ESG matters

Environmental, Social and Governance thought pieces

Issue 9

The Millennials: Shaping the future of food

| Access to Medicines strategies: Providing long term rewards for pharmaceutical innovation |
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Allianz Global Investors
Dear reader

Welcome to the 9th edition of ESG matters. Within the lead article, I discuss the challenge that companies face globally of producing products to meet the tastes and requirements of the “Millennials”, the next generation of spenders with greater expected purchasing power than the baby boomers. Also, Verity Chegar examines the need for Pharmaceutical company innovation and the potential for longer term rewards. Ange-Wilfried Ezoua investigates the new face of computer trading, HFT, and what that implies for the Regulators. David Diamond additionally reviews the trends and outlook for European corporate governance and finally Henrike Kulman puts Japanese corporate governance progress under the microscope, four years after the Olympus scandal.

I hope that you enjoy reading this edition of ESG matters as much as we have enjoyed making it. Our objective is to provide you with financially relevant and insightful information through an ESG lens.

As always, we welcome your questions or comments on the subjects raised within this edition of ESG matters.

Bozena Jankowska
Global Co-Head of ESG
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Access to Medicines/section 1
Emerging markets offer attractive growth rates for multinational companies with a higher mix of stable North American and European sales. The growing middle class is eating better, living longer, and demanding better services, including healthcare. Total health expenditure per capita correlates strongly with life expectancy for emerging countries. Governments are responding with expanded coverage and care for their citizens, but progress is slow. In the least developed countries, infrastructure needs remain a significant hurdle to delivering care to those who need it most. The World Health Organization (WHO) estimates a third of people in developing countries cannot afford to buy essential medicines. Without meeting the basic needs to sustain life, these populations cannot afford to participate in global economic expansion, much less contribute to global multinational profits.

Access to medicine is a concept that describes efforts to reduce the frictions of delivery and affordability of drugs for lower income customers. Government plays an important role in purchasing essential medicines at scale for delivery to the neediest citizens. Drug manufacturers
increasingly are partnering with NGOs and payers to provide medicines free or at reduced cost. These ‘access to medicine’ programs may seem antithetical to profit maximization and shareholder value creation on the surface. When considered through a long term lens, they can create opportunities for geographic market expansion, reputation enhancement, and political capital creation, which can benefit the long term performance of a company. Investors should consider a drug company’s access to medicines strategy before taking a position in a company.

The ‘Allianz Global Investors Material ESG Framework’ for the pharmaceutical industry includes an allocation to ‘Commercial Strategies for Access to Medicines’. Unlike other material ESG factors such as health and safety, which may be included in frameworks for many sectors, access to medicines is a material ESG factor applied exclusively to companies in the pharmaceutical industry. Although the concept broadly applies for companies in developed countries selling to patients and customers in emerging markets, we apply the metric to large and small companies in all regions. The factor considers the impact of a company’s products on society and measures a company’s strategy to develop drugs that address the world’s greatest needs. Evaluating a company’s “commercial” strategy to providing affordable medicines to poorer patients, though seemingly paradoxical, intentionally points out these approaches can be integrated into for-profit business models with financial benefits to shareholders in the long term.

Consider the case of the first cure for Hepatitis C virus. Between 350,000 and 500,000 people die each year from liver diseases associated with Hepatitis C virus (HCV), a disease that affects more than 130 million people around the world. The WHO lists one of those diseases, cirrhosis of the liver, on its top 20 list of causes of premature death worldwide. Major scientific breakthroughs recently made Hepatitis C a curable disease. While Gilead Sciences had the only cure on the market, pharmacy benefit manager Express Scripts refused to make the cure available to patients covered by its health insurance partners. The reason: Express Scripts argued the drug was too expensive. Gilead priced the pill at US$1,000 apiece, or US$84,000² for a daily combination drug over a recommended 12-week period.

Drug developers aiming to launch a drug in the US or Europe typically price the newly patented medicine at a premium price to recover the costs of years of research and development, clinical trials and testing that typically precede regulatory approval. The US market has historically allowed the highest pricing schemes, but a call for pricing rationalization has crept into national debate more

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**Figure 1: The Access to Medicine Index 2014 - overall ranking**

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<td>1. GlaxoSmithKline plc.</td>
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<td>2. Novo Nordisk A/S</td>
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<td>3. Johnson &amp; Johnson</td>
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<td>4. Novartis AG</td>
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<td>7. Merck &amp; Co. Inc.</td>
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<td>8. Sanofi</td>
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<td>9. AbbVie Inc.</td>
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<td>12. Roche Holding AG</td>
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<td>13. Bristol-Myers Squib Co.</td>
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<td>14. Boehringer Ingelheim GmbH</td>
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<td>15. AstraZeneca plc</td>
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<td>16. Pfizer Inc.</td>
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<td>17. Eli Lilly &amp; Co.</td>
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<td>18. Astellas Pharma Inc.</td>
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<td>19. Daiichi Sankyo Co. Ltd.</td>
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<td>20. Takeda Pharmaceutical Co. Ltd.</td>
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A score of zero means lowest and five signifies highest indicator score among the company set.

recently, and required all players in the US healthcare system to justify the high cost of care. What’s more, the very earliest stages of drug development are often conducted at public universities and government-supported research hospitals underwritten by taxpayer dollars—which calls into question corporate claims for reimbursement of sunk costs.

A company’s ability to deliver medicines at a price perceived to be fair by government payers and other purchasers has considerable impact for its political capital. This political capital can be deployed through other means of cost reductions, potentially reducing the need for political lobbying or improving the chances of a government insurer contract, without the risk of bribery or corruption muddying the waters. In countries like India, where compulsory licensing agreements have allowed local generic manufacturers to replicate branded drugs that are elsewhere protected by patents, offering an affordable price can be critical to retaining market access and intellectual property rights.

