

Corporate Governance, Voting and Stewardship, July – September 2012

This note comments on corporate governance issues and provides examples of corporate governance and engagement activity by the UK office of Schroders during the period July to September 2012. The examples cover activity linked to voting and engagement with companies outside day-to-day investment contact.

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 engagement on governance 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.

Our 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 climbdown 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, 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 corporate governance policy and our statement regarding our compliance with the UK Stewardship Code are both available on the Schroders' Internet site.

We have reviewed our policy document and will shortly be publishing the revised policy. It will be available from the Schroders website.

The policy defines how we vote as well as addressing our role as stewards. The policy is global in that it is applied to all companies, wherever based. It is in the implementation of the policy where there will be differences which take account of local markets: thus, for example, governance standards in emerging markets generally require a certain amount of greater flexibility than in the UK. Since the policy is global, it is therefore separate from our statement covering the UK Stewardship Code.

The changes to our policy are primarily to emphasise the importance we place on the leadership of companies and in particular, that boards of companies must review performance of the boards and the role and performance of individuals and make appropriate changes if necessary.

We have also reviewed our voting universe and determined that we should automatically follow the recommendations of the third party organisation we use to process our voting instructions when voting at companies where the interests we control are a small percentage of a company's share capital. The level at which this policy will be applied is determined by materiality as far as the company is concerned: a 0.01% percentage holding is immaterial in terms of permitting a shareholder to exercise influence in discussions with a board. Further, we found that the number of cases where our voting differs from that of the third party adviser for these low percentage holdings were small. In the case of widely diversified quant funds, in particular, it is also the case that the third party may have greater knowledge of the company concerned. We will retain power to override the third party recommendation, particularly where the relevant holdings form part of a larger holding in a company or where the issues and/or size of the company are important and material.

The UK Stewardship Code has recently been updated. We will therefore update our statement of compliance with the UK Code and publish it on our website.

Selection of Company Contacts

Company A

A company had recently appointed a new chair. Shortly after his appointment, the CEO had resigned. Since the new chair had now been in the role for several weeks, we asked to meet him to discuss performance, the role of the board and what he looked for in a new CEO.

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We discussed the board changes and, in response to a specific request, agreed to be taken inside (and therefore, for the avoidance of doubt, to immediately add the company to our stop list) on the grounds that the announcement of the identity of his proposed CEO may affect the share price.

We were accordingly informed of the name of the candidate. After suitable due diligence, we were able to agree to the appointment. The candidate had relevant experience of the structural challenges facing the industry in which the company operates.

Company B

In August, it was announced that Sir Howard Davies was to be appointed chairman of Phoenix Group Holdings. Sir Howard is currently a director of Prudential plc and will remain so. Since both Phoenix and Prudential are insurers, there is clearly a potential question regarding a conflict of interest.

As holders of shares in Prudential, we contacted the company regarding the potential conflict. In response, a senior member of the Prudential's board returned our call. They outlined that the board had considered the issue carefully, that it would be kept under review and that whilst the potential for a conflict is greater in 2 or 3 years time, currently Phoenix is not competing to an extent that causes a material issue for the position of Sir Howard on the Prudential's board.

In the light of the process followed by the Prudential's board, taking account of the detail they have considered on a potential conflict and that the board will keep the issue under review, we can support the decision of the Prudential's board and support Sir Howard Davies continuing role on the board.

Company C: Royal Bank of Scotland

We had discussions with senior board members regarding the IPO of Direct Line. RBS must dispose of Direct Line due to an EU requirement following the state aid provided to RBS in 2008/09. We did not and could not object to Direct Line no longer being part of RBS but were concerned that an IPO required shareholders to buy something in which they already held an interest. There was sympathy for our view within the company but the disposal of Direct Line by a distribution of shares rather than a sale would have an adverse impact on the capital position of RBS. The IPO better-enabled RBS to continue to meet regulatory requirements for capital. Accordingly, since regulators may be hostile to anything other than an IPO, the board had little choice.

Company D

Another shareholder has acquired a significant stake in a company and is pressurising the company's board to improve performance. We do not agree with a number of the proposals from the shareholder because, for example, some of the solutions will not be effective or may simply be damaging. We have, nonetheless, maintained contact with the shareholder and wish to maintain a constructive relationship. We both control a material proportion of the company's shares but it provided an illustration of shareholders holding very different views.

Company E

We asked to meet the chairman of a company which has under-performed, partly due to a poor service levels for customers.

The meeting was helpful in that the chairman had identified relevant shortcomings in the business and a succession process to replace the chief executive was underway. The weaknesses were more operational than strategic, which a new CEO would be better equipped to resolve.

Company F

Our analyst had identified shortcomings in the method used to calculate returns at a company. The method had the potential benefit for executives of reducing the thresholds required in order to obtain performance related pay. We raised the matter with the company and had a number of discussions with them, at senior executive and non-executive levels. The company agreed to review their process and discussed their findings. In conclusion, they have amended their process and in doing so, addressed the key issues of concern. Accordingly, we anticipate being able to support the board. In coming to that view, we believe that the board had not adopted the previous policy with the intention of benefiting the executives.

Company K: Xstrata/Glencore

During the quarter, it was unclear if the merger between Glencore and Xstrata would occur. On 1 October, it was announced that a revised structure would be implemented. We remain opposed to the transaction, notwithstanding the improved terms for Xstrata shareholders. It is the view of our fund managers that Xstrata shareholders are not adequately compensated for surrendering control.

When it had appeared possible, towards the end of the quarter, that the merger might not be approved by Xstrata shareholders, we were concerned as to the future management of Xstrata and in particular, that it was important for the

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future of Xstrata that Mick Davis to be retained as chief executive. Accordingly, we contacted a number of other shareholders on the issue to seek their support and to put that view to the company.

The revised structure announced on 1 October, therefore, remains unacceptable because Mick Davis will be chief executive of the combined entity for only 6 months. Combined with the poor terms offered to Xstrata shareholders, we remain intent on voting against the transaction.

Company L: Darty

In January 2009, Darty made a share award to their new CEO. Subsequent remuneration reports noted that the award was subject to performance conditions tied to total return. However, the award vested in 2012 notwithstanding that the return targets had not been achieved. When questioned, the company explained that the award was a recruitment award (thus, made to compensate new recruits for awards lost by reason of leaving a previous employer) and that the existence of performance targets was incorrectly reported.

The incorrect report regarding the performance conditions and the poor performance of the company's share price played a major part in the remuneration report resolution being defeated at the company's recent AGM.

We were concerned about the error and felt the error did justify a vote against the remuneration report: the news that performance conditions linked to returns did not exist might have been material in affecting the behaviour of the CEO. The new chair of the company had been on the board for more than 2 years and as a member of the remuneration committee, did share some responsibility for the mis-reporting. However, after much discussion in-house, we elected to vote for the remuneration resolution and actively encouraged other shareholders to do the same. The new chair had a record of success as an executive and is clearly qualified to address performance shortcomings at the company. At a subsequent meeting with the chair, he offered his apologies.