Red Line Voting

A new approach to asset owner voting in the UK stock market by the Association of Member Nominated Trustees

The Red Lines

Voting instructions

Environmental

Social

Corporate Governance

amnt Association of Member Nominated Trustees

2016

Introduction

Pension trustees *should* take into account environmental and social issues that are financially material to their investments, as well as corporate governance matters. This was the conclusion of the Law Commission's 2014 *Report on Fiduciary Duties of Investment Intermediaries*.

The AMNT agrees that trustees should be adopting active responsible investment policies covering environmental, social and corporate governance (ESG) matters and directing how their votes are cast at shareholder meetings of the companies in which they invest. Most pension schemes have found this extremely difficult to achieve in practice, particularly small schemes and those that pool their money with other investors in 'pooled funds' whose fund managers have generally been reluctant to allow investors to direct how the votes associated with their investments are cast.

Red Line Voting, developed by the Association of Member Nominated Trustees, will offer pension scheme trustees (and other asset owners) the opportunity to direct the voting of the UK-listed shares they own on behalf of their members to an extent never before possible for many.

The Red Lines have been designed specifically to enable those investing in pooled funds to direct the votes associated with their investment: the fund managers may receive Red Line Voting instructions from numerous investors in the fund, but they would be the same instructions making them easier to handle. Of about £5.5-trillion of assets under management in the UK in 2014, more than £2.5-trillion was in pooled funds, so this is a major step forward for UK investors. The greater volume of engagement with the process will also benefit those who already participate fully.

Red Lines identify poor practice which should always be opposed and give specific instructions to fund managers to use schemes' votes to oppose it. The Red Lines cover a broad range of environmental, social and governance areas where failure to meet reasonable standards poses a risk to the company and its shareholders over the long term. To give just one example: if the world fails to slow the pace of climate change, the outlook for pension scheme investment returns would be catastrophic. So the AMNT believes it is absolutely in the interests of the pension scheme and its beneficiaries to have a robust policy on climate change, which we are confident we have achieved. Indeed, the Red Lines provide the UK's first ready-made, easy to understand policy for investors on climate change and on social issues.

Trustee bodies will be able to adopt the Red Lines en bloc or, if they choose, a subset of them, that their fund managers will be instructed to follow. If in any particular case managers think it not in the client's interests to comply with such an instruction they will be free to vote otherwise, provided that they explain to the client why they did so. The AMNT believes this initiative should have no cost to schemes but will enable them better to discharge their responsibilities as asset owners. It will also enable consistent implementation of their ESG policy across all the funds in which they invest. And at this critical time, it will enable pension schemes to actively play their part in the fight against climate change.

The Association of Member Nominated Trustees

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Introductory guidance

These Red Lines specify a vote against. Where a Red Line has been breached an abstention will not fulfil the Red Line instruction. Any abstention in the event of breach of a Red Line instruction is to be regarded as the intermediary choosing to vote contrary to a Red Line instruction, and so the intermediary will be required to explain to the client why they did so.

If any of the voting actions specify a vote against someone who is not standing for election, or against a role that a company does not have, then the alternative is to vote against the chair of the board. If he/she is not standing for election then the vote is against the chair of the relevant committee; if there is no such committee then the vote is against the senior independent director, and if this person is not standing for election then the vote is against the longest serving independent non-executive director.

Reference to the board shall be taken to mean the main board.

The AMNT is not authorised to provide investment advice and neither the Red Lines nor this document constitute investment advice.

Environment

These Red Lines have been developed in accordance with Principles 1, 7, 8 and 9 of the United Nations Global Compact and with the advice of CDP (formerly the Carbon Disclosure Project)

E1.) *If the company does not have an Environmental Sustainability Committee chaired by a board director, or if the company is outside the FTSE 350 and does not have a named board member with responsibility for this area as evidence of appropriate concern, vote against the chair of the board.*

Explanation

It is important for shareholders that companies maintain a close watch on these sources of risk to their reputation and business sustainability, and that this is actively overseen at board level.

Guidance

This is in furtherance of Principles 7, 8 and 9 of the UN Global Compact.

The remit of a committee is material, not the title and the company may decide that this committee should also have responsibility for corporate social responsibility and health & safety. This committee should have clear board accountability and be chaired by or reporting to a named board member. The committee should have oversight of policies and operational controls of environmental and health & safety risks and this should be integrated into the board agenda on strategy and business performance.

In terms of the effectiveness of operational controls, the committee should

- cover material issues relating to the risks of the company's operations and markets;
- provide evidence that they are meeting regularly: the frequency should reflect the nature of the business but minimum twice a year; and
- provide evidence that the meetings are well attended by board members. There must always be at least one present and unless there are exceptional circumstances each board member appointed to the committee should attend every half-yearly meeting or, if there are more than two per year, at least 66% of them.

E2.) *If the company has failed to disclose quantitative and qualitative environmental information through CDP's climate change, water and forests questionnaires, vote against the re-election of the chair of the Environmental Sustainability Committee or, in the absence of such a committee, against the re-election of the Chair of the main Board.*

If for the third consecutive year a company has received lower than a C grade in any of CDP's scoring methodologies, vote as above.

Explanation

The effectiveness of a company in this area must be transparent if shareholders are properly to assess its strengths and weaknesses and that of its management. Building a sustainable and resilient business model should be at the core of the corporate strategy.

The key areas, depending on the nature of the business and sector, are climate change and energy, water scarcity and quality, biodiversity and forests, other natural resources, waste, general pollution and environmental accidents. Clearly these will vary in the weight given to them depending on the nature of the business. The risk mapping should not only identify risks but also new business opportunities that it presents and consider the impact on direct operations, supply chain and the products and services the company produces.