In addition to the equity pricing model described above, pharmaceutical companies might offer differential or tiered pricing. This means selling an identical drug in two regions for vastly different prices. This strategy can allow a company to set pricing that is proportionate to income levels while achieving an overall sales amount that is still profitable to the corporate center and to shareholders. Additionally, it can be an opportunity to extend the sales of earlier generation drugs that are priced lower than the latest generations, which may vary by dosage or delivery method but deliver comparable outcomes.

On a more micro scale than country-level pricing, many drug makers are offering patient assistance programs organized by individual drug that purport to bridge the gap for patients who fall below the affordability index of the country list price. These programs can make medications more affordable for patients with cancer and HIV, where protracted treatment programs are not uncommon but very expensive. Unfortunately, information about the number of patients served through these programs is not generally available and therefore the impacts are unknown.

We have scored more than 120 companies on their access to medicines performance, though many more pharmaceutical companies listed on worldwide exchanges could report their strategies for improved comparisons. The Sustainability Accounting Standards Board recommends biotech and pharmaceutical companies include a qualitative description of their commercial strategies for access to medicines. This would include a list of drugs on the WHO List of Prequalified medicinal Products and a description of the initiatives to promote access in priority countries defined by the Access to Medicine Index.

The Access to Medicines Foundation publishes an index ranking of the largest research-based drug companies. Companies score higher for access programs, such as tiered pricing for low and middle income countries. Similarly, they score more points for commercial decisions to research and develop drugs that address diseases the WHO has classified as the world’s most burdensome, including infectious diseases like HIV and malaria and neglected tropical diseases. Pharmaceutical companies with portfolios exclusively focused on elective treatments would score lower by contrast.

Investors value pharmaceutical stocks as a multiple of the revenues the company will generate from sales over 5-20 or more years. Already this extended timeframe approaches the longer timescales associated with sustainable and responsible investing. Environmental and social impacts are not easily measured in quarterly earnings reports, and the outcomes of structural change become evident years later. A research and development oriented drug company invests in people and technology to test ideas for many years before possibly receiving regulatory approval to sell the drugs and earn a profit. Recouping this investment through pricing, geographic market expansion, and development for new applications (labels) for existing medicines are revenue drivers. Commercial strategies for access to medicines can offer long term healthcare investors insight into a company’s strategic growth prospects and risk protections. A company’s behavior today can influence how its innovation is rewarded for decades to come.

2 http://www.msfaccess.org/content/barriers-access-and-scale-hepatitis-c-hcv-treatment-gileads-anti-diversion-program
The Millennials: Shaping the future of food

During the first eight years of my life, I grew up in communist Poland. I remember the food queues, but despite this, I also remember the delicious home-made food cooked by my grandmother. Back in those days in Poland, processed food was considered a luxury and western brands were a treat which could only be bought in special government approved shops. When I moved to England in 1980 my whole world changed. Food as I knew it was different. There were no food queues for one, but for me the biggest revelation was the fast food restaurants like McDonald’s, Burger King and Taco Bell, as well as the huge variety of snacks and treats readily available. At that time, in the early 1980’s, the links between processed foods and obesity were tenuous, but as the problem continued to grow it started to reach the public consciousness. Over time this has led to an increasingly bigger spotlight being directed at processed food and fast food companies. Books such as ‘Salt, Sugar, Fat: How the Food Giants Hooked Us’ by Michael Moss were published and documentaries like ‘Super Size Me’ were released, openly criticising food and beverage companies and the role they play in contributing to the growing global obesity crisis.
With lifestyles changing, people becoming less active and the convenience of processed foods featuring ever more in our diets, we have seen almost a doubling of obesity worldwide since the 1980’s.

According to the World Health Organisation (WHO), 65% of the world’s population live in countries where being overweight and obesity kills more people than in countries where under-nutrition is a killer. Of greater concern, the WHO estimates that 42 million children under the age of 5 were overweight or obese in 2013.

At the same time, we are seeing the emergence of the next demographic – the ‘Millennials’. Born between 1980 and 2000, the Millennials are predicted to be the next big spenders. Today, their spending is at US$2.45 trillion, and by 2018, it is projected to reach US$3.39 trillion surpassing the ‘Baby Boomers’2. This is a group of future consumers that companies simply cannot ignore. Millennials have different attitudes to life and in this instance food. They put more importance on ‘wellness’ in their daily lives and are more likely to try and maintain healthy eating habits. They place priority on freshness, quality and ingredient transparency. Yet, despite this, obesity among the Millennials is also a problem. In the past 35 years, obesity has tripled from 8% in 1971-74 to 24% in 2005-063, driven by a significant drop in exercise, a general lack of awareness on serving sizes and knowledge of the number of calories per day that are appropriate to consume. Also Millennials are, by definition, time starved so eating ‘on the go’ and snacking is common.

Unlike previous generations, the Millennials are ‘digital natives’. They were born into the digital world, meaning that social media makes up a huge part of their lives. A 2013 Food Survey by Sanford Bernstein shows that individuals who are very active on social media tend to be more distrustful of the food system than others4. Millennials remain highly sceptical of nutrition information being made available to them, believing it to be influenced by corporate interests. As a consequence, when food and beverage companies make claims about the healthy properties of their products without making many changes to improve their nutritional value, Millennials will be less likely to believe them and will be more likely to turn away from them. We have already seen two casualties – McDonalds and Coca-Cola. In the case of McDonalds we have been seeing a steady drop in their sales volumes with the third quarter in 2014 seeing a 30% sales slump5. What is becoming evident is that the company has a serious branding problem with respect to the health and wellness issue and this, we believe, will inhibit their ability to fix their sales problem easily. The company has been attempting to attract customers (and in particular Millennials) by launching various campaigns, for example, by allowing customers to customise their menu by choosing their own toppings and ingredients, or the social media campaign called “Our Food. Your Questions” which allows customers via Twitter or Facebook to ask questions about how McDonald’s food is prepared, sourced or what it contains. More recently the company has hired a social media marketing agency to target Millennials with a campaign that speaks directly to Millennials philanthropic priorities, recognising that they are drawn to companies that have a history of giving back. Maybe it’s too little too late, and a burger is a burger, but this illustrates two things. Firstly, consumers are becoming more aware and want to be more informed.
about the food they are putting into their bodies, and, companies that are slow to adapt to changing consumer tastes, particularly those around healthier eating, freshness and quality will suffer. Secondly, product reformulation and the use of newer and ‘better for you’ ingredients is a major challenge for companies. Coca-Cola, the second casualty of the emerging health and wellness trend with mixed sales growth over the last few years, has in 2014 launched ‘Coke Life’ which is based on a natural, plant based sweetener called stevia (sweeteners extracted from stevia leaves are calorie-free and up to 200 times sweeter than table sugar). Based on AllianzGI proprietary analysis, feedback from the product launch is mixed with some stating that stevia can leave a bitter after taste. This illustrates the difficulties faced by companies as they strive to improve the nutritional value of their products.

