Schroders

UK Corporate Governance, Voting and Stewardship, January – March 2013

This note comments on corporate governance issues and provides examples of corporate governance and stewardship activity by the UK office of Schroders at UK companies during the period January to March 2013.

General approach to engagement and corporate governance

As in previous reports, the following paragraphs illustrate our approach to engagement with companies and our views regarding disclosure of that engagement.

The aim of all stewardship activity by Schroders is to enhance the value of the funds managed for clients. To achieve this aim, we find it essential to take a pragmatic approach in terms of how we deal with companies and how we report our engagement with them. We believe that additional value is created by engaging with and if necessary encouraging change at companies but recognise asset allocation and selection of individual stocks may have a greater impact on the returns in a client's portfolio.

These reports on voting, engagement and corporate governance are necessarily brief and generally hide the names of the companies involved and only provide a sample of activity. We believe it necessary to avoid conducting public discussions if change might involve a climb-down by the company: it is generally preferable for companies (indeed, for any person) to accept and agree with change rather than to have it forced upon them. Publicising concerns about a director or the board of an organisation will be destabilising to the company, may damage our ability to conduct constructive discussions with any company in future, may damage the value of a company and may discourage talented individuals from becoming members of listed company boards. Further, particularly where Schroders manages shares comprising a significant proportion of a company's share capital, it is not in clients' interests to disclose details of the engagement Schroders must inevitably have with these companies.

There are occasions, however, where it is appropriate to reveal contact with companies, particularly in high profile cases or where we have taken a stance that requires explanation and justification.

Schroders also produces reports on engagement with companies on corporate and social responsibility. These reports are available from client directors or our SRI specialists.

Corporate Governance Policy

The Schroders 2013 corporate governance policy and our statement regarding our compliance with the UK Stewardship Code 2012 are both available on the Schroders' Internet site.

Selection of Company Contacts

Company A

We requested a meeting with the chairman of a company in which we have a material holding. We had conducted some engagement with the company in recent years, as a result of which it had made some changes regarding the governance of the company. Accordingly, it was appropriate to meet the chairman again. The meeting was wide-ranging in scope and covered strategy, performance, operational issues and board and management succession.

The debate and on-going engagement was, we believe, a model of shareholder stewardship involving challenge, consideration of alternative scenarios, risk and the potential of the business to improve.

Over recent months, performance of the business has improved, accompanied by an increase in the share price.

Company B

A company had previously announced the retirement of the CFO and identified his replacement from within the company. The transition was to be over several months. We suggested to the company that the long handover was not required and – more importantly – had the potential to lead to inefficiency for staff and shareholders alike as parties tried to identify who would be responsible for business issues. The chairman was sympathetic to our comments and noted that the CFO-designate was undertaking planning for 2013/2014. The chair noted the board would be discussing the matter and our comments would be passed to the board.

Subsequently, it was announced that the current CFO would stand down as CFO and from the board and the successor appointed at an earlier date, but would remain with the company until the originally planned date. We view this as a sensible outcome, with the new CFO assuming nominal and actual control but with the outgoing CFO remaining available to smooth the transition.

Company C

A company sent us a copy of the draft AGM notice, for our information. We responded that we would oppose the powers to issue shares and the re-election of the CEO. Our reasons to oppose these resolutions were concerns that the company was too acquisitive and had consistently over-looked poor performance at a core business. These points have been raised regularly with the CEO of the company for some years, with the previous chairman and with the recently appointed chair. As a result of our threat to vote against, the chair asked to see us.

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The meeting was helpful in that the chair set out the steps the company is taking on the areas we are concerned with. The constructive reaction of the chair allowed us to agree to vote for all resolutions except the power to disapply pre-emption rights on the issue of shares for cash on which we will abstain. We will be able to monitor the progress the company makes and continue engagement with the company, particularly if there are areas where the company falls short. It was disappointing that we had to use the threat of voting against to draw greater attention to the weaknesses of the business but the prompt reaction of the chair was positive and we hope there will be a successful outcome over the longer term.