For example companies exposed to water risk must be expected to conduct a water risk assessment that accounts for the impacts of current and future direct and indirect water use and discharge. The assessment must encompass the availability of a stable supply of adequate quality freshwater as well as reflect the local hydrological, social, economic and regulatory context in which the company operates, buys from or sells to, i.e. direct operations and/or supply chain, products and services, and/or business partners.

The action plan should reflect the risks identified and include clear targets and key performance indicators related to activities within the direct control of the company or its suppliers – e.g. water conservation, improvements in water discharge quality and waste-water treatment. In order to meaningfully mitigate water risks however, the action plan should also incorporate catchment based actions – e.g. contributing to sustainable water management within the catchment through positive water policy engagement.

In addition, the action plan must incorporate monitoring, evaluation and reporting systems of impacts of activities.

CDP, formerly called the Carbon Disclosure Project, is a global not-for-profit organisation which holds the largest and most comprehensive collection globally of primary corporate climate change, water and forest risk information. United Nations Secretary General Ban Ki Moon has stated: "No other organisation is gathering this type of corporate climate change data and providing it to the marketplace." CDP has separate questionnaires for climate change, water and forests plus sector-specific modules within these. CDP sends the appropriate questionnaires to each FTSE-listed company based on sector relevance. For example they would not send the forest and water questionnaires to a bank.

In 2014 71% of the FTSE 350 responded to the CDP's climate change information request.

Guidance

This is in furtherance of Principles 1, 7 and 8 of the UN Global Compact.

A company's environmental performance is assessed as part of the CDP climate change, water and forests scoring methodologies which are publicly available, and so their CDP grade will reflect this.

Three years is an adequate length of time to allow a company to put the appropriate reporting requirements and management systems in place in order to achieve an adequate CDP grade.

The scores of UK companies in 2014 can be found here: www.cdp.net/CDPResults/UK-corporate-environmental-report-2014.pdf

E3.) *If the company has answered "No" to the CDP's question on whether it supports an international agreement between governments on climate change, vote against the chair of the Environmental Sustainability Committee.*

Explanation

It is extremely relevant for shareholders to ascertain whether companies are confident that they will continue to thrive in the wake of the pledged government action to reduce carbon emissions and the expected rise of global temperatures by 2ºC.

Guidance

All major states including the UK have agreed to the Copenhagen Accord 2009 which recognised the scientific view that the increase in global temperature must be kept below 2ºC if disastrous effects are not to ensue for life on earth. Signatory countries pledged to reduce carbon emissions to ensure that a greater increase does not occur.

In 2015, in advance of the Paris Climate Conference, the CDP included a question in its climate change questionnaire which every company received: "Would your organization's board of directors support an international agreement between governments on climate change, which seeks to limit global temperature rise to under two degrees Celsius from pre-industrial levels in line with IPCC scenarios such as RCP2.6?" (The Intergovernmental Panel on Climate Change is a scientific intergovernmental body under the UN which produces information relevant to understanding the scientific basis of risk of human-induced climate change; RCP 2.6 is the most conservative of four projections of global warming.)

This is in furtherance of Principles 7, 8 and 9 of the UN Global Compact.

E4.) *Year one: If the company has failed to introduce and disclose emission reduction targets vote against the re-election of the chair of the Environmental Sustainability Committee.*

Year two: If the company has failed to commit to introducing and disclose science-based emission reduction targets with a coherent strategy and action plan in line with a 2 degree scenario vote against the re-election of the chair of the Environmental Sustainability Committee.

Year three: if the company has failed to introduce and disclose the above, vote against the re-election of the chair of the Environmental Sustainability Committee.

Explanation

The effectiveness or otherwise of a company in this area must be transparent if shareholders are properly to assess its strength and that of its management.

Building a sustainable model should be at the core of the business strategy. The goals should be relevant, material and authentic.

Guidance

This is in furtherance of Principles 7, 8 and 9 of the UN Global Compact.

Meaningful targets means those developed in line with accepted existing methodologies as set out in Science Based Targets, a joint initiative by CDP, the UN Global Compact, the World Resources Institute and WWF.

For newly listed companies 'year one' will be deemed to be the first year that ends after listing.

E5.) *If the company has a history of major incidents of environmental damage, or a major incident in the year under report, and the directors' report does not include a substantial account of how it is responding to resulting criticism and of the ways in which it proposes to minimise the risks of repetition, vote against the reappointment of the chair. If the remuneration policy proposes any increase in salary or bonus for directors employed at the time of the incident, vote against the remuneration report.*

Explanation

It is of the highest importance to their shareholders that companies should not shrug off environmental damage they cause, that they should learn lessons of incidents of such damage and that they should take appropriate steps to secure and deserve a reputation for responsibility in the future.

Guidance

Major incidents can be defined by whether there is an evident impact on the accounts.

It would be helpful for trustee boards to have feedback on how those judgements are exercised.

This is in furtherance of Principles 7, 8 and 9 of the UN Global Compact.

Social

These Red Lines have been developed in accordance with Principles 1, 2, 3, 4, 5, 6 and 10 of the United Nations Global Compact plus associated Conventions of the International Labour Organisation, and the UK Corporate Governance Code

S1.) *If the company does not have a Corporate Social Responsibility and Health & Safety Committee chaired by a board director, or if the company is outside the FTSE 350 and it does not have a named board member with responsibility for this area as evidence of appropriate concern, vote against the chair of the board.*

Explanation

It is important for shareholders that companies maintain a close watch on these sources of risk to their reputation and business sustainability, and that this is actively overseen at board level.

