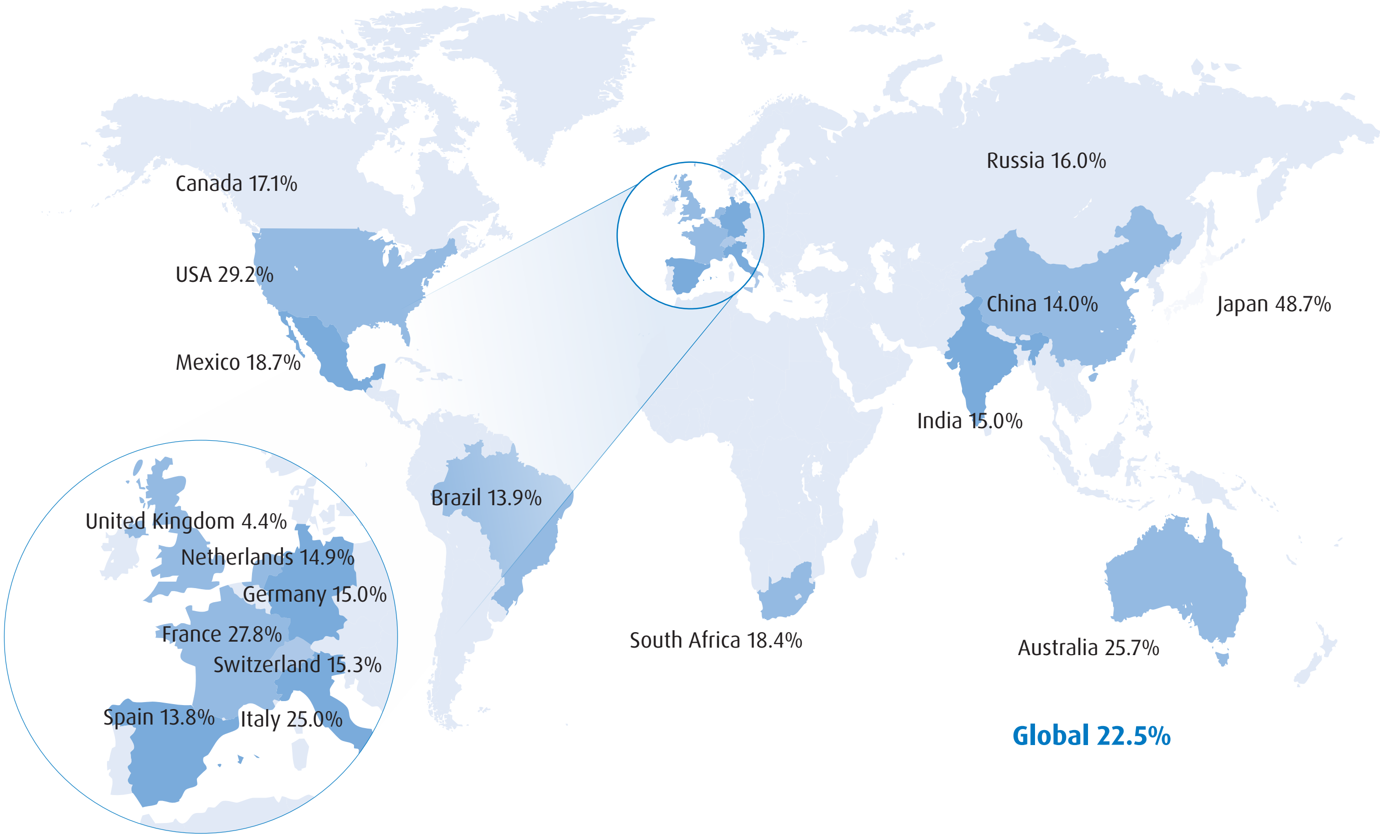
How we voted in 2015

How we voted	Number of Resolutions actually voted	Votes With Management	Votes Against Management	No vote[1]
Board Elections	36,759	71.9%	26.4%	1.7%
Capital Structure	6,241	77.9%	20.1%	2.0%
Remuneration	6,295	53.4%	44.0%	2.7%
Routine & Other Business	18,691	89.3%	7.5%	3.2%
Shareholder Proposals	1,457	53.2%	40.5%	6.3%
All Proposals	69,443	75.1%	22.6%	2.3%

[14] These relate to holdings in funds managed in the Europe, Middle East and Africa (EMEA) region. There are certain exceptions. Separate governance policies currently apply to some assets managed by LGM Investments, Pyrford International, Thames River (Thames River Capital LLP and Thames River Multi-Capital LLP), F&C Portugal S.A. and BMO Real Estate Partners. In some cases clients may not mandate us to vote or engage within a segregated account.