Company D

We were consulted by a company regarding the pay structure for senior executives. The proposals included a significant salary rise for the newly appointed CEO. Our focus in discussions with companies about pay is usually on how pay is aligned with performance. In this case, the company proposed a salary increase of over 20%, justified by the CEO's new appointment to the role, the rate in the market, the pay levels of executives already at the company and a reduction in the maximum bonus opportunity. These arguments were strong and in the past, would usually have been accepted by shareholders with little objection. The environment, however, has changed. We objected to the increase and accordingly met the chair of the board's remuneration committee. We recognised the strength of the company's arguments but insisted that significant increases in salary were not justifiable. We preferred to see the previous bonus maximum retained with a lower salary. After some discussion, we accepted that the CEO could not be paid less than other executives on the board and given the promotion of his role, we accepted an increase of 8%. We also indicated that we did not expect to see the salary automatically increase to the level originally proposed but have to recognise that if the environment changes and/or salary levels increased, there may be increases ahead of the rest of the workforce.

The company subsequently implemented the 8% salary increase as well as cutting the maximum bonus level. The company deserves credit for its pragmatism.

Company E

We attended a group dinner with the chair and non-executives of one of the UK banks. The dinner provided an opportunity to question chairs of the various committees – including audit, remuneration and risk - on the operation and work of the committees and governance of the banks.

In this case, it is our view that the governance of the company deserves the support of shareholders.

An area of concern regarding governance may become the workload on the boards – board meetings having 60 items on the agenda, 600 pages of documentation for the board alone with further paperwork for the board committees. The individuals on this board are intelligent, talented individuals with a great deal of bandwidth and are good communicators (as recipients and givers of information) but how boards manage this workload is an issue to be considered into the future.

Company F

We met the chair of a company who is also a major shareholder. The share price of the company is significantly below the net asset value. Whilst we understand the need for the business to invest for the longer term, the discount of the share price to net asset value is long running. We suggested that the company use cash to buy-back shares, in order to generate a return on capital significantly above the company's current returns and to signal to the market that the company is seeking to narrow the discount and address a perception that the business is run in the interests of the chairman The issues were debated with the chairman but he generally disagreed. He wished to retain cash in order to invest in further assets.

This engagement with the chairman has been running for some years but the chairman is showing little sign of being receptive to the wishes of shareholders generally. However, whilst returns on capital are far from optimal, the company does generate some returns and the chairman is unlikely to tolerate losses for any period of time.

Company G

We met another shareholder of a company in which we both have significant interests. The other shareholder has been agitating for faster change at a company but we have been more supportive of management. We continue to disagree but at least have on-going contact to discuss developments at the company.

Company H

We met the chair of the remuneration committee of a company regarding the performance conditions attaching to variable pay (both annual bonuses and long term incentives). Although the discussion was on pay, it was a proxy for a wider issue regarding business risk.

Pay is currently closely linked to earnings per share performance. The company's business model has involved many acquisitions and we are concerned that rewarding acquisitions – rather than the returns generated on those acquisitions over the longer term – may encourage acquisitions that carry too much risk and/or are ultimately destroying value. The company has introduced a returns-based metric to some of their pay but we would prefer to see all or at least a greater

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proportion linked to returns. The company did ask us to let them know of companies using returns based measures: whilst they have not accepted our arguments, it is positive that they are at least considering the issues.

Company I: Bumi plc

As highlighted in the press, we were supportive of resolutions put forward by Nat Rothschild to change the board at Bumi at a recent EGM. The resolutions were defeated and we are therefore now supporting the efforts of the board to effect a separation of the interests of major shareholders connected to the Bakrie family and independent shareholders. The EGM was clearly in favour of the board. We believe it would be damaging to maintain a continuing hostile stance. When separation proposals are published, we will review them and we hope that we will be in a position to be able to vote for them. We have communicated those views to the Bumi board.

Company J

We met the chairman of a major bank and discussed the company's new strategy, performance, risk, regulation, pay, governance and board membership. We also raised how the bank was handling the hostile public and political atmosphere and various reviews on the company, the company's board and/or banking.

Company K

During one of the regular 1:1 visits by a CEO recently appointed to a company, we welcomed the changes he has identified that need to be made. It follows several years of questioning the company at various levels.

Amongst the changes to be made and for which we have expressed our support are a more disciplined approach to capital expenditure – more rigorous hurdles on investment, for example; a recognition that returns to shareholders have been (at best) disappointing; and, a recognition that the company's record on acquisitions has been poor. The new CEO was exploring with shareholders where the balance lay between continuing investment and providing cash to shareholders: it musty be noted that we are not seeking to prevent a company investing in projects that will generate good returns for shareholders but that hurdles must be in place to ensure that where investments are made, proper returns are generated.

We confirmed that returns to shareholders have been poor with the company having undertaken value-destroying acquisitions, to which we had objected. We also welcomed steps the company will take to cut costs which have grown significantly in recent years.

