edentree
investment management

AMITY INSIGHT

CORPORATE GOVERNANCE

Doing better business by doing business better

PROFITS WITH PRINCIPLES

AMITY INSIGHT

DID YOU KNOW?

The UK is a world leader in corporate governance thinking, producing the world's first Corporate Governance Code in 1992, and the world's first shareholder Stewardship Code

By **Esmé van Herwijnen**
Responsible Investment Analyst

We believe corporate governance matters. Governance is one of the Amity Fund's nine positive pillars of responsible investing and is a fundamental part of what, for us, makes an attractive long-term investment. Corporate governance is the framework by which companies are directed and controlled for the long-term benefit of shareholders. It concerns the arrangements for appointing and remunerating directors and auditors and for ensuring an appropriate balance of independent non-executives is in place.

A strong corporate governance regime should reassure investors that the companies they invest in are managed by directors in the long-term interests of their shareholders. Shareholders, in turn, have a stewardship role in holding companies to account via informed exercising of their voting rights and through constructive long-term engagement.

The frequency of corporate scandals, from mis-selling of financial products to market manipulation and accounting fraud, suggests that confidence in corporate governance may be at an all-time low. The architecture itself has been subject to almost constant review and refinement as investors and companies try to find a perfect form of governance that will prevent potential and actual malfeasance and improve corporate performance. This is unlikely, but as we argue in this Amity Insight, since 1992 when the world's first Corporate Governance Code was published, most jurisdictions have introduced rules and guidance for the governance of companies. This alone suggests the importance placed upon companies operating in accordance with market best practice, or being required to explain if they divert from it.

We have come a long way. Before the Cadbury Report in 1992, UK boards were typically run by executives and led by a single chair/CEO. There were no independent non-executive directors, and no formal Remuneration Committee or Remuneration Report. Transparency, openness and diversity were poor.

We strongly believe corporate governance represents a partnership in which active, informed shareholders exercise stewardship; engaging with companies over poor governance and voting to oppose boards where proposals are not in shareholder interests. In this Insight we look at areas of conflict such as remuneration, new areas of thinking such as auditors and diversity, and how EdenTree exercises its votes transparently on behalf of clients.

AVOIDING FAILURE: DOING BUSINESS BETTER

How can investors protect themselves against the risk of business failure and mismanagement of the companies in which they invest? How can countries successfully promote inward investment and build market confidence? Over the past quarter century, these questions have overlapped in the minds of governments, regulators and investors in the wake of several high-profile business failures.

One solution has been the development of rules or principles that drive thinking around 'best practice' in company governance. Almost 25 years after the launch of the ground-breaking Cadbury Code of Corporate Governance in the UK, this Amity Insight looks in depth at the journey towards a global standard of corporate governance. There are now over 100 national, regional and pan-global codes of corporate governance in existence, showing just how much progress has been made in the past two decades.

Corporate governance is about the way companies are directed and managed on behalf of the owners (its shareholders). It concerns the arrangements for appointing and remunerating board directors and auditors, and the controls in place to enable them to discharge their respective responsibilities with diligence and effect. In the UK's 'principles based' culture, these provide best practice guidance against which companies are asked to 'comply or explain'. In the US and elsewhere, it often constitutes a 'rules based' system, laid down in primary or regulatory legislation.

Since 1992, most mature economies have developed national guidance of their own – from Canada in 1994, to Luxembourg in 2006. Emerging and developing economies have followed suit – Nigeria (2003), Tunisia (2008), Ghana (2010) and Azerbaijan (2011) for instance. In addition there is a body of international literature that takes the UK model as a starting point, published by the OECD, World Bank, Commonwealth and EU.

We do not believe there is a 'one size fits all' model, but we do expect companies to comply with best practice within their jurisdiction, or as a minimum, apply the OECD corporate governance ground rules. Although we do not apply UK governance best practice in other territories, we do believe that some of the UK's general principles, such as the separation of the roles of chair and chief executive, are universal and represent best practice.

DID YOU KNOW?

