Schroders

Corporate Governance, Voting and Stewardship, Jan – Mar 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 January to March 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.

Selection of Company Contacts

Company A

We have been engaging over recent months with a company where we feel that the board would benefit from some reshaping. Accordingly, in response another shareholder suggesting a candidate to the board, we considered there was a case to appoint 2 new board members. The other shareholder agreed. We therefore approached the company to suggest they appoint these new directors. We also lobbied other shareholders to support the appointments: all agreed. The company subsequently appointed both directors.

We are increasingly of the view, however, that since the board was weak and since the company has under-performed over a number of years, that there is a case for further change to the board. We believe that the problems for the company are more the responsibility, in this case, of the chairman and we therefore asked him to retire from the board. He does not agree and we have therefore contacted other shareholders. We are unable to represent these other shareholders in discussions with the company but we know some other major shareholders share our views and will communicate those views to the company. One major shareholder, however, whilst recognising some flaws, does not want to disrupt the company by changing the chairman at the current; time.

We continue discussions with the company and other shareholders.

Company B

A financial services company undertook a consultation on pay arrangements for the senior executives and in particular, the performance conditions attaching to the long term incentive plan. The proposed targets are based on a basket of measures: economic profit, absolute total shareholder return, short term funding, non-core assets, "net simplification benefits" and customer satisfaction. Whilst these measures are important to the overall value of the company, several of the measures may provide rewards notwithstanding that the overall financial performance of the company might decline. The mix of measures might not reflect their relative importance. We therefore object to baskets of measures as a matter of principle. It is our view that long term incentives, on which shareholders at UK companies have a periodic binding vote,

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should be closely linked to the returns that are generated for shareholders. Returns will be reflected in the TSR measure and (subject to detail) the economic profit target. The other measures are less closely linked and would therefore be measures we would oppose.

However, in the current environment, the board of the company faces a difficult task overseeing a recovery. The board, including the executives, is generally performing well and deserves the support of shareholders. Further, in response to feedback, the board did increase the elements of the LTIP awards tied to the targets we prefer. Therefore, whilst we have made our objections to the detail of the pay arrangements known to the company, we will vote for all resolutions at the AGM. Remuneration is simply one aspect of the management of a complex group which does not outweigh the good governance at a financial services company in a hostile environment.

Company C

A company has been subject to criticism recently regarding the pay arrangements of the company's executives. The company has been consulting shareholders and met some opposition. Objections include that the chief executive's salary is too high given the company's market capitalisation. We would note that the company continues to make a profit and that the market significantly undervalues the shares – which is one of the reasons the shares are held. We also believe that the company has been actively trying to engage responsibly with shareholders. Accordingly, we continue to support the board.

Company D

We continued discussions with a company regarding CEO and chairman succession.

The company has now recently appointed an executive who it is anticipated he will be a leading candidate for the CEO role when the current incumbent reaches retirement.

A successor to the current chairman has also been identified. However, the timing of the transition is currently unclear. The matter will be discussed again with the company.

Company E

We met the chairman of a company regarding the company investing in areas that we would consider to be carrying high risk, potentially damaging the value of the company and/or imposing significant liabilities over a long period. The chairman explained this had arisen partly from regulatory issues.

The discussion also covered the strength of the balance sheet.

The chairman did provide an assurance that the company is being run for the interests of shareholders. We were also informed that the company looks at returns and the cost of capital.

We also discussed new pay arrangements for the executives. The targets will shift from TSR and EPS to a basket of measures. As at other companies, we are concerned that the basket of measures (including non-financial measures) simply measure inputs rather than returns to shareholders and that the targets may not be aligned with returns to shareholders. Accordingly, it is likely we will have to oppose the remuneration report at the forthcoming AGM.

Company F

We have been engaging with a company for some months regarding the investment opportunities available to the company and a concern that shareholders were not adequately rewarded compared with other stakeholders. We had several meetings with board members, including the CEO. Our concerns were not alleviated when the reasons for the company's actions appeared to keep changing: initially, whether business partners would remain, the effect on senior staff and the strength of the company's balance sheet.

More recently, we received a call from another shareholder. They wished to see a change of executive management: we instantly agreed and learnt that the other shareholder was speaking to other shareholders.

The CEO subsequently left the company and a search has commenced for a successor.

Company G

A company appointed a non-executive director whose record as an executive at other companies had been disappointing. We therefore discussed with the chairman why the individual had been appointed and noted i) we disagreed with the appointment of that person, believing they would not be suitable for the board ii) we would vote against their re-appointment at their next AGM. Not unexpectedly, the chairman disagreed. The matter has been flagged, however, and we hope the chairman will at least feed our reaction back to headhunters.

Company H: BP

We attended a meeting, jointly with other shareholders, with the chairman and some of the non-executive directors. The

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meeting consisted of a company presentation and the opportunity to ask questions.