Guidance

This is in furtherance of Principles 1 to 6 and 10 of the UN Global Compact.

The remit of the committee is material, not the title and the company may decide that this committee should also have responsibility for environmental sustainability. This committee should have clear board accountability and be chaired by or reporting to a named board member. The committee should have oversight of policies and operational controls of health & safety and social risks and this should be integrated into the board agenda on strategy and business performance.

In terms of the effectiveness of operational controls, the committee should

- cover material issues relating to the risks of the company's operations and markets;
- provide evidence that they are meeting regularly: the frequency should reflect the nature of the business but minimum twice a year; and
- provide evidence that the meetings are well attended by board members. There must always be at least one present and unless there are exceptional circumstances each board member appointed to the committee should attend every half-yearly meeting or, if there are more than two per year, at least 66% of them.

S2.) *Year one: If the company has not committed itself to publish within the next 12 months equality monitoring data for its workforce covering at minimum gender, race and disability, and including management and board, vote against the re-election of the chair of the committee responsible for corporate social responsibility or, in the absence of such committee, vote against the chair of the board.*

Year two: if the company has not begun annual publication of such data, vote as above.

Explanation

It is in the shareholders' interests that the company is employing the best people for the job regardless of their race, gender etc and the way to measure the company's progress in this regard is by carrying out annual equality monitoring.

Guidance

In order to measure progress on achieving diversity, with regard to provision B.2.4 of the Financial Reporting Council's UK Corporate Governance Code, the tools need to be put in place with which to measure it. Equality monitoring is considered good practice as set out in guidance by the Equality and Human Rights Commission.

This Red Line is in furtherance of Principles 1 and 6 of the United Nations Global Compact, the ILO Equal Remuneration Convention 1951 No 100 and the ILO Discrimination (Employment and Occupation) Convention 1958 No 111. Their purpose is to ensure that all appointments are on the basis of merit.

For newly listed companies 'year one' will be deemed to be the first year that ends after listing.

S3.) *If there is no diversity strategy in place to address a lack of minority ethnic representation at board or senior management level, and there is no visible minority representation at that level, vote against the chair of the nomination committee.*

Explanation

It is in the shareholders' interests that the most senior executives have been selected on merit and, as stated by the Financial Reporting Council's Corporate Governance Code, that the board has a wide diversity of talent. The purpose of this Red Line is to ensure that all appointments are on the basis of merit.

Guidance

The issue here is whether there is a strategy in place. It is not about voting against boards without visible minority representation per se. Adoption of a diversity strategy is also in accordance with the guidance of the Equality and Human Rights Commission.

For a company with major overseas exposure it should consider the need to appoint to the board foreign nationals from the countries in which it operates in order to ensure that the board has a sufficiently deep understanding of these markets.

This Red Line is in furtherance of the Financial Reporting Council's Corporate Governance Code which states that constructive and challenging dialogue is essential to the effective functioning of a board and that one way to encourage this is through having sufficient diversity on the board. The 2014 Code now states that this includes gender and race. The Red Line implements Clause B.2.4 of the Code which states that a section of the company's annual report should include a description of the board's policy on diversity, any measurable objectives that it has set for implementing the policy and progress on achieving the objectives.

This Red Line is also in furtherance of Principles 1 and 6 of the United Nations Global Compact, the ILO Equal Remuneration Convention 1951 No 100 and the ILO Discrimination (Employment and Occupation) Convention 1958 No 111.

The definition of 'senior management' should be determined by the board but should include the first layer of management below board level.

A strategy should set out what it wishes to achieve and how it intends to achieve it.

If the company fails to disclose whether there are any visible minorities at board and senior management level, vote against the chair of the nomination committee.

S4.) *Vote against the re-election of the chair of the nomination committee if there is no strategy in place to address any under-representation of women at board level and fewer than 25% of the company's board members are female.*

Explanation

It is in the shareholders' interests that the most senior executives have been selected on merit and, as set out by the Financial Reporting Council's Corporate Governance Code, that the board has a wide diversity of talent. This is also in furtherance of the Davies Review 2011 into low representation of women on boards which recommended that companies should aim for 25% representation by 2015. The purpose of this Red Line is to ensure that all appointments are on the basis of merit.

Guidance

The issue here is whether there is a strategy in place. It is not about voting against boards with less than 25% female board representation per se. A review of the situation in March 2015 stated that the representation is now 23.5% on FTSE 100 boards and that there are no all-male boards, and 18% in the FTSE 250 with 23 all-male boards.

A strategy should set out what it wishes to achieve and how it intends to achieve it.

This Red Line is in furtherance of Clause B.2.4 of the FRC Corporate Governance Code which states that a section of the company's annual report should include a description of the board's policy on diversity, any measurable objectives that it has set for implementing the policy and progress on achieving the objectives.

It is also in furtherance of Principles 1 and 6 of the United Nations Global Compact, the ILO Equal Remuneration Convention 1951 No 100 and the ILO Discrimination (Employment and Occupation) Convention 1958 No 111.

S5.) *Vote against the chair of the nomination committee if the company does not have a policy of market testing of all board and senior management positions through an open appointments process for all vacancies.*

Explanation

It is in the shareholders' interests that the company employs the best candidates for senior roles. The best way to achieve this is to ensure market competition for these roles through open advertising.

Guidance

This does not mean that internal appointments are unacceptable, nor that recruitment consultants cannot be utilised. It simply means that the company should ensure open competition for these roles in order to be satisfied that it selects the best candidate.

This Red Line is in furtherance of the UK Corporate Governance Code which states that "there should be a formal, rigorous and transparent procedure for the appointment of new directors to the board."