It is still common practice in the US for the roles of chairman and chief executive to be combined in a single individual. Less than a third of S&P 500 companies have an independent chairman

There are now over 100 national, regional and international codes of corporate governance

TIMELINE OF CHANGE: THE MARCH TO MODERN CORPORATE GOVERNANCE

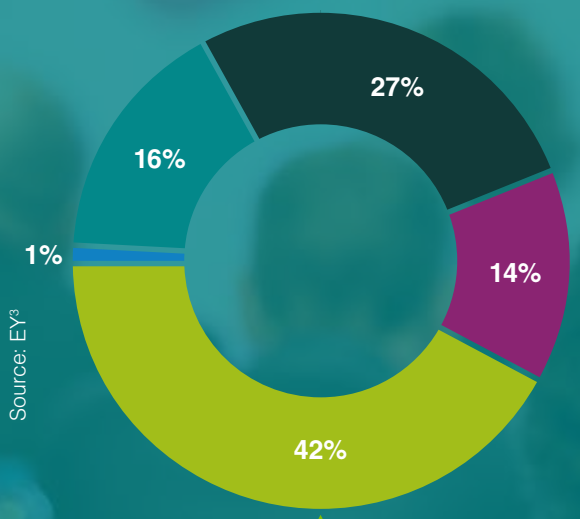
FOCUS ON SHAREHOLDER ACTIVISM

The US is the most activist market in the world, with over 1,000 shareholder resolutions filed during the 2015 proxy season. In the UK, Europe and Asia, shareholder resolutions are much rarer; in the UK for instance, only a handful have been filed in the past five years. In continental Europe, only Sweden enjoys a flourishing reputation for shareholder activism focused on resolutions.

In the US the main Governance issue in 2015 was investor scrutiny of board compositions, leading to the 'proxy access campaign'. This was focused on affording shareholders the right to nominate directors to the board. In 2015, 120 proxy access proposals were filed, more than 60% of which received majority support[1]. Environmental and social concerns continued to be the largest category of resolutions filed in the US, accounting for 42% of total proposals[2]. EdenTree has a policy of supporting proposals where these appear reasonable and proportionate and in keeping with our general stance on environmental, social and governance (ESG) positives. In 2015 we supported the proxy access campaign and resolutions filed by shareholders calling for the roles of chair and chief executive to be separated. We routinely support resolutions calling for enhanced ESG disclosure where they relate to material risk.

In the UK a coalition of 150 investors targeted BP and Shell, requiring them to disclose more information on portfolio resilience arising from climate change. The resolutions received 98.2% support at BP and 98.9% at Shell. Similar resolutions will be filed at three UK domiciled mining companies in 2016 (Anglo American, Rio Tinto and Glencore).

SHAREHOLDER PROPOSAL SUBMISSIONS IN THE US BY PROPOSAL CATEGORY, 2015



Source: EY[3]

Top four environmental/social sub-categories

- Political spending/lobbying
- Climate change sustainability
- EEO/corporate diversity
- Labour/human rights

Board-focused
Routine
Compensation
Anti-takeover/strategic
Environmental/social

1. ISS www.issgovernance.com/governance-exchange/governance-insights/#1452866844042-c6b24eea-1b36
2. www.ey.com/GL/en/Issues/Governance-and-reporting/EY-four-takeaways-from-proxy-season-2015#shareholder-proposal-submissions
3. Ibid.

1995
Barings Collapse
Greenbury Code

1997
Australia
Japan
Netherlands

1998
Hampel Report
Combined Code (UK)

EXECUTIVE PAY: HOW MUCH IS TOO MUCH?

Excessive executive pay has been common currency for some time. Hardly a day goes by without headlines referring to 'fat cat' pay causing public anger. Since the early investor revolts at British Gas (1995) and GlaxoSmithKline (2003), there has been ongoing debate about excessive pay, its structure, links to performance and rewards for failure. But for investors, just how much is too much?