In the presentation, BP placed a particular emphasis on how it is changing following the Macondo deep water oil spill in the Gulf of Mexico. The board was keen to show how the culture is changing with an emphasis on safety being the overriding concern. Whether that emphasis is reflected in all safety key performance indicators is to be established but, for example, the board believes BP is being far more rigorous when hiring rigs – previously, the company might have accepted a rig subject to remedial work on defects. In contrast, BP would not reject such rigs.

There has been some questioning of the role of the chairman during the disaster and subsequently. It was therefore reassuring that during this meeting, the chairman did indeed appear to be acting as a chairman.

Company I

We have concerns regarding the intentions of a company to acquire businesses. Since evidence indicates that most acquisitions destroy value, we are understandably sceptical and asked to meet the chairman.

We believe the chairman failed to justify the plans to expand by acquisition. We were also unconvinced regarding the relatively lacklustre performance of the company over recent years. Accordingly, we suspect it would benefit the company to have a new chairman. We have raised the idea of an approach with other shareholders to the company to ask for a new chairman but thus far, other shareholders have not shared our concerns.

Company I: Easyjet

We voted for all resolutions at the February 2012 Easyjet AGM. We heard the arguments advanced by Stelios Haji-Ioannou as to why a vote against the remuneration report may be justified but we disagreed with his views. Stelios has conducted a long-running argument with the board regarding further investment in new aircraft. Whilst there are elements of his argument that may be justified, the management team at Easyjet has performed well operationally. The long-running and high-profile aspects of his campaign, the creditable performance of the Easyjet management and a series of discussions with management and advisers led us to conclude it was entirely appropriate to continue to support the board.

Company K: Xstrata/Glencore

During the quarter, Xstrata and Glencore announced a merger. As reported in the press, Schroders is concerned that the deal is not appropriate for the non-Glencore shareholders of Xstrata on grounds of pricing. In addition, the governance arrangements following the merger appear sub-optimal with the current Xstrata CEO becoming CEO of the combined group and the Glencore CEO deputy CEO. Both are strong individuals who are leading large organisations and we perceive there is a risk of conflict and/or distraction if there are 2 heads of a company.

The meetings to approve the merger are due to be held in the next quarter and it is likely that we will vote against the merger unless the terms of the deal for Xstrata shareholders are improved.

Company L

Over a period of time, our fund managers had increasing concerns regarding the integrity of a company's calculation of earnings per share and that the published EPS did not properly reflect the actual performance of the company.

A proposal by the company to base a large proportion of performance related remuneration on earnings per share therefore provided a further opportunity to discuss the company's earnings with board members. The company did not satisfy our concerns, however and it is therefore likely we will oppose the remuneration resolution – and possibly other resolutions, at the company's 2012 AGM.

Company M: Royal Bank of Scotland

In January, RBS announced it proposed to pay CEO Stephen Hester a bonus. The announcement resulted in proposals for a vote in Parliament, in response to which Stephen Hester surrendered the bonus.

For independent (of Government) shareholders, the outcome was disappointing. Hester has performed well: the challenges at RBS were and are great and his work and achievements in returning RBS to a sustainable company are considerable. He deserved a bonus. There have been weak arguments that a bonus was not deserved because the share rice had fallen but much of the fall was accounted for by regulatory decisions and issues over which Hester had no control.

The chairman of the remuneration committee and the board generally had worked in recent months to provide a great deal of information explaining the basis for decisions on bonuses and justifying the remuneration committee & board's proposed bonus. Indeed, the company has been exemplary in its efforts to communicate to major shareholders the process by which the bonus was set.

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It would be damaging to RBS if Hester left. A suitable alternative might be found but there is always a risk that a replacement would not be as capable. Further, it must be recognised that Hester's achievements make him suitable to be appointed as CEO at most companies, including higher-paying non-UK financial firms.

Following the bonus surrender, we have discussed the situation with other members of the RBS board, in particular to determine if it is possible to avoid a repeat of the events of this year. We also discussed the matter with UKFI (the agency responsible for holding the UK Government's stake in RBS). The board faces a difficult situation and there is no easy answer to ensure the situation will not arise again next year. Experience during the 1990s (when executive pay continued as a high profile subject for some years after the end of a recession) indicates the subject will remain high profile. It is to be hoped, however, that special interest groups and politicians do not choose to simply gain publicity at a cost to RBS, employees and shareholders (both private and government).

We will vote for the company's remuneration and other resolutions at the 2012 AGM.

Other issues

Meetings have been held with the FSA regarding the regulation of banks. There may be a case that in response to the financial crisis, regulators may impose restrictions on banks that reduce potential returns and therefore reduce the prospect of banks being investable. The FSA/Government are understandably concerned regarding the cost to the UK economy of the financial crisis in 2008 and are implementing measures to stop the same occurring again. It is a moot point as to where the dividing line between proper regulation and over-regulation occurs. It remains our concern, however, that there is a risk that poor returns from banks caused by high levels of regulation will, ironically, reduce the level of capital available to banks and therefore potentially undermine strengthening of the capital bases of banks.