The food and beverage industry is however, aiming to increase efforts in this area. Post publication of the WHO Global Action Plan for the Prevention and Control of Noncommunicable Diseases 2013-2020 report, the food and beverage industry has, via the International Food & Beverage Alliance (IFBA), announced that it will step up its efforts and commitments on health and wellness and diet related health issues at a global level. The industry initiative first came to life in 2008 in support of the WHO Global Strategy on Diet, Physical Activity and Health. This seems like an effort to self-regulate, in order to avoid tighter regulation, and demonstrate that the industry is willing to invest in product formulation and innovation, improved consumer information, more responsible marketing especially to children under 12 and promotion of healthy lifestyles.

However, if food and beverage companies are to ensure they remain ‘future proof’ and able to meet fast changing consumer preferences which appear in the case of Millennials to be gravitated towards fresher, healthier and simpler products, they need to really focus on innovation. Nevertheless, the pace of innovation is challenged by the fact that reformulation or change in ingredients can compromise taste and texture which in itself can turn consumers away from products. Despite this we continue to question whether food and beverage companies are innovating fast enough (over and above tinkering around the edges by emphasising specific nutritional benefits of their products which may still be laden with sugar, fat or salt). This frustration which was recently shared by Wal-Mart’s new CEO Doug McMillan who in his presentation of the company’s new strategy, expressed disappointment with branded food and beverage companies for their lack of consumer-winning innovation particularly for healthier products.

Evidence that health, wellness and product innovation are increasingly interlinked with food and beverage company fortunes is becoming more compelling. As investors, if we are to pick the winners of the future, the onus should be to look beyond just the financial metrics, which provide part of the picture, and with the help of the environmental social and governance lens aim to understand how far companies are willing to push themselves on their nutrition-related policies, practices and performance to deliver the innovation that is being asked of them.

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1. www.who.int/mediacentre/factsheets/fs311/en/
2. Generation Y Survey, Oracle Financial Services and EFAMA, September 2010
3. www.cdc.gov/nchs/data/hus/hus08.pdf
Financial markets have significantly changed due to globalization, competition and evolving regulation, but more importantly due to new technologies which are fuelling countless new products and services, and contributing to its dynamism. Particularly, and not without controversy, high frequency computer-based trading (HFT) has grown in recent years to represent well over 50% of total volume US-listed equities according to the Securities Exchange Commission (SEC)1.

"As a result of the use of algorithms, trading banks of the future would simply consist of a computer, a man and a dog. The computer would be there to handle the transactions, and the dog would be there to stop the man from interfering with its trading programs. The man’s job would be to feed the dog.” – Chris Skinner, Chairman, The Financial Services Club.

Is this a true flavour of where financial markets are heading to? Along with the associated risks? In
order to assess what lies ahead, let’s look at how and why the current situation evolved.

**Technology driving changes in financial markets**

The shift to computer trading systems initiated in the 1980’s meant that certain tasks, previously carried out manually, could be automated. Quickly after, algorithms were developed for use by the buy-side to manage orders and to reduce market impact by optimizing trade execution once the buy-and-sell decisions had been made. Continuous evolution has meant that while initial first generation algorithms (fairly simple in their goals and logic) were pure trade execution-oriented, second-generation algorithms (strategy implementation) have become much more sophisticated, and are typically used to produce own trading signals which are then executed by trade execution algorithms. Third-generation algorithms include intelligent logic that interprets market activity and adjusts the trading strategy of the order based on what the algorithm perceives is happening in the market.

The convergence of cheap computer power, statistically sophisticated and computationally intensive trading strategies, and fast automated execution means that it has become entirely commonplace in recent years for market participants to seek counterparties to a transaction electronically and then execute the deal, all within a few seconds.

At the same time, a new style of trading emerged: High Frequency Trading (HFT). HFT involves tailor-made algorithms running on high-speed computers, analyzing massive amounts of market data while exploiting trading opportunities that may open up for milliseconds, well before human operators could assimilate the information. Market participants constantly take advantage of very small price imbalances; by doing that at a high rate of recurrence they are often able to generate sizeable profits.

**Regulation as a catalyst**

In some ways, the pre-crisis Regulation National Market System (RegNMS) and Markets in Financial Instruments Directive (MiFID) in the US and Europe respectively introduced greater competition in the provision of services to investors and between trading venues, which paved the way for HFT.

How exactly? Through a more fragmented structure of equity markets. Now that securities are tradable on several venues simultaneously, it is nearly impossible, from a proprietary trading perspective, to control pricing with a human eye or indeed to process the information in a timely fashion in the human brain. Instead you need a ‘computerized eye’ to manage prices, expected returns and the associated risks. Therefore, the employment of simple algorithms to efficiently handle these aspects has become standard procedure. Add to this the new tariff structures, e.g. maker-taker pricing proposed by exchanges to respond to the increased competition, which have also spurred the development of more sophisticated algorithms to work off more complex order management tasks. It is no surprise therefore that HFT activity exploded in relative terms as well as in absolute magnitude, but at what costs?