It is also in furtherance of Principles 1 and 6 of the United Nations Global Compact, the ILO Equal Remuneration Convention 1951 No 100 and the ILO Discrimination (Employment and Occupation) Convention 1958 No 111. Their purpose is to ensure that all appointments are on the basis of merit.

It is recognised that while a company may have a strategy that is generally compliant, it may encounter circumstances in which an appointment needs to be arranged for a post but it would be commercially damaging for the company to publicise the prospective vacancy. We would expect voting on this Red Line to take that into account provided that diversity was part of the brief guiding the search. Absence of evidence for such a policy should not be taken automatically as evidence of its absence, but should give rise to further enquiry.

S6.) *In furtherance of Principle One of the United Nations Global Compact, vote against the board's remuneration proposals if any members of staff, including subcontracted staff employed in the UK,*

- *are paid below the Living Wage or where applicable the London Living Wage and the company has no plans to address this;*
- *do not have employment contracts specifying the number of working hours per week, or (aside from overtime with increased pay) allow more than a 25% increase or decrease on that figure to meet business needs.*

Explanation

Growth in productivity is in the shareholders' interests and this is a serious issue in the UK. Studies show that greater productivity comes from a workforce that is paid fairly. This is also in furtherance of Section 172 of the Companies Act 2006 which requires directors to promote the success of the company with regard to the interests of its employees, the impact of the company's operations on the community and the need to act fairly as between members of the company.

Guidance

Regarding the Living Wage, the issue here is whether there is a plan to introduce the Living Wage if anyone is paid less than this. The plan must specify a timetable for its introduction. For the avoidance of doubt, this Red Line refers to the rate set by the Living Wage Foundation which in 2016 is £8.25 per hour outside London and £9.40 per hour in London, and not to the statutory National Minimum Wage while it is lower.

The specification on employment contracts takes German legislation as a model, which is also used in other countries: it recognises the need among some enterprises for flexible hours, up or down 25% on the specified contractual working time (specifically the German Part-time Work and Fixed-term Contracts Act, the *Teilzeitarbeit- und befristete Arbeitsverträgegesetz*).

In recognition of the current lack of disclosure in this area, in year one when investment managers engage with companies that have not disclosed the information required under this Red Line they will be expected to engage on this point. In year two failure to disclose this information will trigger a vote against.

S7.) *Vote against political donations and political expenditure.*

Explanation

There is a serious concern that political donations and political expenditure by a company are likely to reflect the private leanings of senior management rather than the interests of the company or its shareholders.

Guidance

The expressions "political donation" and "political expenditure" are to be construed in accordance with sections 364 and 365 of the Companies Act 2006.

Under section 366 of that Act, shareholder approval is generally required before any such donations are made or such expenditure incurred. The Red Line should not be taken to apply in circumstances where that section does not apply, e.g. where the donations made by the company and its subsidiaries total less than £5k for the last 12 months, or where a donation is made to an all party parliamentary group.

S8.) *Vote against the re-election of the Chair of the main board if there is a failure to abide by the UN Global Compact standards on freedom of association, including the recognition of independent trade unions for the purpose of collective agreement.*

Explanation

It is in shareholders' interests that directors fulfil their duties under Section 172 of the Companies Act 2006 by conforming to international conventions that protect people's rights to freedom of association within their own company and within the supply chain. Failure to do so may cause reputational damage, labour unrest and a fall in share value.

Guidance

This is in furtherance of Principle Three of the United Nations Global Compact, the ILO Freedom of Association and Protection of the Right to Organise Convention, 1948, No 87, which protects people's rights to join in association for the defence of the members' interests. The Right to Organise and Collective Bargaining Convention, 1949, No 98, contains the right to collective bargaining, which depends on recognising an independent trade union with a democratic structure.

The lack of a recognised union in a company will not in itself trigger a vote under this Red Line. In order for this Red Line to be enacted a company will have committed a hostile act, such as refusal to grant a request for voluntary recognition made by an independent trade union (as defined by the Trade Union and Labour Relations (Consolidation) Act 1992 and certified as independent by the Certification Officer); derecognising or partially derecognising a trade union that is currently recognised or attempting to do so; or having a policy that is hostile to trade unions such as refusal to permit union representatives to visit the company's premises by invitation of workers.

S9.) *Year one: Where a company has breached labour standards or law, vote against the chair of the committee responsible for corporate social responsibility.*

Year two: If undertakings made by the company in year one to establish procedures to prevent a repetition are not introduced, and/or there are further breaches, vote against the Chair of the main board.

Explanation

This Red Line is in furtherance of Section 172 of the Companies Act 2006 which imposes a duty upon a director to promote the success of the company having regard to, among other factors, the interests of the company's employees and the desirability of the company maintaining a reputation for high standards of business conduct.

This is also in furtherance of Principles One to Five of the UN Global Compact. The persistence of labour rights violations in supply chains is a pressing issue. Four 'core' ILO Conventions entail an absolute prohibition on forced labour and child labour.

Guidance

This might be evidenced by the determination of a court of law or major labour unrest that causes substantial value destruction. This does not include minor breaches. It would be helpful for trustee boards to receive feedback on how "major" and "minor" are interpreted by those entrusted with voting.

S10.) *Where the company has a history of major breakdowns of industrial partnership, or of serious endangerment of health and safety, or of fraud, bribery or other corrupt practices among its staff, or has sustained major damage from any of those causes in the year under report, and the directors' report does not include a substantial account of how it is responding to resulting criticism and of the ways in which it proposes to minimise the risks of repetition, vote against the adoption of that report.*

If the remuneration policy proposes any increase in salary or bonus for directors employed at the time of the incident, vote against the remuneration report.

