SOUTH YORKSHIRE PENSIONS AUTHORITY

SHAREHOLDER ENGAGEMENT

SHAREHOLDER ENGAGEMENT AND THE AUTHORITY'S RESPONSIBILITIES AS A SHAREHOLDER

This policy statement is an outline of the Authority's approach to shareholder engagement. It sets out the broad policies which the Authority believes constitute best practice and provides the framework within which it will enter into engagement with companies. At the heart of this approach lies the Authority's belief that as a shareholder its primary duty is to those on whose behalf it invests. This Statement should be read in conjunction with the Authority's Statement of Investment Principles and its Voting Guidelines.

The Authority believes in supporting incumbent management wherever possible but recognises that the neglect of corporate governance and corporate responsibility (CR) issues could lead to reduced shareholder returns. Whilst the Authority wishes to protect shareholder value it also seeks the enhancement of investment returns which will contribute to the longer term performance of the pension fund it administers. This approach is central to its strategy. For example, notwithstanding the presumption that the Authority supports the company in which it has invested that does not mean that the Authority will automatically agree with a board recommendation concerning a takeover or acquisition. The decisions taken by directors on strategic or operational issues clearly impact on the financial interests of shareholders and, hence, any beneficiaries to whom they have a fiduciary duty. When determining policy in such situations the Authority places the highest priority on optimising the Fund's interests. The underlying philosophy behind all its investment decisions is the belief that those companies which adopt best practice in CR matters will ultimately outperform those that do not.

The Authority recognises that investment in a company not only brings rights but also carries responsibilities. The Authority believes that good governance in the companies in which it invests is best achieved by ensuring that directors are held accountable during their stewardship of the company. It regards its voting rights as an asset and uses them carefully. The Authority, however, has limited resources and recognises that it is not always possible for it to conduct constructive engagement alone: therefore, it will enter into collaboration with other like-minded investors when the occasion warrants doing so and circumstances allow.

The Authority will try to use its influence as a shareholder to promote corporate responsibility and high standards of corporate governance in the companies in which it invests; however, it recognises the constraints which it faces in trying to achieve those aims. The Authority is, therefore, an active member and supporter of the Local Authority Pension Fund Forum and encourages LAPFF in its campaigns and initiatives. The Authority has established a set of voting guidelines which cover

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corporate governance issues and has engaged a third party service provider to ensure that its votes are executed in accordance with its policies.

The policies of engagement set out below do not constitute an attempt to micro-manage the affairs of investee companies: rather, they are methods designed to ensure that the Authority obtains value from its investments and addresses any concerns arising from under-performance. The policies do not preclude a decision to sell a holding where the Authority determines that is the most effective response.

The following section sets out the Authority's broad approach to its responsibilities as a shareholder. These broad principles provide the framework within which the more detailed voting guidelines are administered and will be interpreted flexibly according to the specific circumstances of each company and meeting.

SHAREHOLDER ENGAGEMENT AND RESPONSIBILITIES

A) The composition of the Board and appointment of directors

Introduction

Arguably the most crucial element in determining corporate performance and the one which is most open to direct shareholder influence is the composition and effectiveness of the board. Therefore, shareholders should regard voting upon the appointment of directors as probably the most important single corporate governance issue they face. This is not a straightforward task, however, as there are a number of factors that shareholders ought to consider when evaluating potential board members and few annual reports provide sufficient information to assist them in the task. It is important that the quality of background material is improved and made more readily available.

Composition of the board

The Authority broadly follows the principles set out in the UK Corporate Governance Code ("Code"). In order to undertake its functions the Authority believes that a board should consist of an even balance of executive directors and non-executive directors: the latter's primary function is to hold executive management accountable for their actions and to represent shareholders interests. In order to do this they need to be independent and the board's composition needs to be diverse. The ratio of different types of director and the overall size of the board is important. Independent non-executives should not find themselves outnumbered and outvoted. Boards do not need to be of a standard size: indeed, boards with large numbers of directors may become unwieldy. The Authority accepts that different companies need different board structures and that there is no simple model that can be adopted by all boards: however, the Authority would normally expect at least half of the board to consist of independent non-executive directors. The Authority recognises that costs associated with corporate governance issues can be disproportionately higher for smaller companies but considers that the arguments for modification to the Code with respect to smaller companies are not compelling. The boards of investment trusts and similar companies face different issues and these should be reflected within their board structures.