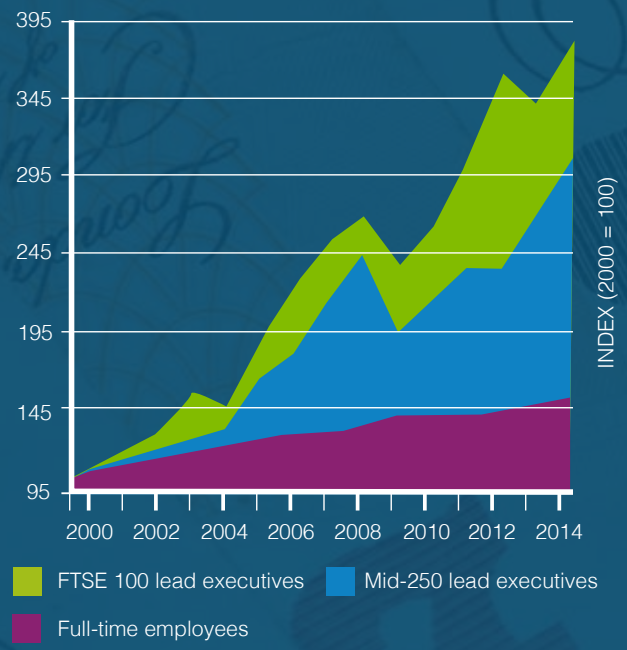
In 2015 the median gross annual salary in the UK was around £27,600; but this obscures great disparities between the lowest paid (around £12,000 on the National Minimum Wage or £15,000 for the lowest 10%) and the highest[4]. Research shows FTSE100 chief executives are paid, on average, 183 times that of a UK worker. A FTSE100 chief executive's package, which typically includes base salary, benefits, short-term bonus, long-term incentives and pension, is now £5m a year. Individual cases of extreme earning power – the CEO of FTSE100 company WPP for instance, earned £43m in 2014 – also brings large pay disparities into stark relief.

Another way of looking at the issue is via the differential between the highest paid and the lowest (or average paid) within a company. On this basis, the extremes are again striking – FTSE100 CEOs had reportedly made more money by the first Tuesday of 2016 than the typical UK worker earns all year[5]!

So how much is too much? Attempts to quantify 'excess' have proved elusive. In the 1920s the celebrated banker JP Morgan insisted that the differential between the highest and lowest paid within the bank should be no more than 20 times. The John Lewis Partnership model applies a multiplier of no more than 75 times, whilst the Church Investors Group, a coalition of faith investors, suggested that a multiplier of more than 75 times 'was hard to justify' in terms of social cohesion and fairness. In 2015, the US Securities and Exchange Commission (SEC) adopted a rule that requires a public company to disclose the ratio of the compensation of its CEO to the median compensation of its employees, which, it's hoped, will provide greater transparency around pay differentials. In the UK, 66% of people support the idea of the introduction of a maximum pay 'gap', so bosses cannot earn more than a fixed amount above the average employee of their company[6].

Compensation is on the whole lower in continental Europe, and lower still in Asia.

THE WIDENING PAY GAP



Source: IDS Executive Compensation Review[7]

4. Annual Survey of Hours and Earnings, 2015, Office for National Statistics
5. High Pay Centre
6. High Pay Centre survey: A Force for Fairness http://highpaycentre.org/Files/A_Force_for_Fairness.pdf
7. www.dailymail.co.uk/news/article-2790344/top-bosses-pay-soars-20-staff-feel-squeeze-boardroom-executives-ftse100-companies-earn-average-2-4million.html