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### Main characteristics attributed to HFT (SEC):

1. Use of extraordinarily high speed and sophisticated programs for generating, routing, and executing orders.
2. Use of co-location services and individual data feeds offered by exchanges and others to minimize network and other latencies.
4. Submission of numerous orders that are cancelled shortly after submission.
5. Ending the trading day in as close to a flat position as possible.

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**Figure 1: Reasons for using algorithms**

- Anonymity, 13%
- Reduce market impact, 12%
- Ease of use, 12%
- Trader productivity, 11%
- Execution consistency, 11%
- Internal crossing, 11%
- Price improvement, 9%
- Customisation, 7%
- Commission rates, 7%
- Speed, 6%
- Match pre-trade estimates, 1%

A mitigated impact on market quality

Narrowed bid-ask spreads, increased market liquidity, reduced measures of price volatility and improvements in the price discovery process are some of the most cited benefits attributed to HFT in equity markets. Some HFT can actually involve a price reversal strategy in which the trader rapidly buys securities after price declines and rapidly sells them after prices increase. This process could arguably help detect price anomalies and help stabilize prices. However, if various observers assert that HFT appears to have contributed to these improvements over the past decade or so, it can be argued that correlation is not necessarily causation. Various changes in the equity market structure from developments such as decimalization, regulation and the general expansion in computer technology during the period are likely to have also played key roles and it is hard to disentangle the individual impact.

One sure thing is that the nature of market making has changed, with HFT now providing the bulk of such activity in equities. However, unlike designated specialists, HFT typically operate with little capital, hold small inventory positions and have no obligations to provide liquidity during periods of market stress. These factors, together with the ultra-fast speed of trading, create the potential for periodic illiquidity. The US Flash Crash in May 2010 is a concrete example of this, which saw the S&P500, the Nasdaq 100 and the Russell 2000 dramatically collapse and recover within minutes, and the Dow Jones Industrial Average (DIIA) experience the biggest intraday point decline in its history. Investigations by the SEC determined that HFT was not actually the cause of the crash, but may have exacerbated it.

Criticism doesn’t stop here. Often pointed out is the so-called phantom liquidity, in which the market liquidity provided by HFT may be fleeting and transient due to the posting and then the almost immediate cancellation of trading orders. Another concern is that HFT firms may engage in manipulative strategies such as ‘front-running’ whereby the firms trade ahead of a large order to buy or sell stocks based on non-public market information about an imminent trade. An even bigger challenge is that HFT often creates two-tiered markets, in which HFT firms pay extra fees for gaining advantage over other traders.

While HFT does not necessarily enable these types of market abuse it offers different and more effective means of engaging in abuses, and the speed and volume of the trades involved can make it harder for regulators to detect when they are happening.

Financial stability & investor confidence

Some research has concluded that algorithmic trades in general tend to be correlated, suggesting that some HFT strategies may not be as varied as those employed by human traders. A potential concern here is that because of this correlation, shocks that hit a small number of very active HFT traders could detrimentally affect the entire market. Also, independent HFT firms are not part of larger conglomerates and hence are lightly capitalized which can exacerbate their financial risk. This raises questions over the ability of many HFT traders to handle the corresponding counterparty risk in such scenarios as they tend to turn over their positions several times a day, while securities trade clearing systems tend to operate at a much slower rate. In combination, these aspects of HFT have led to concerns that under certain scenarios the firms could help to generate systemic market disruptions.

As nicely put by US Senator Carl Levin, Chairman of Permanent Subcommittee on Investigations, “financial markets cannot survive on technology alone. They require a much older concept: trust. And trust is eroding”. Indeed, if technology has been a positive game changer for the average investor with easier market access, decreased commissions and additional liquidity, the difference in
the case of HFT is that its development has coincided with a shift in market structure with which regulators have not kept adequate pace. As a result, investors feel unsafe and worry about the downside risk of putting capital to work and the ability of regulators to curb these contemporary versions of market manipulation. However this lack of faith, if allowed grow, will fuel even greater outflows from equity mutual funds than has been recorded in recent years. Some institutional investors are now taking necessary actions to lessen their exposure to ‘predatory’ HFT strategies, which include turning to dark pools and blocking certain trade venues.

Call to action

What about an appropriate HFT regulation? Regulators do not seem to be working towards global convergence on the regulatory oversight of HFT, probably because they have different opinions about the dangers or the new risks it may cause.

The European Commission (EC) certainly took the most comprehensive approach to date, reviewing MiFID. The EC proposes to make sure that anyone involved in HFT above a minimum quantitative threshold are obliged to be authorized as investment firms and would consequentially be subject to full regulatory oversight, and to a number of organizational prerequisites such as risk management obligations and capital requirements. In addition, operators of regulated markets would be required to ensure that a HFT firm continues to provide liquidity on an ongoing basis subject to conditions similar to those applicable to market makers. In terms of order persistence and tick sizes, operators of regulated markets may be required to ensure that orders remain in the order book for a minimum period before being cancelled, or alternatively to ensure that the ratio of orders to transactions executed by any given participant would not exceed a specified level.

Preventing market failures would also involve a significant strengthening of algorithm testing prior to deployment between firms and venues; along with a market spanning framework of carefully designed safeguards (so-called volatility interruptions in the EU, circuit breakers in the US) which halt the market during market breakdowns, provide the opportunity for participants to cool down and to then re-open trading at new equilibrium prices. Meanwhile, the EU proposal for a financial transaction tax, intended to reduce the attractiveness of HFT, is slowly making its way, but has not yet reached an agreement between Member States.

Nonetheless, the above measures would need to be implemented on an integrated and coordinated international basis in order to realize the greatest added value and efficiency.

One sure thing is that the nature of market making has changed, with HFT now providing the bulk of such activity in equities.

Bottom line

It is a safe assumption that technology will continue to play a key role in the development of financial markets, as it has in its evolution to date. Thus regulators are presented with a tough challenge: keep pace with innovation, address the potential risks it poses to financial stability and market integrity, while at the same time, not stifling advances in the development of markets.