Diversity

The Authority believes that board members should be recruited from as broad a range of backgrounds and experiences as possible. A diversity of directors will improve the representation and accountability of boards and bring new dimensions to board discussions and decision making. Therefore, the Authority encourages companies to recruit non-executives not just from the main boards of other listed companies but also from other bodies within the public, academic, private and voluntary sectors. Companies should consider candidates from all racial and religious backgrounds and look to increase the level of female representation on boards in line with best practice; a diversity policy should also be disclosed in the Annual Report.

Independence

Independence is determined largely by an individual's character and integrity. This cannot be objectively assessed by shareholders on a consistent basis and, therefore, written guidelines are not necessarily appropriate. Nonetheless, the Authority notes the criteria identified within the Code.

The Authority presumes that non-executive directors who have been on a board for nine years or more are no longer independent. Such directors should submit themselves to annual re-election not because they might be regarded as any less able than other directors but because they have been associated with the company longer and are therefore presumed to have a close relationship with the business or fellow directors. The Authority believes it is best practice to reveal any family relationships amongst directors or previous employment associations including cross directorships with other board members. Board members who are or have been directly linked to an external advisor or a major shareholder are presumed not to be independent unless it is otherwise stated. The Authority does not believe that a company should appoint a Chairman who has been a former director or employee of the same company if the time lapse is less than five years.

The Authority appreciates that there can be instances where individual circumstances overrule these sort of presumptions. In those circumstances, the Authority believes that a supporting statement should be published in the annual report.

Balance

When assessing a company's governance structure the Authority takes account of the construction of the board in terms of its composition, separation of powers, the relationship between executive and non-executive directors and board committees. Analysis will focus on those aspects of directors' appointments which can be clearly assessed: the process by which individuals are appointed, their contractual terms and their independence (particularly in the case of non-executives). Again, the need for sufficient, accurate and meaningful information is essential.

Directors' availability and attendance

The Authority supports the view that executive directors can benefit from holding a non-executive position on the board of a company operating in a different sector. However, it is important that directors have sufficient time to devote to the company's

affairs therefore, full time executives should not hold more than one non-executive position in a FTSE 100 company. Concerns over the time directors spend at meetings are growing as the responsibilities of directors grow. This is especially true of non-executive directors. There can be no hard and fast rule on the number of positions that are acceptable: much depends upon the nature of the post and the capabilities of the individual. It is accepted that different positions require different time allocations but shareholders need to be assured that no individual director has taken on too many positions. Therefore, full disclosure should be made of directors' other commitments and attendance records at formal board and committee meetings in the annual report.

The role of the Chairman

The role of the Chairman (he or she) is distinct from that of other board members and should be seen as such. In particular, the Chairman's role should not be confused with that of the Chief Executive. The Chairman should be independent upon appointment and lead the Board and ensure that it operates effectively. The Chairman should also take the lead in communicating with shareholders and the media. However, the Chairman should not be responsible for the day to day management of the business: that responsibility rests with the Chief Executive. A company which combines the two responsibilities in the hands of one person is opening itself to conflicts of interest and an unwarranted concentration of power. Any company intending to combine these roles must justify its position and satisfy shareholders in advance as to how the dangers inherent in such a combination are to be avoided. The Authority's view is that best practice advocates a separation of the roles.

The Authority is predisposed not to support the elevation of a current or near-current CEO to the Chairmanship of the same company. There are arguments on both sides regarding the benefits of such an appointment. The Authority's view is that where such a change is proposed the company must argue the merits in the report.