Explanation

It is of the highest importance to their shareholders that companies should learn the lessons of such shortcomings in their organisational culture and that they should take appropriate steps to secure and deserve a reputation for responsibility in the future.

Guidance

It will be a matter for the judgement of the person entrusted with the vote as to whether incidents are "major" and as to whether responses are "substantial". It would be helpful for trustee boards to have feedback on how those judgements are exercised.

This is in furtherance of Principles 1 and 10 of the UN Global Compact.

Corporate Governance

These Red Lines have been developed in accordance with the Financial Reporting Council's UK Corporate Governance Code

G1.) *If the chair of the board of directors and the position of chief executive have been held by the same person for more than one year, vote against the re-election of the chair of the nomination committee.*

Explanation

It is generally agreed in the UK that chief executives should be accountable to the board for the day-to-day running of the company and be supervised by a non-executive director chairing the board. The concentration of power in the hands of a single individual is prone to encourage abuse, or at least restricted vision, of the interests of the company and its shareholders. Provision A.2.1 of the Code states that these roles should not be combined.

Provision A.3.1 of the Code recognises, however, that exceptionally a board may decide that a CEO may take on the chair. It is evidently considered justifiable only in exceptional circumstances and the Red Line envisages that they should arise only on a transitional basis.

Guidance

See the introductory guidance note on page 5.

G2.) *If a full-time director of the company concurrently holds the chair of another public company or is a director of more than one other public company, vote against that person's re-election.*

Explanation

It is in the interests of shareholders that directors have adequate time to fulfil the responsibilities of their office. While a concurrent non-executive responsibility may bring advantages of cross fertilisation to both companies, it is important that this is not substantially at the expense of commitment to the director's full-time responsibilities.

Guidance

A director should be treated as full-time if he or she is contracted to devote substantially all his or her working time to the company and/or to companies within the same group or otherwise "connected" with the investee company within the meaning of sections 252 to 255 of the Act. This Red Line does go beyond Provision B.3.3 of the Code because it does not confine its relevance to other companies within the FTSE 100.

In the absence of evidence to the contrary an executive director shall be taken to be full-time and a non-executive not; if it is not clear from the remuneration report whether a director is executive, he or she shall be taken to be so.

G3.) *If it is not clear which of the existing directors of a company, and which of any current candidates for election to the board, are independent vote against the adoption of the report and accounts.*

Explanation

According to Provision B.1.1 the annual report should identify which directors the board determines to be independent. Without this information it is difficult to judge whether the board has the balance between independent and other directors set out in the Code and hence to determine whether Red Lines G4 and/or G5 have been breached.

Guidance

If, exceptionally, the report and/or accounts were laid before a general meeting of the company without a motion being put for their adoption, vote against the approval of the remuneration policy, for which a motion is statutorily required.

G4.) *Vote against the re-election of any non-executive director if it could result in that person's continuous service as a director of the company exceeding nine years, unless it is not intended that he or she be treated in future as an independent director.*

Explanation

As an initially independent director's tenure goes on, it may be expected to become more difficult to maintain that independence from the outlook of the company's executive which the shareholders need.

Guidance

If an individual was identified as an independent in the latest directors' report, it is to be assumed that he or she will continue to be so treated, unless documentation circulated to the shareholders in connection with the relevant meeting makes clear that this is not the intention.

G5.) *Vote against the re-election of the chair of the nomination committee if the company does not have the minimum number of independent non-executive directors required by Provision B.1.2 of the FRC's UK Corporate Governance Code.*

Explanation

It is in the very clear interest of shareholders that the outlook of the board is not dominated by the group of the people who are running the business day to day. It is for this reason that the Code says that in companies which are in the FTSE 350 for at least part of the year immediately prior to the reporting year, or since later listing, at least half the board must be independent non-executive directors; and that any other company should have at least two independent non-executive directors.

Guidance

The chair of the board, though he or she should be independent on appointment, is not to count as independent in this context.

A person is to be treated as a non-independent non-executive director if any of the following issues apply:

- Has been an employee of the company or group during the last five years;
- Has, or a connected person has had, within the last three years, a material business relationship with the company either directly, or as a partner, shareholder, director or senior employee of a body that has such a relationship with the company;
- Has received or receives additional remuneration from the company apart from a director's fee, participates in the company's share option or performance-related pay schemes, or is a member of the company's pension scheme;
- Has close family ties with any of the company's advisers, directors or senior employees;
- Holds cross-directorships or has significant links with other directors through involvement in other companies or bodies,
- Represents a significant shareholder;
- Is attested by the board to be a non-independent non-executive director;
- Is a former board chair;
- Has a substantial personal shareholding of ≥ 1%, or
- Has been on the board for nine years or more.

G6.) *If any director of a company will have served continuously as such for more than three years without having been re-elected at a general meeting, vote against the re-election of the chair of the board.*

Explanation

It is in the interests of shareholders that directors be held to account by reasonably frequent elections.

Guidance

Provision B.7.1 of the UK Corporate Governance Code prescribes annual elections of all directors of FTSE 350 companies; and any guarantee to a director that his or her term will, or may, last for more than two years requires shareholder approval under section 188 of the Act.

G7.) *If competition for appointment as statutory auditor has been restricted to the "big four" accounting firms, vote against the re-election of the chair of the audit committee.*

Explanation

Competition encourages businesses to improve the quality of the goods and services they sell in order to attract more customers and expand market share. In a competitive market there will be more choice and more innovation and the competition for business could encourage lower fees. It is therefore in the shareholder's interest that competition for the role of auditor is not restricted to the "big four" accounting firms and that greater competition for this work is encouraged.