With this in mind, one could surmise that there is uncertainty as to whether computer trading would be able to function entirely without any human intervention in the future. Why? Because as Nietzsche said, “only individuals have a sense of responsibility.”

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First of all, what is corporate governance? Corporate governance can be defined as the system by which corporations are managed, controlled and held accountable. Its principles and rules provide the framework that structure the balance of powers and alignment of interests between a company’s board of directors, its senior managers, shareholders and other stakeholders.

Why does good corporate governance matter you may ask? Well, according to the Organisation for Economic Co-operation and Development (OECD): "good corporate governance plays a vital role in underpinning the integrity and efficiency of financial markets. Poor corporate governance weakens a company’s potential and at worst can pave the way for financial difficulties and even fraud. If companies are well governed, they will usually outperform other companies and will be able to attract investors whose support can help to finance further growth.”

Over the last decade corporate scandals and even fraud cases, such as those experienced at Enron, Parmalat, WorldCom and Société Générale and
UBS, have resulted in investors’ increasing interest in improving governance of investee companies.

**Governance developments since the financial crisis**

Since the financial crisis in 2008, there has been a renewed focus by regulators and politicians on corporate governance, and the role of shareholders can, and in fact must, play in order to promote improvement in governance practices as part of their fiduciary duty.

As a result several laws at both the national and EU level have been passed or are being discussed, and governance codes have been and continue to be updated. The common thread behind most changes is for increased supervision and control over company management and greater accountability of directors.

This has resulted in the following developments:

- Raising the bar on transparency requirements, e.g. executive remuneration, board diversity and independence;
- Greater shareholder rights, notably with say-on-pay votes and more frequent director elections;
- EU audit reform, which introduces mandatory auditor rotation and a cap on non-audit fees;
- Better board efficiency and independence, through limitations on board memberships, diversity targets, and independence rules.

The table on page 18 shows a summary of important changes in large European countries over the past several years. It is clear that all countries did not start at a level playing field, and noteworthy that changes made in Italy, Spain and France were more significant, and not focused on the same issues as, for example the UK.

**Review of the 2014 European proxy voting season**

In analyzing the voting patterns this year at over 700 European companies, a recent study conducted by Institutional Shareholder Services Inc. (ISS) highlights several key topics, including: voter turnout, company disclosure, annual general meeting agendas and voting results.²
Shareholder participation – the proportion of a firm’s shares actually voted at AGMs – continues to rise, reaching 65.8% in 2014 vs. 60.4%. While national regulatory codes and investor best practices have incentivised investors to fully integrate voting at AGMs as a component of fiduciary responsibility owed to clients, the roll-out of the EU Shareholder Rights Directive in 2012 has also eliminated some of the obstacles to cross-border voting, such as share-blocking. This enables investors to more easily exercise their voting rights. The UK, France, Luxembourg and Portugal are the markets where shareholders vote the most, with voter turnout above or nearly 70%.

On company disclosure of full voting results, transparency continues to improve also, with levels of vote results now reaching over 94% from only 83% in 2008. This has been driven in part also by the EU Shareholder Rights Directive, which seeks to harmonise levels of post AGM reporting across member States. We note, however, that in a market like Sweden, results remain relatively secretive, with companies only indicating whether resolutions were passed, and without specifying any specific percentage levels of support or dissent.

In terms of AGM meeting agendas the number subjects put forward to shareholders for decision continues to rise, with the number of resolutions reaching an all-time high of 14.5 votable items per AGM on average, a 20% increase since 2008 (please see figure 2). This is due to both changes in corporate governance standards and regulatory obligations, requiring greater accountability and transparency from corporates, such as “say-on-pay”, for example.

We note that the average of 14.5 resolutions per AGMs masks a wide disparity across Europe with three countries breaking or nearly breaking the 20 resolutions per AGM threshold. They are France, Denmark and Switzerland. The latter, with an average of 23 resolutions per AGM or twice as many as last year, is evidently a special case, given that an advisory vote on executive remuneration and the annual election of directors became obligatory for the first time this year.

In terms of AGM agenda topics up for approval by shareholders, director elections represent over 30% of resolutions, a 23% increase over the last seven years. Resolutions pertaining to changes to the capital structure and management remuneration, both represent 15.1% and 10% respectively, and rank second and third place by total number. It is noteworthy that as a proportion of all resolutions, those related to executive compensation have nearly doubled over the period. Finally, resolutions presented by shareholders have remained nearly constant over the period, representing close to 1.0% of the total.

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**Figure 1: Recent governance changes country by country in Europe**

<table>
<thead>
<tr>
<th>UK</th>
<th>France</th>
<th>Germany</th>
<th>Spain</th>
<th>Italy</th>
<th>Netherlands</th>
<th>Switzerland</th>
<th>EU wide</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Say on Pay</strong></td>
<td>Binding since 2014</td>
<td>Advisory since 2014</td>
<td>Voluntary, and consultative since 2009</td>
<td>Advisory since 2011</td>
<td>Advisory since 2012 (binding for banks)</td>
<td>=</td>
<td>Binding from 2015</td>
</tr>
<tr>
<td><strong>Audit quality (non-audit fees, rotation)</strong></td>
<td>=</td>
<td>=</td>
<td>=</td>
<td>=</td>
<td>=</td>
<td>=</td>
<td>=</td>
</tr>
<tr>
<td><strong>Overboarding</strong></td>
<td>=</td>
<td>=</td>
<td>=</td>
<td>=</td>
<td>=</td>
<td>=</td>
<td>=</td>
</tr>
<tr>
<td><strong>Female Representation</strong></td>
<td>Voluntary target (25% by 2015)</td>
<td>40% by 2016 (listed companies, law)</td>
<td>30% by 2016 (listed companies, law)</td>
<td>Voluntary 40% by 2015</td>
<td>1/3 by 2015 (mandatory by law)</td>
<td>=</td>
<td>30% (no sanction if not met)</td>
</tr>
<tr>
<td><strong>Accountability</strong></td>
<td>=</td>
<td>=</td>
<td>=</td>
<td>=</td>
<td>=</td>
<td>=</td>
<td>=</td>
</tr>
</tbody>
</table>

Source: Exane BNP Paribas estimates.

