Division(s): N/A

PENSION FUND COMMITTEE – 16 MARCH 2012

COMPANY ENGAGEMENT

Report by Assistant Chief Executive and Chief Financial Officer

Introduction

1. In December 2011, the Pension Fund Committee considered the benefits and costs of membership of the Local Authority Pension Fund Forum. The Committee decided against joining the forum but resolved to consider the priorities in relation to company engagement, at its next Committee Meeting.

2. The UK Stewardship Code was introduced in 2010 to enhance the quality of engagement between institutional investors and companies, to improve long-term returns to shareholders, and the efficient exercise of governance responsibilities. The Code sets out good practice on engagement with investee companies to which the Financial Reporting Council believes institutional investors should aspire. Institutional shareholders are free to choose whether or not to engage, but their choice should be a considered one based on their investment approach. Where stewardship responsibilities are delegated to asset managers, trustees are responsible for ensuring that appropriate policies are in place, policies are implemented effectively and transparently and that they meet the funds objectives.

3. Principle 3 of the UK Stewardship Code requires institutional Investors to monitor its investee companies. As part of this monitoring, institutional investors should:

   - Seek to satisfy themselves, to the extent possible, that the investee company's board and committee structures are effective, and that independent directors provide adequate oversight, including by meeting the chairman and, where appropriate, other board members.

   - Maintain a clear audit trail, for example, records of private meetings held with companies, of votes cast, and of reasons for voting against the investee company's management, for abstaining, or for voting with management in a contentious situation; and attend the General Meetings of companies in which they have a major holding, where appropriate and practicable.

   - Institutional investors should consider carefully explanations given for departure from the UK Corporate Governance Code and make reasoned judgements in each case. They should give a timely explanation to the company, in writing where appropriate, and be prepared to enter a dialogue if they do not accept the company's position.

- Institutional investors should endeavour to identify problems at an early stage to minimise any loss of shareholder value. If they have concerns they should seek to ensure that the appropriate members of the investee company's board are made aware of them.

4. Principle 4 of the code states that Institutional investors should establish clear guidelines on when and how they will escalate their activities as a method of protecting and enhancing shareholder value.

   - Institutional investors should set out the circumstances when they will actively intervene and regularly assess the outcomes of doing so.

   - Intervention should be considered regardless of whether an active or passive investment policy is followed.

   - In addition, being underweight is not, of itself, a reason for not intervening.

   - Instances when institutional investors may want to intervene include when they have concerns about the company's strategy and performance, its governance or its approach to the risks arising from social and environmental matters.

5. In compliance with the UK Stewardship code, the committee is recommended to consider the corporate governance activities of its fund managers, in particular the key issues for which fund managers would be expected to engage with companies, and if the policies adopted by the managers are acceptable to the Committee.

6. The Pension Fund Committee is responsible for ensuring that the fund's investment managers adopt the UK Stewardship Code. As of 6 December 2010, all UK authorised asset managers are required by the FSA to produce a statement of commitment to the UK Stewardship Code or to explain why it is not appropriate to their business model.

7. Baillie Gifford, Legal and General and UBS confirmed compliance with the Stewardship code, and continue to report compliance on their public websites. The Monitoring and Engagement Policies of the fund managers are summarised in Annex 1.

8. Following the introduction of the UK Stewardship Code, the Fund Managers were requested to include a summary of corporate governance activities, including company engagement within their quarterly reports to the Pension Fund Committee.

9. Examples of recent shareholder engagement activity noted in the quarterly reports include:

Baillie Gifford

- BHP Billiton – Health and Safety policy in developing countries. UK Bribery Act implications.
- Royal Dutch Shell – Board development in Nigeria and Alaska. Progress on permits for drilling off Alaska.
- Tesco – Impact of climate change and water scarcity, relationships with small suppliers and building a resilient supply chain. US Unions and food safety in China.
- Ashtead Group – Remuneration
- IG Group Holdings – Non-Executive directors, nomination process, succession planning and length of tenure.