Company L

We met the chair of a company where the CEO has been a critical part of the company's success. Succession planning is therefore a key issue. The chair is aware of the risks but considers the CEO will remain for several more years. The chair also noted there were options regarding succession.

We questioned the level of capital expenditure. The chair justified the level on the need to provide sufficient competition but that tight control was maintained on expenditure, with checks and balances. Recent investment in a new business area provided a "huge opportunity". The comments were not reassuring and we will continue engaging with the company.

Company M

We met one individual to question the number of boards on which that person served. We were concerned that the number of roles held were a risk to each. We received assurances that no company had suffered due to the multiplicity of roles: it was also claimed that there were special factors at each company, including the working relationships with executives on the boards. The individual accepted we were right to raise the question but was not open to changing his view.

It is a matter we will keep under review.

Company N

We were consulted by a small company on a new pay plan for the executives. The company did not intend to submit the plan to shareholders because it is not required under AIM rules. Since performance related pay may have an effect on behaviour, we are keen to see companies submit plans to shareholder approval, even if AIM listed. The timing of the consultation was frustrating since the company's AGM was a few days away: we viewed this failure to seek shareholder approval as sufficiently serious that we voted against the power of the company to issue shares at the AGM.

The plan on which the company consulted its largest shareholders was reasonably modest, even taking account of the company's size. The proposals rewarded the achievement of absolute total shareholder return. Whilst we have been supportive of these plans in the past, in this case we considered that an emphasis was needed on returns on capital and economic profit in order to ensure that the company would not undertake damaging acquisitions and to ensure that performance of the business was properly measured.

We discussed the proposals with the chair of the remuneration committee and made clear our objections. We also spoke to another significant shareholder and encouraged them to object. Despite that, the company went ahead with the

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proposals.

We will vote appropriately at next year's AGM, if we continue to have a holding.

Our objections did at least provide an opportunity to signal to the board and the executives our concerns regarding the management of the company's portfolio.

Company O: RSA Group

During a meeting with the chair of the company, we questioned the resignation of auditors Deloittes in order for Deloittes to undertake substantial consultancy work. The chair explained that whilst Deloittes were auditors for 2012, they were the best firm – by far - to complete an important IT project in Scandinavia. It is also relevant that the chair was, until recently and prior to his appointment as chair of RSA, chairman of Deloittes in the UK. However, after discussion, we have accepted the RSA explanation for the role of Deloittes.

Deloittes have been replaced by KPMG for 2013.

Company pay consultations

In the course of consultations on pay, we held a series of meetings or telephone calls with the chairs of the companies and/or their chairs of remuneration committees, in addition to the contacts noted above. A regular theme was ensuring the link between pay and performance. We are concerned that a number of companies are moving to pay based on performance metrics that are not sufficiently (or at all) aligned with the interests of shareholders. These include performance conditions based on highly subjective measures: one of our fears is that the discretion provided to some remuneration committees and the woolly nature of these conditions provides the foundations for a series of payments in future where the non-financial conditions will provide rewards notwithstanding that the long term value of the business may have suffered.

These types of condition are often merely inputs: our concern is to ensure that companies produce adequate outputs.

A further trend is for limited or no disclosure of the targets for performance conditions. We believe it is a matter of principle that we cannot support pay long term pay schemes unless the performance conditions are disclosed in full. It is a necessary part of confirming that there will be an alignment of pay and performance.

Some companies promise that the performance conditions will be disclosed after completion of the period over which performance is measured. We obtain no comfort from that stance: if the directors who set poor performance conditions have retired during the performance period, shareholders will be unable to vote on their re-election at AGMs, thus removing an element of accountability.

Companies may claim that the performance conditions they will use contain commercially sensitive data. We disagree: it is then either a case of managing communications with shareholders to make clear the difference between an incentive pay scale and expectations of performance; or, competitors will be find it difficult to determine what a company is doing from a small number of financial target ranges.

UK Stewardship Code 2012

In January, we published our latest statement of compliance with the UK Stewardship Code. The statement is at http://www.schroders.com/global/about-schroders/corporate-responsibility/responsible-investment/uk-stewardship-code.

Investment and Corporate Governance Policy 2013

We have also published a new governance, stewardship and voting policy, at http://www.schroders.com/staticfiles/Schroders/Sites/global/UK-Corp-Gov-Policy-B.pdf. The policy is broadly unchanged but does contain a greater focus on the need for the boards of companies to perform and to be responsible for performance.