- Stable, starting from weak level
- Stable, starting from average level
- Stable, starting from strong level
In terms of voting results, ISS calculates an overall dissent rate reaching 3.9% vs. 3.5% in 2008, a percentage which has risen nearly every year over the period. This dissent rate measures the percentage of shares voted that are not supportive of a particular management proposal, and counts both “against” and “abstain” votes.

Resolutions actually rejected by shareholders remain small in number with a total of 43 out of over 12,000 registered in the 700 companies comprising the study. Some notable examples include the rejection of:

- Thales (FR): supplementary pension scheme for Jean Bernard Lévy, Chair and CEO
- Saft Groupe (FR): severance payment agreement for John Searle
- Easyjet (UK): equity issue without pre-emptive rights
- ABB (CH): approve pool of conditional capital to fund equity compensation to employees
- Teliasonera (SE): approve discharge of Board and President
- Kentz Corporation (UK): approve remuneration report

As one can see from figure 3, however, these 43 resolutions only represent the ‘tip of the iceberg’ in terms of shareholder dissent. A broader measure of shareholder dissent by resolution typology takes into account those AGM items where dissent levels reached over 20%, registering those areas where shareholders have high levels of concern. The twenty percent level is considered by investors to be the threshold at which they expect an official response or action from the company, and can represents a prelude to shareholder engagement.

As can be inferred from figure 3, remuneration linked resolutions along with those related to M&A are those receiving the highest levels of opposition. Taking the example of share plans; the 12.8% number represents the percentage of share plan resolutions, where 20% or more shareholder votes opposed the resolution.

**Recent developments and outlook**

At the EU level there are notable developments on the legislative agenda, which should help shape the evolving outlook for governance in the next few years.

Regarding remuneration there are both measures affecting all European listed companies, and additionally those specifically focused on the financial sector. Regarding executive remuneration and in particular “say-on-pay” the European Commission published in April 2014 a revision to the Shareholder Rights Directive, which includes proposals that would give shareholders a binding vote on executive pay policy every three years and an annual non-binding vote on how the policy has been implemented. As these proposals must still be negotiated with both the European Parliament and The European Council, final provisions are not likely to be finalized until 2015. Given that only a few countries have binding votes on pay, corporate lobbying against a pan-European requirement will be intense. For the financial sector the CRDIV (Capital
Requirement Directive) has already introduced rules putting a ceiling on bankers’ bonuses at 100% fixed salary, with an increase to 200% allowable only by shareholder approval.

Regarding board diversity the European Commission proposed legislation in November 2012 mandating companies to have boards composed of 40% women by 2020. A year later the European Parliament voted in favour of the text and although it now goes to the European Council there is a strong likelihood it will be adopted.

On average European companies have boards which are dominated by men at the level of 82%, but once again disparity of practice is high. As seen in the figure above, in Italy percentage reaches nearly 90%, whereas, perhaps unsurprisingly the rate is closer to 60-75% in the Nordics. Overall, board diversity in terms of gender, but also in terms of nationality, age and competency, still leaves room for improvement. The debate on whether quotas are the answer is not fully closed, but in any case, companies are already anticipating the legislative agenda, by looking outside their traditional pool of candidates, as they renew their boards.

Finally, regarding reform of the audit framework for companies the EU Commission initially made far-reaching proposals for a new Regulation and a Directive on auditor independence and quality. The Directive was approved by the member states in April of this year. Both the Regulation and the Directive are expected to come into force in the next two years, after publication. The key characteristics are as follows:

- Mandatory auditor rotation: every 10 years with member states permitted to allow extension of 10 years. In the case of companies undergoing a dual audit the extension may be for up to 14 years. A transitional period of up to
In terms of AGM meeting agendas the number subjects put forward to shareholders for decision continues to rise.

6 years will be introduced for auditors with tenures in excess of 20 years.

- Prohibition against non-audit services: this constitutes an extension of the existing list, which now also includes most tax-related advice, internal control, financial and investment strategy, working capital and cash management.

- Cap on no-audit fees: for the remaining consulting services allowed the fees generated may not exceed 70% of the 3 year average of statutory audit fees.

- Competition: contract clauses obliging audits by the “big four” (KPMG, PwC, Ernst & Young, Deloitte) are prohibited.

- Transparency: auditors will be required to produce more detailed audit reports, for the benefit of investor comprehension, including any critical judgments, which might be merited.

1 www.oecd.org/daf/ca/corporategovernanceprinciples/
Four years after Olympus: Japan’s dynamic progress towards improving corporate governance

HENRIKE KULMANN EXAMINES THE IMPACT OF THE CORPORATE GOVERNANCE REFORMS IMPLEMENTED BY PRIME MINISTER SHINZO ABE AND DISCUSSES THE CHANGING FACE OF CORPORATIONS IN JAPAN.

Since 2013, Japan has embarked on a journey aimed at enhancing companies’ corporate governance practices and taking concrete steps to drive positive change. The Economist calls it “a revolution in the making”.

After a period of corporate scandals between 2010 and 2012, with the Olympus accounting scandal being one of the most prominent cases attracting significant media attention, there has been a substantial shift from the past. Back in 2012, we were hopeful that the Olympus case would act as a catalyst to drive future reforms (see ESG Matters, March 2012) and argued that reform, i.e. to improve board effectiveness, was needed to restore investors’ confidence and ensure Japan’s competitiveness in the global market.