India/Belgium
France/Germany

Turnbull Report
Internal Controls
OECD Principles

1998

1999

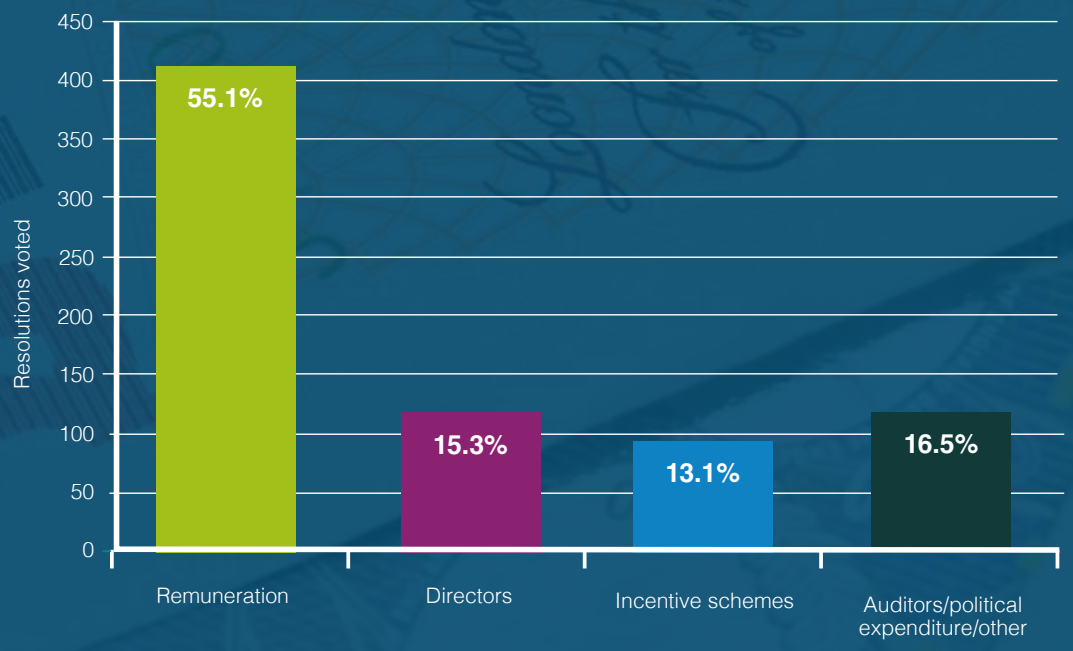
In Europe, the UK and Germany have higher overall levels of executive pay, the former perhaps reflecting the importance of financial services to the UK economy and where a 'bonus culture' is well entrenched.

EdenTree pays careful attention when it comes to voting on executive pay. We apply an 'excess test' in cases where annual and long-term awards in aggregate exceed 300% of salary per year. Awards may be justified by exceptionally challenging performance hurdles, or unusually low base salaries, or they may just be excessive!

At EdenTree we publish our thoughts on pay in our Corporate Governance and UK Stewardship Code Policies. Essentially, we look for three things in assessing whether remuneration policy is fair and designed to incentivise superior out-performance: first, the quality of disclosure to allow shareholders an informed view; second, whether performance hurdles are genuinely stretching and aligned to shareholders; and finally any potential for excess. The latter is, of course, subjective, but we understand clients will not want us to support rewards for failure, incentivising undue risk or in paying excessively. Shareholders sometimes approve high rewards for superior performance but EdenTree subscribes to the view that excessive pay should always be avoided. Factors we look for in choosing whether to oppose include undemanding performance criteria; hurdles linked to share price increase; factors generally outside of a director's control; and long-term incentives tiered towards rewarding for average performance. In 2015, 59% of all resolutions we opposed or abstained related to remuneration and long-term incentive plans, opposing 75 company remuneration reports and 23 long-term incentive plans. Over the five years (2011–2015), 68.2% of all action against company proposals EdenTree took was remuneration based.

You can find out more at www.edentreeim.com where our corporate governance polices and global proxy voting reports are available.

UK VOTING 2011–2015: RESOLUTIONS OPPOSED/ABSTAINED



Source: EdenTree IM.

Italy
Portugal
USA

Denmark/Sweden
China
Singapore

Enron collapse
Worldcom bankruptcy

1999 **2000/01** **2001/02**

GENDER DIVERSITY IN THE BOARD ROOM

Improving board diversity has become an important consideration for investors. The number of female directors has increased significantly over the last few years, but it has taken concerted effort. In 2011, Lord Davies published his review ('Women on Boards'), highlighting the fact that women made up just 12.5% of FTSE100 board positions. His review set in train a voluntary approach that encouraged companies to aim for 25% female representation on boards by 2015. At the end of 2015, this goal had been reached with 26.1% of FTSE100 directors being female[8]. The voluntary approach was proven to be effective in the UK market, while other countries have adopted a regulatory or quotas based approach. Norway introduced a mandatory 40% quota in 2003 where non-compliance can result in a fine, whilst last year Germany set a quota of 30% for women on supervisory boards.