Guidance

The issue of auditors' conflicts of interest and the concentration of the industry has been an important one that has not been tackled with the serious reforms called for after the Enron scandal of 2001.

This Red Line will come into effect with regard to appointments made in any financial year starting in 2016 and thereafter.

G8.) *If the appointment of the company's statutory auditor or auditors has not been the subject of a formal tender process within the past 10 years, vote against the re-election of the chair of the audit committee.*

Explanation

Shareholders need to have full confidence in the reliability of the company's accounts, so it is in the shareholders' interests that a company does not develop so close a relationship with its auditors as to risk compromising the independence of their role. Provision C.3.7 of the Code requires this of FTSE 350 companies.

Guidance

If it is not apparent from the material circulated to the shareholders in connection with the company's accounts meeting whether this Red Line has been breached, it should be assumed that it has, unless the person exercising the vote has knowledge that it has not.

If, at the time of the vote, a formal tender process has been scheduled to take place within the next financial year, a vote under G8 will not be triggered.

G9.) *If the company's statutory auditors have for a period of 15 years or more been the same, or drawn from the same firm, vote against the re-election of the chair of the audit committee.*

Explanation

It is in the interests of shareholders that a company does not develop so close a relationship with its auditors as to risk compromising the independence of their role.

Guidance

If it is not apparent from the material circulated to the shareholders in connection with the company's accounts meeting whether this Red Line has been breached, it should be assumed that it has, unless the person exercising the vote has knowledge that it has not. A firm formed by the merger of predecessor firms is to be taken to be the same as each of those.

G10.) *If over the reporting period relevant to the latest accounts meeting of a company its auditors (including any of their associates) were due to be paid an amount in fees for non-audit services greater than that properly fixed as remuneration for audit work, vote against the re-election of the chair of the audit committee.*

Explanation

The closer the involvement of an auditor or a firm of accountants with the company, the greater the strain on the independence of the auditors and the risk to the interests of the shareholders. The independence of an auditor may be questionable if it receives more money for its non-audit work for a company than it receives in audit fees.

Guidance

Associates of the auditor or of any other entity are in this connection those so defined in Schedule 1 to the Companies (Disclosure of Auditor Remuneration and Liability Limitation Agreements) Regulations 2008 (SI No 489), e.g. partners, subsidiaries. Remuneration for audit work should be taken to mean that receivable for the auditing of the company's (or relevant group) accounts, aggregated with any for the auditing of accounts of any associate of the company. Non-audit services constitute all other services to be reported under regulation 5(3) of those Regulations (as amended by SI 2011 No 2198) – a comprehensive list is set out in Schedule 2A to them.

The "accounts meeting" of a company is that defined as such by Section 437 (3) of the Companies Act 2006.

G11.) *Vote against the re-election of the chair of the board and any non-independent members of the audit committee if that committee is not to consist of a majority of independent non-executive directors.*

Explanation

Provision C.3.1 of the Code requires an audit committee and envisages that it will consist of independent non-executive directors. The deployment of independents in this role, especially in managing the company's relationship with the auditors, mitigates the risk of that relationship becoming incestuous.

Guidance

If an individual was identified as an independent in the latest directors' report, it is to be assumed that he or she will continue to be so treated, unless documentation circulated to the shareholders in connection with the relevant meeting makes clear that this is not the intention. Conversely, an individual not so identified should normally be taken to be non-independent.

G12.) *If the directors' reports do not indicate how one may readily access policy of the company in relation to the management of its tax affairs, vote against the re-election of the chair of the committee responsible for corporate social responsibility.*

Explanation

It is increasingly seen as good practice in the context of corporate risk management, including management of reputational risk, for a company's board to have a published tax policy indicating the company's approach to planning and negotiating tax matters, and to allow stakeholders to monitor its handling of risk in this area. This is not to be seen as the sole concern of the finance department.

Guidance

If the company has no committee with oversight of corporate social responsibility (or, outside the FTSE 350 a director with this responsibility), vote against the chair of the audit committee.

G13.) *If authorisation is sought for the directors of a company to allot shares in it without offering full pre-emption to existing shareholders, vote against giving it if the authority is to last beyond the next AGM, or if general exclusion of pre-emption is sought over more than 5% of issued share capital (or more than 10% if for a specified acquisition or capital investment), or if a specific exclusion is sought over more than one-third of issued share capital.*

Explanation

It is not generally in the interests of shareholders for their holding to be diluted by the issue of new shares, so if new shares need to be issued, shareholders should normally expect to have the opportunity to avoid that dilution by having first refusal, i.e. the right of pre emption. The Investment Association and the Pre Emption Group of the Financial Reporting Council, however, recognise that some flexibility is in the interests of companies and their owners.

Guidance

The limits set by the Red Line broadly reflect the criteria described in the FRC Pre Emption Group's 2015 paper Disapplying Pre Emption Rights: a statement of principles (especially paragraphs 3 and 4 of Part 2A) and in the Investment Association's Share Capital Management Guidelines (July 2014), though it is recognised that they are more tightly prescriptive.

The reference to shares should be taken to include other equity securities.

It is possible for the articles of a company to permit directors to disapply the general right of pre-emption which ordinary shareholders are given by section 561 of the Act. Accordingly, a resolution to adopt new articles which would introduce, or maintain, such a right of disapplication should be voted against, as well as special resolutions bundling this issue with others.