[1] The majority of 'no votes' take place in markets that employ shareblocking, where most clients elect not to vote so as not to constrain their investment decisions. The 'routine & other business' category also includes non-voting proposals which is the reason for the relatively high proportion of no votes.

Global votes against management 2015



France & Italy

Changes to law in France and Italy allowed companies to provide enhanced voting rights for long-term holders of shares. This was a negative development which institutional investors consider to undermine the important "one-share, one-vote" principle. In response, investors urged companies in these markets not to adopt the changes. Particularly in Italy, the engagement received positive responses from companies. This led to very few, mostly small issuers adopting enhanced voting rights.

Switzerland

2015 saw more major governance reforms in Switzerland as a result of the Minder initiative against excessive remuneration. Swiss companies now face binding shareholder votes on executive remuneration and annual re-elections of directors. The rights of minority shareholders also became a hot topic after the proposed takeover of Sika by Saint-Gobain exposed practices that benefit controlling shareholders at the expense of minority investors. We held a seminar on these issues for a group of investors to improve understanding and strengthen engagement.

Germany

German corporate governance standards continue to lag other developed markets in key respects, including reporting on board effectiveness and nominations, as well as access by institutional investors to supervisory boards and board diversity. The reluctance by German corporates to undertake significant improvements in board diversity has forced regulatory action through the introduction of board gender quotas.

Japan

After years of severely lagging other developed markets, corporate governance standards at Japanese companies have improved since Prime Minister Shinzo Abe was elected in late 2012. Japan established a Corporate Governance Code in 2015 which calls for boards to have two external directors. We welcomed this standard in a market where all-insider boards were a normality. In a joint-investor initiative, we are urging the largest listed companies to establish one-third independence on their boards by 2017 annual shareholder meetings (AGMs).

Company: JPMorgan Chase & Co | **Issue:** Remuneration

Background

JPMorgan has been a focus of corporate governance engagement since the global financial crisis. Over the past few years the board has gradually undertaken some reforms with a number of enhancements introduced. This was particularly the case after the so-called "London whale" incident in 2012 where the US bank suffered more than $6 billion in trading losses. Meaningful changes, however, to executive compensation structures continued to fall short. Incentive-based awards remained largely discretionary and company disclosures lagged industry practices in detailing how the compensation committee exercises such discretion. It was difficult to ascertain how executive compensation aligns with the investor experience. Many of these concerns came to a head at the bank's AGM in May where 39% of votes did not support CEO Jamie Dimon's pay package.

Engagement action

Prior to the AGM, we travelled to the US to meet JPMorgan and to express our concerns. We followed up with another detailed discussion once the exact details of the pay plan were released. Following the controversial and highly publicised vote, we held two further meetings with the bank to discuss its response. We provided the company with specific examples of what we consider to be appropriate compensation practices. We encouraged refreshing the board's compensation committee and impressed the benefits of bringing in new perspectives. We highlighted the potential for reputational risk if a swift and thorough reform of the bank's pay plans was not undertaken.

Verdict

When the preliminary vote results were disclosed at the annual shareholder meeting, the bank announced that shareholders' concerns had been noted given the low support for the vote on executive compensation. After extensive follow-up dialogue with the bank, we are finally seeing some signs of long overdue changes such as specific performance metrics for the long-term plan. We will continue to engage the bank on specific details through early 2016. We expect the bank to introduce changes to its compensation plans ahead of the next annual shareholder meeting.