The Authority is likely to question the commitment of the Chairman if he has more than one Chairmanship of a listed company and too many other directorships.

Succession planning

Traditionally boards have been weak in planning for an orderly succession of directors. The Authority expects the board to disclose how it goes about planning for succession, the factors considered and where the decision-making responsibility lies. Succession policy should form part of the terms of reference for a formal nomination committee, comprised solely of independent directors and headed by the Chairman, though external advisors may be employed. It is the Chairman's responsibility to ensure that the board is properly constituted and that its members meet the requirements of the company.

Directors' remuneration

There is a clear conflict of interest when directors set their own remuneration. The establishment and use of a wholly independent remuneration committee is, in the Authority's view, a prerequisite.

It perhaps goes without saying that remuneration has a direct link to corporate performance. The Authority approves of and encourages the introduction of incentive schemes to all employees within a firm. Apart from the positive contribution such schemes should make to corporate performance and shareholder return the Authority is also aware that poorly structured schemes can result in senior management receiving unmerited rewards for substandard performance which, apart from being wrong in itself, could adversely affect the motivation of other employees. Employee incentive plans will be scrutinised carefully to ensure that the targets set are sufficiently ambitious and challenging (without being unachievable) and that the awards are in an acceptable form. The Authority would expect remuneration to be expressly linked to stated business objectives and that these are fully disclosed in the annual report.

Whilst not as contentious as they once were the Authority still regards directors' service contracts as being a fundamental part of corporate governance consideration. The Authority expects all executive directors to have contracts that are based upon no longer than twelve months salary. The Authority will also scrutinise retirement benefit policies of directors and expects these to be for the benefit of the director only and not for any dependants. Any loans or third party contractual arrangements, such as the provision of housing or removal expenses, should be declared within the annual report.

B) Financial reporting and accountability

Presentation and sustainability

A company board's primary duty of accountability is to its shareholders and since the shareholders' primary focus is financial return it is right and proper that the board should concentrate upon that aspect of corporate performance. However, the Authority is a long term investor faced with meeting long term liabilities and believes that companies should be managed on a sustainable basis. As a consequence the Authority fully supports the provisions of the Companies Act 2006 codifying directors' duties. The Authority believes that it is crucial that the board develops and then manages and monitors a long-term strategy in order to secure its financial future. For example, where earnings do not cover a proposed dividend before exceptional items and there is no clear justification for the proposal the Authority may consider voting against approving the payment. Similarly, the Authority will normally support a scrip dividend resolution but would vote against it if no cash alternative was offered. If a dividend has been declared but it is not put to a vote the Authority will vote against the Report and Accounts.

In the past financial reporting has tended to be opaque and technical. Since it is a major element in reporting to shareholders the accounts need to be more than just objective and comprehensive: they need to be as transparent as possible and reflective of all material issues. Any accounting policies or judgements that have a material impact on results need to be clearly stated and explained. Risk control policies and processes should be fully described.

The Authority thinks that as well as reporting financial performance companies should consider providing additional information on a range of issues that also reflect the directors' stewardship of the company. These could include, for example, information on a company's commitment to employees, its charitable and community initiatives and on its impact on the environment in which it operates. The Authority

expects every annual report (other than those for investment trusts) to include an environmental section, which identifies key quantitative data relating to energy and water consumption, emissions and waste etc., explains any contentious issues and outlines reporting and evaluation criteria. It is important that the risk areas reported upon should not be limited to financial ones.

Audit

The Authority fully supports the view that the audit process must be, and must be seen to be, objective, rigorous and independent if it is to provide assurance to users of accounts and to maintain the confidence of the capital markets. Recent events have led many to question the objectivity of the audit process. The Authority is concerned about the potential conflict of interest between audit and non-audit work when conducted by the same firm for a client and urges companies to make a full disclosure where such a conflict arises. There can be legitimate reasons for employing the same firm to do both types of work, but these need to be identified. Any material links between the audit firm and the client need to be highlighted as a matter of course. The most appropriate place for such disclosures is the audit committee report.