Whilst steady progress has been made, there is still further to go. In the UK, women have been appointed to non-executive roles in the main and still represent less than 10% of executive positions[9]. Why is this important? We genuinely believe companies that are alive to the business case for encouraging and empowering diversity will be better performers in the long term. There is considerable academic evidence to suggest boards make better decisions when there are a variety of voices, opinions and expertise present so as to avoid 'group-think'.

At EdenTree we have integrated board diversity into our UK corporate governance policy, and from 2016 will look to vote against Nomination Committee directors where companies have made little meaningful progress since 2010 to improve board diversity. In 2015 we engaged with eight FTSE100 companies that had failed to meet the target of 25% women directors by the deadline. Working with the 30% Club (of which we are members), we are now engaging with FTSE250 companies where there are all male boards to drive further progress in medium and smaller companies.

DID YOU KNOW?

Japanese companies generally hold their AGMs on a single day. In 2015 40% of listed Japanese firms, representing 31% of total Japanese market cap, held their shareholder meetings on 26 June

Since 2011, US shareholders have had a statutory right to a 'say on pay' with executive compensation put to a vote. US stock option schemes often have no performance requirements attached, unlike in the UK, when a single scheme can have up to four separate performance tests

8. Women on Boards Davies review, five year summary October 2015 www.gov.uk/government/uploads/system/uploads/attachment_data/file/482059/BIS-15-585-women-on-boards-davies-review-5-year-summary-october-2015.pdf
9. Ibid.

2002
Sarbanes/Oxley enacted

2002
Brazil
Russia
Switzerland

2003
Higgs Report (UK)
Non-executives
Smith Review; Audit (UK)
Parmalat (Italy) failure

EXTERNAL AUDITOR INDEPENDENCE

External auditors play a crucial role in providing independent assurance of a company's annual financial statements. Investors rely on high-quality financial information to give a true and fair view of a company's performance and prospects, hence the importance that the external auditor be independent and objective.

Best practice recommended by the EU now includes regular auditor rotation (every 10 years) and a limit on non-audit fees that can be charged relative to the overall audit fee (a maximum of 70% of audit fees billed). In 2015 we took significant action in the UK and US where there had been no audit tender for 15 years or longer. In some instances, companies had not changed auditor for over a century leading to charges that, crucially, they lack independence that may compromise their ability to provide objective assurance.

DID YOU KNOW?

Share-blocking, where investors in some European markets have to waive their rights in order to vote, has been outlawed by the European Commission. The practice was widespread in France, Italy and Spain and continues occasionally in Norway, Luxembourg and Switzerland

Anglo-American models of governance prefer a single unitary board of executives and non-executives but in much of Europe a two-tier system of supervisory and executive boards is preferred; in Germany the former can be filled largely by employee representatives as at Volkswagen and Deutsche Post

In 2014, the UK introduced a binding vote on Remuneration Policy every three years and an advisory vote on the Remuneration Report annually. Few markets in Europe currently allow shareholders to vote on pay. Shareholders have been able to vote on pay in the UK since 2003

CORPORATE GOVERNANCE: A CONCLUDING VIEW

At EdenTree our due diligence looks beyond the headlines; we look closely at the quality of company governance and the company's ownership structure. As a minimum, we expect companies to meet recognised best practice standards in the registered home market, and to provide full and transparent disclosure on the basic principles of corporate governance, the responsibilities of the board, and its committees, and whether directors are considered independent or connected.

In addition we do not generally favour investment in companies where there is a significant government stake, except in OECD territories or in jurisdictions that are judged by Freedom House to be fully 'free' (for instance Brazil). For that reason we do not invest directly in China domiciled companies (known as the 'Shanghai A Share'), preferring those listed in Hong Kong (the 'H Share') with no government stake or tie and where international accounting standards and corporate governance practices are more robust.