Three years after our first article, corporate governance reform is now at the heart of Prime Minister Shinzo Abe’s financial revitalization strategy. Based on this, we are now seeing regulators, the Tokyo Stock Exchange (TSE), and companies taking action. The ultimate aim of reform is not to simply enhance corporate governance but to
boost companies’ profitability and productivity, and achieve a continuous rise in corporate value. Main focus areas include return on equity (ROE) increase, board reform, as well as an unwinding of cross-shareholding structures which are considered to be an origin for low returns and a culture of complacent managers.

The key initiatives of Abenomics “third arrow” include;

1) **Amendments to the Companies Act:** enacted on 20 June 2014 and will come in to effect on 1 April 2015. A new comply-or-explain rule on outside directors will effectively make the appointment of outside directors the norm for listed companies. In addition, it establishes a new framework for companies with audit committees and other committee structures. In essence, the changes are aimed at promoting the use of the outside director roles to improve board oversight.

2) **Principles for Responsible Institutional Investors:** Japan’s Stewardship Code which is based on the UK model and was issued by the Financial Services Agency (FSA) to promote investor and company dialogue, and also to prevent short-termism. Since February 2014, 184 institutional investors, including Allianz Global Investors, have signed up and agreed to the comply-or-explain based system. Importantly, the Japanese Government Pension Investment Fund (GPIF) supports the Code and thus, acts as a catalyst for a wide adoption amongst institutional investors. Signatories are expected to engage constructively in order to sustain growth in companies. Together with the Corporate Governance Code, which is aimed at corporations instead of institutional investors, we believe Japan has set the foundation for meaningful dialogue between investors and companies. The Principles for investors and the Code for corporates are indispensable to one another and should set the stage for a constructive dialogue.

3) **Corporate Governance Code:** will take effect on June 1, 2015. It sets out behavioral guidelines for listed companies. The final draft of the Code has been adopted by the Council of Experts of the FSA on March 5, 2015 following a period of public comments. The Code is based on the following five core principles:
   - Protection of shareholders’ rights
   - Incorporation of other stakeholders and sustainability factors

<table>
<thead>
<tr>
<th>Shareholder returns distribution ratio</th>
<th>Total shareholder return ratio breakdown</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dividend</td>
<td>Share buybacks</td>
</tr>
<tr>
<td>Japan</td>
<td>81.5%</td>
</tr>
<tr>
<td>US</td>
<td>42.1%</td>
</tr>
<tr>
<td>Europe</td>
<td>75.7%</td>
</tr>
</tbody>
</table>

Source: Nomura, based on company data and Bloomberg data. Note: Japan: all listed companies. US: S&P500, Europe: Bloomberg Europe 500. Japanese data is fiscal year basis, US and Europe data is calendar year basis.

### Figure 1: Difference in shareholder returns for Japan, US and Europe (CY13, FY13)

<table>
<thead>
<tr>
<th>Shareholder returns distribution ratio</th>
<th>Total shareholder return ratio breakdown</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dividend</td>
<td>Share buybacks</td>
</tr>
<tr>
<td>Japan (TOPIX)</td>
<td>5.0%</td>
</tr>
<tr>
<td>US (S&amp;P 500)</td>
<td>15.5%</td>
</tr>
<tr>
<td>Europe (Bloomberg European 500)</td>
<td>10.2%</td>
</tr>
</tbody>
</table>

Source: Nomura, based on Bloomberg and company disclosures. Note: 1. Japan data for fiscal year; US and European data for calendar year. 2. Financial stocks (as classified by GICS) are excluded from each index. 3. Data on shareholders’ equity and total assets as of fiscal year-end.

### Figure 2: The low ROE of most Japanese companies is mainly the result of low sales margins rather than leverage
Positive trend to continue to help improve capital efficiency. We are already seeing improvements on various sides and expect this lower end of the global corporate governance spectrum. Our research report on the Ito-Review, published in August 2014, makes recommendations to companies on improving board composition and structure, which requires companies to have at least two outside directors. This new option should facilitate the appointment of external directors due to the risk of a conflict of interests.

The Code will be incorporated into TSE regulations with the revisions taking effect at the same time as the Code. As a result, companies will have to explain non-compliance with the Corporate Governance Code going forward. Listed companies will have to provide explanations in their corporate governance reports without delay after annual general meetings (AGMs), and within six months of the first AGM in or after June 2015. For example, companies with June 2015 AGMs will therefore publish their first corporate governance reports to comply with the Code and new listing rules in December 2015. While disclosure based on the Code’s principles is only going to start towards the end of 2015, we do expect this to be a topic for the upcoming 2015 proxy voting season in Japan with shareholders asking companies about companies’ disclosure plans and addressing potential issues of non-compliance to the Code.

4) **JPX-Nikkei 400 index**: launched in January 2014 and emphasizes ROE and governance factors. It takes into consideration whether companies have adopted the IFRS and monitors outside director appointment (one or two outside directors minimum). GPIF has plans to introduce this index as the new benchmark for part of their passively-managed domestic equity portfolio, replacing TOPIX. We believe this is vital to ensure the widespread uptake of the index. There is reportedly a keen interest amongst companies to be included. To give an example, Amada has made substantial changes to its capital and shareholder return policies to qualify for the index.

5) **Ito-Review**: compiled by the Ministry of Economy, Trade and Industry (METI) in August 2014. Similar to the Kay Review in the UK, the report on “Competitiveness and Incentives for Sustainable Growth: Building a Favorable Relationship between Companies and Investors” makes recommendations to companies seeking to raise corporate value and generate continuous growth via investor dialogue and capital procurement. The review recommends that Japanese companies should “commit to achieving a minimum ROE of 8% and identifies low profitability as the root cause for low ROE in Japan.**

Embedded in the government’s growth strategy, these initiatives and rules should help to move Japan upwards from the currently lower end of the global corporate governance spectrum. We are already seeing improvements on various sides and expect this positive trend to continue to help improve capital efficiency.