G14.) *Vote against any proposal for shareholder support for a dispensation from Rule 9 of the Takeover Code.*

Explanation

Rule 9 of the Takeover Code is designed to protect minority shareholders, as pension schemes will almost always be. It requires a person (or group) who has acquired a sizeable stake (30% or more) in a company to make an offer for all its shares and securities, but the Panel on Takeovers and Mergers will generally waive the requirement if a majority of independent shareholders vote to favour that.

Guidance

In cases where it might genuinely be in minority shareholders' interests for an offer not to be insisted upon, the Panel has power to waive the requirement without a shareholder vote, so only in the most exceptional circumstances should such a vote be supported.

G15.) *If there is no separate resolution to approve the final dividend, vote against the report and accounts.*

Explanation

If shareholders are to have adequate control of the way in which profits are used, it is important that issues of dividend policy are not obscured by being bundled with other matters.

Guidance

Those exercising votes are encouraged to extend the coverage of this Red Line beyond final dividends to other distributions within the meaning of Part 23 of the Act where it is practicable to do so.

G16.) *Vote against the chairman of the board and the re-election of non-independent members of the remuneration committee if the committee does not consist of a majority of independent non-executive directors.*

Explanation

It is essential to the shareholder's interests that the remuneration committee has a majority of independent non-executive directors: it is not acceptable that directors should preside over their own remuneration packages.

Guidance

This is in accordance with Section D of the UK Corporate Governance Code clause D.2.1 which specifies that the remuneration committee should comprise three (or in smaller companies two) independent non-executive directors, and that the company chairman may be a member of, but not chair, the committee if he or she was considered independent on appointment as chairman.

A person is to be treated as a non-independent non-executive director if any of the following issues apply:

- Has been an employee of the company or group during the last five years;
- Has, or a connected person has had, within the last three years, a material business relationship with the company either directly, or as a partner, shareholder, director or senior employee of a body that has such a relationship with the company;
- Has received or receives additional remuneration from the company apart from a director's fee, participates in the company's share option or performance-related pay schemes, or is a member of the company's pension scheme;
- Has close family ties with any of the company's advisers, directors or senior employees;
- Holds cross-directorships or has significant links with other directors through involvement in other companies or bodies,
- Represents a significant shareholder;
- Is attested by the board to be a non-independent non-executive director;
- Is a former board chair;
- Has a substantial personal shareholding of ≥ 1%, or
- Has been on the board for nine years or more.

G17.) *Vote against the remuneration policy in the case of any of the following:*

- ***Failure to use service contracts in relation to executive directors, which should be no more than one rolling year in duration and in the case of termination be subject to mitigation;***
- ***Awarding of a 'sign-on' bonus without the inclusion of any conditionality***
- ***Service contracts with provisions that in effect reward failure;***
- ***Basic salary increase greater than inflation or that given to the rest of the workforce;***
- ***Layering of bonus schemes on top of existing bonus schemes;***
- ***Uncapped bonuses***
- ***Too wide discretion given to the remuneration committee***
- ***No provision for claw back***
- ***No provision for withholding of benefits on cessation of employment***

Explanation

It is in shareholders' interests that remuneration packages are straightforward, clear, do not allow bonuses that are in effect unearned (such as signing on bonuses) and bonuses that have no defined upper limit. They should not reward failure, for example contracts should be no more than one rolling year in duration and there should be clawback clauses, and bonuses or Long Term Incentive Plans should be awarded pro rata.

Guidance

Section D of the UK Corporate Governance Code and Schedule A: "Performance conditions including non-financial metrics where appropriate should be relevant, stretching and designed to promote the long-term success of the company. Remuneration incentives should be compatible with risk policies and systems. Upper limits should be set and disclosed."

Layering of bonus schemes on top of existing ones captures instances where companies attempt to overlay a new short or long term incentive scheme (or schemes) in addition to the existing arrangements.

G18.) *Vote against the remuneration report and/or the remuneration policy in the case of any of the following:*

- ***Lack of clarity***
- ***Lack of transparency***
- ***Failure to include company productivity in the performance metrics***
- ***Failure to consider vertical comparability issues***
- ***Absence of incentives based on performance conditions over at least three years***
- ***incentives which would have the effect of making directors focus on short-term returns at the expense of sustainable business success.***

Vote against the remuneration report in the case of any of the following:

- ***Bonuses being awarded despite decline in the company's performance***
- ***Inappropriate use of discretion***
- ***Payment of a transaction bonus***

Explanation

The remuneration report reports on the remuneration that has been paid in the past year.

The remuneration policy sets out the remuneration committee's plans for directors' remuneration packages going forward.

A transaction bonus is one that is determined on the completion of a transaction, typically merger or acquisition, rather than after any benefits of that transaction to the company have had time to show themselves (usually five years on).

Vertical comparability issues are those concerning the appropriateness or otherwise of differentials in pay within the company.

Guidance

In furtherance of Section D of the UK Corporate Governance Code. The level of clarity required is that which a professional familiar with executive remuneration would expect, not that which would make the position obvious to a lay person. Lack of clarity may not include instances where companies have subsequently provided a satisfactory explanation upon enquiry. It necessarily infers the application of subjective judgement which may well vary according to individual expertise.

Lack of transparency: examples include no quantified targets disclosed or no disclosure of the peer group when using such a group as a comparison.

G19.) *Vote against the remuneration report or policy if the total remuneration package of any director is more than 100 times greater than the average pay of the company's UK workforce, other than in exceptional circumstances which must be fully justified.*

Explanation

The UK Corporate Governance Code makes clear that the remuneration committee "should be sensitive to pay and employment conditions elsewhere in the group especially when determining annual salary increases." It is not in the shareholders' interests for companies to ignore this matter as doing so may cause any of the following: internal resentment, falls in productivity, industrial unrest, reputational damage, fall in output and fall in shareholder value. If the average wage in a company is approximately the national UK median annual earnings for full-time employees of about £27,000 per year, a director earning 100 times this would be paid £2.7-million.