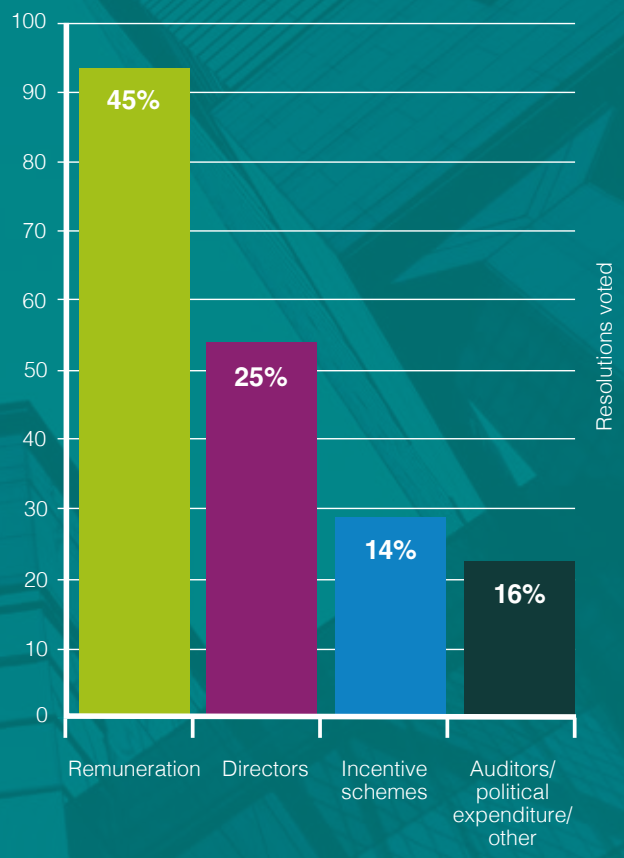
In 2011 EdenTree started voting globally and we now vote in all jurisdictions where we are shareholders, save in markets that are 'share-blocked'.

We revise our UK and overseas corporate governance policies annually, and these together with our UK Stewardship Code Statement are published online. Our global voting records are published in full on a quarterly basis at www.edentreeim.com

In 2015, we voted on 4,042 UK resolutions at 279 meetings, taking action in 5% of cases (209 resolutions) – the majority remuneration related. Overseas, we voted at 213 meetings in over 25 territories on 2,363 resolutions, taking action in 16% of cases. The majority of action taken was against directors, usually on non-independence grounds.

All of our UK voting is researched and executed in-house; our service partner providing research for the UK is IVIS (Institutional Voting Information Service), whilst Glass Lewis & Co. provides research and execution for contracted out overseas voting in all territories ex-UK (where UK includes Guernsey, Jersey and Isle of Man).

UK VOTING ACTION 2015



Source: EdenTree IM.

UK Stewardship Code
UK Corporate Governance Code

Dodd-Frank Act (US)

Olympus fraud
Lord Davies Report on Gender Diversity (UK)

2010 **2011** **2012**

VIEW FROM THE TOP

At EdenTree, the responsibility for making investment decisions on behalf of our clients relies on us paying very close attention to the underlying corporate governance. Companies are assessed on the quality of the governance framework in place to ensure that they appear accountable, transparent and non-conflicted. Boards should have an appropriate balance of independent non-executives with a healthy mix of skills, competencies and genders with an objective, independent external auditor. Companies should structure remuneration so as to motivate and incentivise directors without overpaying or leading to excess, with an ability to 'clawback' bonus incentives in the event of proven malfeasance.

Each company is looked at on merit, and our votes lodged for every company we own. This is a big task, but we believe it is important for client investors to be assured that close attention is paid to the way companies are organised. As John Plender said in early 2016 in the Financial Times: 'There is plenty of bad governance around. It is hard to see who, other than shareholders, will address that. They have to be encouraged to raise their game.'