Company: Volkswagen | **Issue:** Board effectiveness

Background

The revelation that Volkswagen (VW) had manipulated emissions data of engines sent a shock wave through the automotive industry. We were deeply concerned about the likely impact on sales, the reputational damage and the potential penalties arising from legal action in the US and Europe. Our initial assessment was that the emissions scandal was a symptom of broader issues at VW around its corporate culture and corporate governance issues. VW needed to address these issues in order to restore trust among customers, employees, investors and broader stakeholders.

Engagement action

We responded to the scandal by writing to the company to strongly urge the Supervisory Board to disclose, at the earliest opportunity, how VW's internal processes were being strengthened in order to prevent further incidents of a similar nature. Irregularities had remained unreported and unaddressed for a significant period of time which brought into question the effectiveness of VW's risk management and compliance systems. The irregularities also raised questions around business ethics and conduct within the company, as well as the integrity of its employees and management. We therefore urged the Supervisory Board to communicate to investors its thinking about recent internal appointments to the Management Board. We stressed that a key change would be the appointment of a highly-regarded, experienced, independent Chairman who would be widely seen as a key element of the cultural change process.

Verdict

Despite some notable changes to the senior management team, we are not convinced that the company is making a concerted effort to address deep-seated cultural issues within the organisation. We expect clear communication from the management and supervisory boards on specific steps taken to address internal control and corporate culture issues throughout the ranks. We also expect the company to address a corporate governance model which we believe has contributed to a delay in uncovering of emission irregularities.

Company: Renault | **Issue:** Shareholder rights

Background

In April, the French government temporarily increased its stake in the automaker from 15% to approximately 19%. This was solely in order to be able to block Renault's proposal to opt out from enforcement of the Florange Law which grants double-voting rights to long-term shareholders. The government wanted to benefit from enhanced voting rights and from retaining greater control even when it eventually decreased its stake. We believe that the introduction of double-voting rights is against the interests of minority shareholders in French companies. This is because differential voting rights lead to a distortion in the market as they allow entities to exercise enhanced or even controlling influence over companies without the corresponding economic stake and associated risk, and can be used as tools to entrench management.

Engagement action

We met with Renault ahead of the AGM. We were pleased that the board had taken investor concerns into account and was proposing to opt out from the double voting rights regime in defiance of the government. We voted in favour of the company's proposal at the AGM. In addition, we wrote to the French State Shareholding Agency which is responsible for the government's holdings in listed companies, but little further dialogue ensued. Also in 2015, in collaboration with eight other investors, we wrote to the boards of approximately 100 French-listed companies explaining investor concerns about double-voting rights and encouraging them to retain the "one-share-one-vote" regime.

Verdict

As a result of the French government's actions, the opt-out resolution narrowly failed to achieve the required majority. Double voting rights will now unfortunately apply at Renault. This outcome triggered a power struggle and a re-alignment of the alliance between Renault, the French government and Nissan. The Japanese automaker has a 15% stake in the company but no voting rights. We will keep a watchful eye on any ensuing changes to the company's governance structure including at the 2016 AGM.

Company: Toyota | **Issue:** Shareholder rights

Background

The establishment of the Corporate Governance Code in February was a key moment marking the widespread governance reform that has been taking place in Japan in recent years. Despite this positive mood in the country, there were some negative governance developments. The country's largest and most influential company, Toyota, announced plans to issue a new unlisted share class to be sold only to domestic retail investors. These enjoy a principal guarantee, making them a debt-like security, yet they carry voting rights similar to common stock. We were concerned that this distorts the "one-share-one-vote" principle and dilutes the voice of existing institutional shareholders.

Engagement action

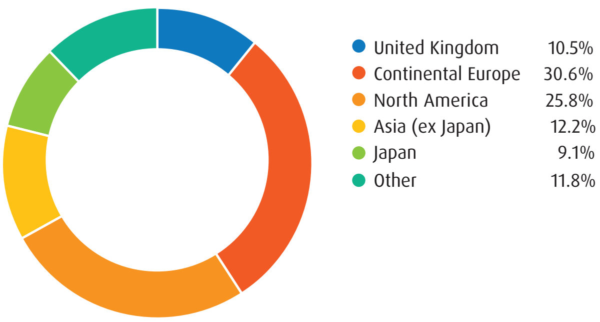
We joined a group of major institutional investors in expressing our concerns to the company. We wrote to the Chairman and also met a senior executive to ask for the proposal for the so-called "Model AA" shares to be dropped. We were not convinced that the company needed to create a dual-class structure to ensure long-term shareholders and to finance research and development (R&D) especially as the company is cash-rich. We stated to the company that the Corporate Governance Code did not envision the creation of a new share class that discriminates against existing common shareholders, many of whom are long-term holders of the stock and all of whom are prepared to accept the risk that their principal is not guaranteed.