Guidance

The single total figure for each director's remuneration is that required to be included in the remuneration report by paragraphs 4 and 5 of Part 3 of Schedule 8 to the Large and Medium-sized Companies and Groups (Accounts) Regulations 2008 (SI 2008/410, as amended by SI 2013/1981). Schedule 8 paragraphs 38-39 state that the company has to state how the pay and employment conditions of employees have been taken into account when setting directors' pay. Paragraph 39(b) requires that report to set out what, if any, comparison measurements were used and how.

If adopted as proposed in early 2015, the EU Shareholder Rights Directive will require disclosure of the ratio between the average remuneration of directors and that of the workforce.

The company should explain the basis of its calculations (similar to the US Securities and Exchange Commission proposed rule required under the Dodd-Frank Act). Part-time salaries may be calculated as pro rata full time pay.

If workforce costs are given only for a wider group than the UK workforce then the average pay of the wider group should be used.

G20.) *Vote against the remuneration policy (or the Long Term Incentive Plan if there is a separate vote on it) if the LTIP could result in an award higher than 300% of salary.*

Explanation

Long Term Incentive Plans (LTIPs) should be aligned to shareholders' interests – but there is evidence to show that LTIP payments to executives in the FTSE 350 increased by over 250% between 2000 and 2013, roughly five times faster than returns to shareholders, and there is negligible linkage between LTIP payments to executives and shareholder returns. This is not in the shareholder's interests.

Guidance

The UK Corporate Governance Code states: "Boards of listed companies will need to ensure that executive remuneration is aligned to the long-term success of the company and demonstrate this more clearly to shareholders." LTIPs sometimes require specific shareholder approval and sometimes not, depending on how they are structured.

G21.) *Vote against the remuneration policy if the CEO's remuneration package does not include criteria for awards to be linked to relevant corporate social responsibility and environmental sustainability targets.*

Explanation

By incorporating such targets companies show that they integrate sustainability criteria into their overall business planning and that they are truly committed to acting in a socially and environmentally sustainable manner. Setting such targets also reinforces the notion that sustainability is an important driver of business value and can help shift the focus away from short-term returns.

The integration of CSR performance indicators as direct drivers of executives' variable remuneration is a practice that is of growing importance. This practice - part of a more general trend of convergence between the fields of CSR and corporate governance - has a double raison d'être. First, a remuneration policy which internalizes the interests of a broader range of stakeholders can reinforce the company's reputational asset and improve the relationship with both its investors and communities. Second, monetary incentives linked to sustainable development can effectively contribute to improve the company's management of ESG risks, which in turn may be associated with better financial performance in the medium to long term. Under this point of view, the use of CSR performance objectives is an innovative way to anchor the bonuses of managers to a perspective of long-term value creation.

Guidance

In the 2014 UK Corporate Governance Code the Financial Reporting Council has focussed on the risks which affect longer term viability, and (as stated earlier) "Boards of listed companies will need to ensure that executive remuneration is aligned to the long-term success of the company and demonstrate this more clearly to shareholders." Linking executive pay to achievement of corporate responsibility and environmental sustainability performance targets is aligned with the intentions of the code and in the interests of shareholders.

G22.) *Vote against the remuneration policy if the performance measures are only stock-market related such as Total Shareholder Return.*

Explanation

Stock market related performance metrics can be manipulated – for example a share buy-back can raise the share price; saving money by closing an R&D department could increase short-term profit at the expense of long-term product development. It is in the shareholders' interests that performance metrics are linked to the company's strategic plan and key performance indicators (KPIs) and ensure there is a strong read-across from the company's strategy to the drivers of executives' remuneration.

Guidance

The Code states: "Executive directors' remuneration should be designed to promote the long-term success of the company. Performance-related elements should be transparent, stretching and rigorously applied."

Appendix

The Ten Principles of the United Nations Global Compact

The UN Global Compact's ten principles in the areas of human rights, labour, the environment and anti-corruption enjoy universal consensus and are derived from:

- The Universal Declaration of Human Rights
- The International Labour Organization's Declaration on Fundamental Principles and Rights at Work
- The Rio Declaration on Environment and Development
- The United Nations Convention Against Corruption

The UN Global Compact asks companies to embrace, support and enact, within their sphere of influence, a set of core values in the areas of human rights, labour standards, the environment and anti-corruption:

Human Rights

Principle 1: Businesses should support and respect the protection of internationally proclaimed human rights; and

Principle 2: make sure that they are not complicit in human rights abuses.

Labour

Principle 3: Businesses should uphold the freedom of association and the effective recognition of the right to collective bargaining;

Principle 4: the elimination of all forms of forced and compulsory labour;

Principle 5: the effective abolition of child labour; and

Principle 6: the elimination of discrimination in respect of employment and occupation.

Environment

Principle 7: Businesses should support a precautionary approach to environmental challenges;

Principle 8: undertake initiatives to promote greater environmental responsibility; and

Principle 9: encourage the development and diffusion of environmentally friendly technologies.

Anti-Corruption

Principle 10: Businesses should work against corruption in all its forms, including extortion and bribery.

The UK Corporate Governance Code

The UK Corporate Governance Code can be found here:

www.frc.org.uk/Our-Work/Publications/Corporate-Governance/UK-Corporate-Governance-Code-2014.pdf

Red Line Voting

Association of Member Nominated Trustees

A new approach to asset owner voting in the UK stock market
by the Association of Member Nominated Trustees