We have been raising the game when it comes to corporate governance for many years by challenging, opposing and encouraging higher standards. We will continue to do this as yet another proxy voting season beckons.

We do hope you have enjoyed this look at corporate governance and as always we invite your comments and feedback.

Neville White
Head of SRI Policy and Research

2014
Petrobras corruption scandal
French Florange Law
UK first policy vote on executive pay

2015
Toshiba accounting scandal
Volkswagen emissions scandal

2017
2nd Remuneration Policy vote (UK)

WHY EDENTREE?

- Over 25 years of experience of socially responsible investing (SRI)
- Funds that are both positively and negatively screened
- An investment team with a wealth of experience spanning many years
- A comprehensive in-house SRI research function
- An independent panel that reviews investment decisions
- A robust, socially responsible investment process
- A pride in our independent analysis. We're not afraid to adopt contrarian positions and are in favour of long-term investment horizons
- A consideration of the preservation of capital as our primary responsibility, preferring absolute returns over relative performance
- Fund Managers at EdenTree are unconstrained by rigid stock lists, permitting more flexibility to take advantage of good-value opportunities as they present themselves
- Decision-making for the long term, as frequent trading increases costs and decreases returns
- Avoidance of companies materially involved in alcohol production, gambling operations, pornographic and violent material, tobacco production, testing animals for cosmetic or household products, supporting oppressive regimes or strategic weapon production
- Actively seeking out companies with a record of involvement and good performance in terms of business practices, community relations, corporate governance, education, environmental management, healthcare, human rights, labour relations and urban regeneration

OUR PEOPLE

citywire AA

FE ALPHA MANAGER 2014 SUE ROUND

Sue Round
Director of Group Investments and Senior Fund Manager

Sue is the UK's longest-serving retail SRI Fund Manager. She launched the Amity UK Fund 27 years ago – pioneering our Profit with Principles investment approach. She is also AA rated by Citywire as of April 2016.

Neville White
Head of SRI Policy and Research

Neville is in charge of our Socially Responsible Investing team. His extensive experience includes being responsible for managing global corporate governance proxy voting for CCLA Investment Management.

FE ALPHA MANAGER 2016 ROBIN HEPWORTH

FUND MANAGER OF THE YEAR AWARDS 2015 WINNER GLOBAL EQUITY

citywire

Rob Hepworth
Chief Investment Officer and Senior Fund Manager

Rob has previously been voted Investment Week's Fund Manager of the Year and has been recognised as one of Citywire's top 10 Fund Managers of the past decade. This places him in the top 10% of all UK Unit Trust and OEIC Managers.

Ketan Patel CFA
Fund Manager

Ketan began his career on the equity derivatives trading desk at JP Morgan, before moving to Insight Investment as a Global Healthcare Analyst. Ketan leads the team's company research, supporting the Fund Managers' investment decision-making. He has been a CFA Charterholder since 2009.

Chris Hiorns CFA
Fund Manager

Chris has worked at EdenTree since 1996. He started as a Graduate Trainee and worked as an Investment Analyst before being appointed as the Fund Manager for the Amity European Fund in 2007 and the Amity Sterling Bond Fund in 2008.

Phil Harris
Fund Manager

With over 25 years' experience in UK small and mid-cap company sectors, Phil joined EdenTree in 2015 to run the UK Equity Growth Fund. He focuses on growth small-caps and previously specialised in corporate activism.

Peter Cameron CFA
Associate Fund Manager

Peter is an experienced Equity Analyst, having worked in both the Quant solutions and SRI performance and portfolio risk teams at Aviva. He holds a Master's degree in Corporate Governance, and is a CFA Charterholder.

Esmé van Herwijnen
SRI Analyst

Esmé holds a Master's degree in Sustainable Business from Toulouse Business School and gained experience in ESG research from Sustainalytics and PIRC. She supports our SRI team with company screening, proxy voting and engagement.

NOTES

How to contact us

We hope you have found this Amity Insight interesting and useful. If you have any questions, or would like to know more about our responsible investment, in-house research and analysis, please get in touch.

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