Legal and General

- FFD - Wrote to 6 UK companies and collaboratively to 25 global companies, most exposed to impacts on forestry to request disclosure of their footprint through the framework of Forest Footprint Disclosure.
- Rank Group Plc – Protection of shareholder rights related to takeover bid.
- Easyjet – EGM proposal of major shareholder and company results.
- Sports Direct – acquisition of properties from the company’s major shareholder, related party conflicts of interest.
- Thomas Cook Group plc – Governance issues and strategy, Appointment of new Chairman.
- Novo Nordisk – Board structure.
- Johnson Johnson – Remuneration policy and long-term cash plan.
- G4S – Takeover equity rights issue.
- Charter International – Takeover shareprice.
- Pfzer – Remuneration policy severance payment to previous Chief Executive.
- Swiss Re – General governance issues
- Toyota Motor Corp – Lack of Independent directors
- Antofagasta – Independence and diversity of the board, safety training and water efficiency.

UBS

- Vodafone – acquisitions strategy, operating performance, re-election of chairman.
- BskyB – Remuneration and re-election of James Murdock, conflict of interest.
- Sage Group – Acquisition in Australia.

10. The Oxfordshire County Council Pension Fund delegates Stewardship responsibilities to its asset managers. The Pension Fund Committee is responsible for ensuring that each investment manager has an explicit

strategy setting out when they would intervene in a company, which itself is acceptable to the Committee. Key questions the Committee need to consider in relation to this policy are:

i. Do the fund's asset managers have appropriate stewardship policies in place?
ii. Are they implemented effectively and transparently?
iii. If not, what changes need to be made to meet the fund's requirements?
iv. What reporting level of detail should the fund's asset managers provide on engagement?
v. How frequently should reporting and monitoring take place?
vi. Does the asset manager have sufficient resources dedicated to stewardship?
vii. Are the circumstances in which the asset manager escalates their engagement activities appropriate?
viii. Are the escalation methods appropriate?
ix. How are the outcomes of engagement activities assessed and are they appropriate?

11. The Myners Principles encourage the involvement of pension funds in the oversight of the companies they own, due to the strong influence they can have in improving long-term financial returns through good corporate governance and social responsibility. Recent examples of where governance and corporate responsibility risks have materialised highlight the importance to shareholders of such issues. (BP, Northern Rock, RBS etc).

12. Whilst the primary focus of the UK Stewardship code is on the asset managers, the asset owners such as pension funds are strongly encouraged to comply with it, and ensure that their asset managers adopt and comply with the code.

Recommendation

13. The Committee are RECOMMENDED to consider the policies and performance of the fund's investment managers in relation to company engagement and if they meet the requirements of the Oxfordshire County Council Pension Fund.

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Background papers: Nil
February 2012

Annex 1

Summary of Fund Manager Engagement Policies

Baillie Gifford

14. Baillie Gifford 'participate in constructive consultation with companies and have regular meetings with management and/or board members to monitor performance'. The factors taken into account include:

- Company strategy
- Operational performance
- Acquisitions and mergers policy
- Corporate governance
- Risk management and internal controls
- Corporate social responsibility

15. Baillie Gifford endeavour to invest in companies where they have confidence in the board and management to set and implement strategy on behalf of shareholders. An example is company executives who hold shares, and incentive schemes which are fair and aligned with the interests of external shareholders

16. Baillie Gifford are keen to see evidence of companies adopting long-term strategies for developing business, such as continuing to invest in R&D, regardless of economic conditions.

17. 'Discussions on executive remuneration represent a growing proportion of 'our engagement with companies. Executive remuneration should be simple with more focus on the long-term.

18. Baillie Gifford believe executives should build up a shareholding in the company. Performance targets need to be appropriate for the business.

19. The oil and gas and mining sectors are high impact with physical and visual effects on the environment and health and safety risks. Health, safety and environmental performance can be used as an indicator for management quality.

20. 'We will intervene in a company when we have concerns about any aspect of corporate performance and where shareholders' interests may be at risk'.
The form of intervention will vary according to individual circumstances and may include:

    - Meeting or engaging with management and/or board members to discuss concerns.

    - Working with other institutional shareholders to encourage a company to address concerns.

- Selling out of or reducing a holding when appropriate and in the clients' Interest.