The provisions of the Code regarding the responsibilities and composition of the audit committee are regarded as minimum requirements and companies should disclose the extent to which their arrangements exceed those set out in the Code.

As a rule the Authority will vote against the re-appointment of auditors where non-audit fees are considerably in excess of audit fees in the year under review and on a three year aggregate basis unless sufficient explanation is given in the accounts. The Authority suggests that the length of tenure of audit firms warrants scrutiny and that the periodic change of advisors should be encouraged. If the auditor has been in place for more than ten fiscal years the Authority will vote against their appointment. Where an auditor has resigned an explanation should be given. If the accounts have been qualified or there has been or is non-compliance with legal or regulatory requirements or the auditor has been replaced the Authority would expect this to be drawn to shareholders' attention in the main body of the annual report. If the appropriate disclosures are not made the Authority will vote accordingly.

Political donations

The Authority has concerns over the reputational risks and democratic implications of companies becoming involved in funding the political process both at home and abroad. The Authority, therefore, considers it prudent to oppose all political donations.

Voting rights and capital issuance

The Authority supports the pre-emption rights principle and considers it acceptable that directors have authority to allot shares on this basis. Resolutions seeking authority to issue shares with and without pre-emption rights should be separate and should specify the amounts involved, the time periods covered and whether there is any intention to utilise the authority.

Similarly, the Authority does not necessarily oppose a company re-purchasing its own shares but recognises the effect such buy backs might have on incentive

schemes where earnings per share measures are a condition of the scheme. The impact of such measures should be reported on. The Authority encourages companies to set out the criteria for calculating the buy back price to ensure that it benefits long-term shareholders.

Resolutions on increasing the authorised share capital or the re-purchasing of shares must not be excessive in the terms of the existing share capital and must be accompanied by a full explanation.

The Authority believes that shareholders who have the same financial commitment to the company should have the same rights and, therefore, opposes dual share structures which have differential voting rights. These are disadvantageous to many shareholders and should be abolished.

Takeover and acquisitions

As explained above, the Authority will normally support incumbent management but reserves the right to consider each individual case on its merits. The Authority will, therefore, exercise its vote on specific corporate actions such as takeovers, mergers or capital reorganisations in line with its broad policy considerations. Seldom will compliance with corporate governance best practice be the sole determinant when evaluating the merits of merger and acquisition activity but the Authority expects full information to be provided to shareholders on governance issues when they are asked to approve such transactions. Recommendations regarding takeovers should be approved by the full board.

Articles of Association and adopting the report and accounts

It is unlikely that the Authority will oppose a vote to adopt the report and accounts simply because it objects to them per se but it might vote against them in order to lodge dissatisfaction with other points raised within this policy statement. Although it is a blunt tool to use it can be an effective one especially if the appropriate Chair or senior director is not standing for election.

If proposals to adopt new Articles or amend existing articles might result in shareholders' interests being adversely affected the Authority will oppose the changes.

<u>Investment trusts</u>

The Authority acknowledges that issues faced by the boards of investment companies are often different to those of other listed companies and does not expect the same corporate governance guidelines to apply to them. In particular, the Authority believes that investment companies can operate with smaller boards and should not necessarily be required to report on such matters as environmental issues. However, the Authority considers that the conventions applying to audit and board composition and director independence do apply and the Authority will oppose the election of any representative of an incumbent investment manager on to the board of a trust managed or advised by that manager. Independence of the board from the manager is key and the Authority believes that management contracts should not exceed one year and should be reviewed every year. The Authority will be wary of endorsing the appointment of any director who has a number of relationships with an individual fund manager. In broad terms, the Authority believes

that the same requirements for independence, diversity and competence apply to the board of an investment trust as to any other quoted company.

The Authority may oppose the adoption of the report and accounts of an investment trust where there is no commitment that the trust exercises its own votes and no explanation of the voting policy.

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