**Increasing ROE**

There are now three benchmarks in terms of ROE which are relevant for Japanese listed companies: 1) Proxy voting advisor ISS set an average ROE of a minimum of 5% over the past five years in its reviewed guidelines for 2015 and recommends voting against proposals to appoint board members if that criteria is not met. Around 16% of companies with a market cap of JPY 100bn or above might not meet this benchmark. 2) The Ito-Review recommends an 8% ROE. An ROE comparison between Japan, the US and Europe shows that there are no major differences in terms of financial leverage and asset turnover. Thus, in order to raise margins, Japanese companies have an incentive to expand overseas and look for M&A opportunities with a focus on corporate restructuring and increasing profitability. At the same time, measures such as share buybacks and capital policy are important to improve shareholder returns. 3) For the companies listed in the JPX-Nikkei 400 index the average ROE of constituent stocks was 11.2% (FY 2011-2013). Since Japanese companies are interested in qualifying for the index, we believe it is likely that a growing number of companies will aim to grow their ROE to double digits in the medium term.

**Improving board efficiency**

Over the last few years, we have seen an increasing number of Japanese companies appointing outside directors. Compared to 2012, we there has been a rise of about 15% to 70%. Amongst the top 100 companies based on market cap, only two have not done so yet. An amendment to the Companies Act on 20 June 2014, which will come in to effect on 1 April 2015, sets new rules regarding outside directors. Going forward, listed companies with no outside directors appointed will have to explain at their AGM why appointing an external director would not be appropriate. With no transitional measures, this will apply to the approximately 70% of listed companies that will hold general shareholders’ meetings in June 2015. The purpose of appointing outside directors is to increase the supervisory role of the board of directors. Furthermore, the Companies Act changed the definition of outside directors: directors of a parent company, executive directors of affiliated companies, and certain close family members of directors may no longer be appointed as outside directors due to the risk of a conflict of interests.

In addition, the revision introduces a new corporate governance structure for large public companies via an audit/ supervisory committee. This new option should facilitate the appointment of outside directors and provides an alternative to the existing system with a board of statutory auditors – the kansayaku system (Note: since 2003, companies can also opt for a US-type three committee structure, which requires companies to have a least two outside
There is no requirement for statutory auditors, instead three or more directors (majority external directors) will audit the management of the company when appointed as audit/supervisory committee members. While companies with a kansayaku board will need to have at least four outsiders, those with a supervisory board can have a minimum of two. Starting in 2016, we could see an increase in the number of companies changing to the new supervisory committee structure. Since directors are appointed for a two year term, instead of one year, they should be in a better position to audit and supervise effectively. Since committee members are also directors, they have voting rights at board meetings and can request reports on the business, investigate operations and financial issues of the company. Overall, these measures should positively impact board effectiveness and help to increase transparency of board practices.

Unwinding of cross-shareholdings

When the Japan Revitalization Strategy 2014 was published, it also formulated the goal to work towards the unwinding of cross-shareholdings, a common occurrence in Japan. With few exceptions, cross-holdings are harmful because partners usually do not disagree with each other. They also impair capital efficiency as companies tend to buy shares of other listed companies instead of investing it in factories or in acquisitions. The Corporate Governance Code addresses this and will ask companies who hold shares of other listed companies as cross-shareholdings to disclose their cross-shareholding policy with an explanation from the board detailing the objective and rationale of the cross-shareholding. In addition, companies should set and disclose policies related to voting rights as to their cross-shareholdings. Currently, companies disclose related information in their security filings and often use a boilerplate to explain its purpose. It remains to be seen if firms will make a real effort in providing more details. Some companies may decide to sell shares when convincing arguments to continue ownership cannot be made – especially as we expect engagement activity to get into full swing. The investor community is already seeing an increase in the number of companies that are prepared to engage. The latest example of a change in attitude is Fanuc – known to be one of Japan’s most insular companies. On 13 April 2015 President Yoshiharu Inaba announced that it will set up an investor relations department and that it will change direction in favour of shareholders including possible buybacks and higher dividends. This announcement caused a 13% jump in share price at the day of the announcement and should send a clear signal to other corporates.

We are optimistic that more Japanese companies will start changing their attitude to shareholders and improve their corporate governance practices going forward. The foundation is set and it is now up to the companies to act.
The investor community is already seeing an increase in the number of companies that are prepared to engage.

“...”
Please find below biographies of the contributors to this edition of ESG Matters:

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Bozena is a Director and the Global Co-Head of ESG with Allianz Global Investors, which she joined in 2000. Being the co-head of the firm’s Environmental, Social and Governance (ESG) team, Bozena is responsible for directing the firm’s global ESG research platform which supports both specialist SRI funds and ESG integration. Bozena also leads the firm’s efforts to provide insights into sustainability issues, and establishes and manages research partnerships within the firm and with external research institutes and academic institutions. In 2006, she was responsible for the design, launch and management of the Global Ecotrends Fund which became a significant global fund franchise reaching assets under management of EUR 1bn. Between 2012-2014 she was Chair of the UK SIF Analyst Committee and is representing Allianz Global Investors on the Cambridge Institute for Sustainability Leadership Investment Leaders Group. She previously worked at John Laing PLC as their business and environment advisor. Bozena has a B.Sc. in Environmental Science from the University of Sussex and an M.Sc. with distinction in Environmental Technology from the Imperial College of Science, Technology and Medicine. In 2009, she was named as a Financial News Rising Star in Fund Management.

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Verity joined AllianzGI in 2006. She is responsible for publishing ESG research with a primary focus on technology stocks. In addition, she is a member of the AllianzGI San Francisco Proxy Voting Committee. Verity joined AllianzGI’s ESG Research team in 2011 as an analyst covering US stocks. Previously, she was a Senior Portfolio Associate on the US Large Cap Equity Portfolio Management team. Prior to AllianzGI, she worked as a research assistant at small-cap investment advisor Hoover Investment Management. Her career began at The Financial Relations Board, an investor relations consultancy. Verity received her bachelor’s degree from Mount Holyoke College. Verity serves on the Advisory Council of the Sustainable Accounting Standards Board and is a member of the US SIF Social Investment Research Analyst Network.

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