Legal and General

21. Legal and General Investment Management (LGIM) aims to maximise shareholder value by promoting integrity in business. LGIM expect all listed investee companies and those seeking a listing, regardless of their domicile to demonstrate the highest standards of corporate governance.

22. Engagement activities in which LGIM have been involved in include:

    - Board performance
    - Succession planning
    - Remuneration
    - Environmental and Social Responsibility
    - Mergers and Acquisitions and other capital issues

23. LGIM believes there should be a clear division of responsibilities and the roles of the Chairman and Chief Executive should be separate. The Chairman should be available to meet with shareholders and should manage concerns raised by investors effectively. LGIM expects to engage with the Chairman of major investee companies on a regular basis.

24. LGIM expects all Listed companies to establish an Audit Committee, a Remuneration Committee and a Nomination Committee. These should comprise at least three independent non-executive directors as its members.

25. Remuneration levels should be sufficient to attract, retain and motivate directors of the quality required to rund the company successfully. However, a company should avoid paying more than is necessary for this purpose. A significant proportion of executive directors' remuneration should be structured so as to link to the rewards to corporate and individual performance.

26. LGIM applies its global corporate governance policy when monitoring investee companies and seeks an explanation for their departure from best practice. If LGIM believe that their concerns are not being addressed, or if they have concerns with the Chairman's performance then they will contact the Senior Independent Director. If engagement with the Senior Independent Director does not deliver any changes LGIM will usually escalate its engagement by collaborating with other institutional investors.

27. LGIM engage with companies to ensure their Corporate and Social Responsibility/Sustainability policy is applicable to their business as well as the industry and region in which they operate. LGIM look for evidence that ambitious, yet realistic targets are set and that appropriate risk management systems are in place for identifying, managing, and mitigating risks.

28. LGIM environmental and social engagement topics include:

- Climate change/energy – expect companies to actively measure, monitor and disclose greenhouse gas emissions in a comparable and consistent manner. Companies in energy intensive sectors, in particular, should participate in the Carbon Disclosure Project to disclose direct and indirect emission levels.

- Environmental Impact – Environmental management and life cycle assessment should be embedded into business operations, where appropriate, to identify environmental impacts as well as efficiency and opportunities for the business. Environmental Impact Assessments should be carried out when considering acquistions. This should include biodiversity impact assessments.

- Human Rights – Companies should consider what impact their business has on society as a whole and ensure that their operations do not violate internationally recognised standards and local laws. Policies and guidelines on human rights and business ethics should be developed and disseminated within the organisation.

- Labour Standards – Companies should respect internationally recognised labour rights and provide a safe working environment for their employees and contractors.

29. <u>UBS</u>

30. UBS Global Asset Management aim to be supportive long-term shareholders. 'We seek to develop both a long-term relationship and an understanding of mutual objectives and concerns with the companies in which we invest on behalf of our clients.'

31. Regular meetings are held typically with company chief executives and finance directors. In addition UBS meet with chairmen and other board members. Corporate strategy and objectives are discussed and performance is assessed and monitored.

32. 'Discussions have covered a wide range of issues including:

- Strategy – including acquisitions and the deployment of capital
- Operational performance
- Quality of the board
- Health and Safety
- Risk Management
- Remuneration

33. UBS generally support executive incentive schemes that

- Require a high level of personal shareholding to ensure alignment of interest with shareholders
- Encourage a long-term perspective
- Are simple
- Are designed to promote sustainable value creatiion in line with the agreed strategy of the company
- Have, as their primary performance hurdle for investing, total shareholder return relative to either a peer group or index.
- Avoid excessive issuance

34. Significant factors for an effective board include:
    - An effective chairman
    - Roles of chairman and chief executive should be separate
    - Board should comprise individuals with appropriate and diverse experience capable of providing good judgement and diligent oversight of management of the company
    - Non-executive directors should provide a challenging, but generally supportive environment for the executive directors.
    - The whole board should be fully involved in endorsing strategy and in all major strategic decisions
    - Appropriate management succession plans should be in place
    - The interests of executives and shareholders should be aligned
    - The financial audit should be independent and accurate
    - The brand and reputation of the company should be protected and enhanced
    - A constructive dialogue with shareholders should be encouraged
    - The board should receive all information necessary to hold management to account.