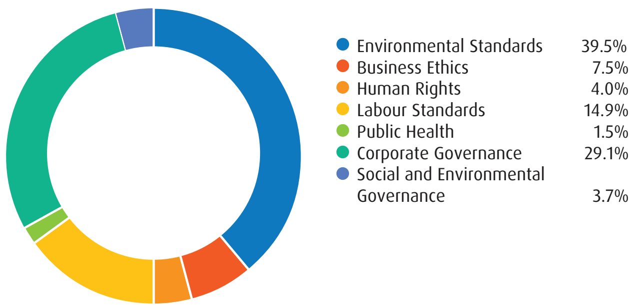
Verdict

Despite the efforts of the international investor group, the proposal was passed at AGM in June. Approximately 75% supported the vote. The plan required two-thirds support to pass. We were disappointed that the company chose to persist with the issuance of the new share class and to largely disregard the concerns of a quarter of its shareholder base. Since then, this 25% of investors have turned the focus on to the wider market to ensure other companies do not copy Toyota's move.

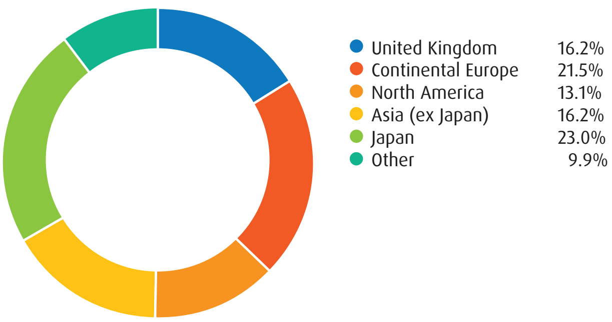
Identifying and pursuing specific and achievable goals are key parts of our engagement process. Our activities resulted in many companies adopting our recommendations, and in so doing, reducing the ESG risks facing their businesses. In 2015 we recorded 241 instances of change – which we call 'milestones' – achieved at companies.

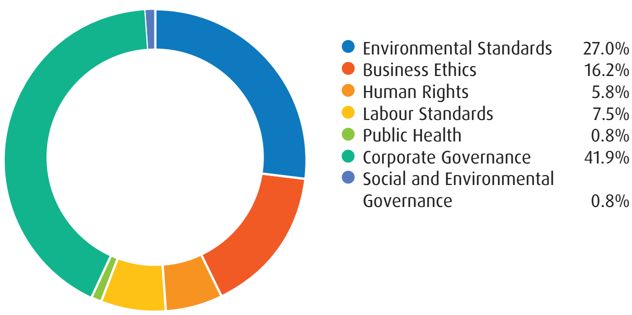
Companies engaged by country and issue





Milestones achieved by country and issue





2015 ESG Viewpoints

January
Responsible investment in high-risk areas*

March
Stranded Assets: fundamental restructuring for European utilities*

May
Stranded Assets: addressing the risks to the coal mining industry*

June
Stranded Assets: planning for a carbon-constrained world*

July
We opposed JPMorgan's pay plans again and this time so did 39% of shareholders*

August
Deutsche Bank finally adopts reforms*
Stranded Assets: Mitigating investment risk posed by climate change

September
Spain implements key governance reforms*

October
Corporate tax practices – evaluating the risks*
Bangladesh revisited: progress, slowly but surely

November
The Paris climate negotiations: a world in transition
Green bonds: financing the transition to a new economy

December
Paris climate deal: the investor reaction

*These Viewpoints are confidential and for ***reo***® clients only

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