Agenda Item

4

General Governance Matters

Agenda Item 4

FALKIRK COUNCIL

Subject: **General Governance Matters**

Meeting: **Joint Meeting of Pensions Committee and Pension Board**

Date: **8 December 2016**

Submitted by: **Director of Corporate and Housing Services**

1. Purpose of Report

1.1 This report updates the Board and Committee on miscellaneous matters associated with the business of Falkirk Council Pension Fund.

2. Recommendations

2.1 The Pensions Committee and Board are invited to note the content of this report.

2.2 The Pensions Committee agrees that the Chief Finance Officer maintain discussions with Scottish LGPS Funds regarding the creation of a collective vehicle for Scottish infrastructure investment.

3. Matters for Consideration

3.1 The following matters are covered in the body of the report

- Risk Register
- Pension Fund Budget Update
- Scheme Structure Review
- Pension Board Governance Review
- Employer Funding Event
- Pooling Assets in England and Wales
- Infrastructure
- Corporate Governance Issues
- Scotland–Wide Pensions Training

4. Risk Register

4.1 A significant area of heightened risk to the Fund this quarter relates to asset values being affected by political uncertainty as detailed overleaf:

Identified Risk per Risk Register	Reason for Change in Risk Rating
Asset values affected by political uncertainty	The election of Donald Trump to the US Presidency and uncertainties over his approach to foreign relations, trade agreements and infrastructure investment may add to market volatility over the coming months. *Mitigation – As a long term investor with a well-diversified portfolio of investments and no immediate cash flow requirement, the Fund has the capacity to weather short term market noise. Investment strategy remains under regular review and can be adjusted if better sources of risk adjusted return are identified.*

5. The Pension Fund budget for 2016/17 was agreed at the Committee meeting of 11 March 2016.

The table below shows the variances from the expected outturn against budget.

Falkirk Council Pension Fund **As at 31/10/2016**

	Budget 16-17	Forecast 16-17	Variance 16-17
Administration	**653,130**	**623,130**	**(30,000)**
Oversight & Governance	**558,830**	**558,830**	**0**
Investment Management			
Aberdeen Asset Mgmt	1,200,000	0	(1,200,000)
Schroders Inv Mgmt	700,000	730,000	30,000
Legal & General	300,000	320,000	20,000
Newton Inv Mgmt	1,650,000	1,820,000	170,000
Baillie Gifford	1,500,000	1,430,000	(70,000)
Transaction costs	300,000	300,000	0
Other	275,000	275,000	0
	5,925,000	**4,875,000**	**(1,050,000)**
Pension Fund Total	**7,136,960**	**6,056,960**	**(1,080,000)**

Overall, the Pension Fund's costs are projected to have an underspend of circa £1m. The main contributor is the one year fee break from Aberdeen Asset Management budgeted at £1.2m. These savings are expected to be offset by an overspend of £150k in other fund manager fees. Strong investment returns and the depreciation of sterling have led to increased portfolio valuations and higher fees as these are based on valuations.

A reduction in IT costs is projected to result in a small saving within the Administration budget. Oversight and Governance costs are projected to be in line with budget.

6. Scheme Structure Review

6.1 As part of the agreement surrounding the introduction of LGPS (Scotland) 2015, it was agreed that a structural review of the Scheme would be conducted by the Scheme Advisory Board.

6.2 Data, including cost information, has been gathered over the past 12 months and consultants appointed to provide an options appraisal. This could include the status quo of 11 Funds, increased collaboration, pooling or fund mergers.

6.3 A report is expected to be presented to the Scheme Advisory Board in March with Funds and other stakeholders being consulted thereafter.

7. Pension Board Governance Review

7.1 Scottish Ministers are undertaking a review of the effectiveness of Pension Boards across Public Sector Pension Schemes, including the Boards of the LGPS Funds.

7.2 KPMG have been appointed to undertake the review which is being led by an Ian Pollitt. Members of the Board are likely to be contacted by KPMG for their opinions. The fact that neither Committees nor Fund officers are being contacted is perhaps a matter of some surprise.

7.3 The Terms of Reference (attached at Appendix 1) require recommendations to be made to Ministers by 30 April 2017. Changes are likely to be limited as the Boards are required to operate within the terms of the Public Service Pensions Act 2013.

8. Employer Funding Event

8.1 An update on Falkirk's funding position was given to employers by the Fund actuary, Hymans Robertson, at a meeting on 23rd November.

8.2 Ahead of the meeting, employers were given an "early warning" report with estimated details of their current funding position and potential employer contribution rates from April 2018 (i.e. this will be the start date of new employer rates following the 2017 valuation).

8.3 Most employers are facing significant hikes in their rates as a result of the low interest rate environment, a lower investment return outlook and the lack of take up of the 50:50 option.

8.4 The consensus amongst employers was that the underlying scheme provisions needed to be revisited nationally. It was noted that Hymans had recently presented details of the funding environment to the Scheme Advisory Board thereby raising the profile of the issue.

9. Pooling Assets in England and Wales

9.1 The UK Government's initiative to pool the assets of 89 LGPS Funds in England and Wales worth approximately £250bn is progressing.

9.2 The objectives are to improve returns, reduce costs, and facilitate larger scale infrastructure investment. Pools will be controlled by FCA approved management boards and will be responsible – instead of elected members - for selecting and monitoring manager performance. Strategic asset allocation will remain the responsibility of local Fund Pension Committees.

9.3 Funds have proposed 8 pools ranging in size from between £12bn - £40bn. Treasury approval is awaited. If the timetable goes to plan, assets will transition to new mandates in April 2018.

9.4 Some fee savings are already being realised such as LGIM reducing fees for their passive mandates - this is being passed onto Scottish Funds as well. Initial savings from pooling will however be offset by the costs of transitioning the assets and the compliance and legal costs of setting up Pool Boards with FCA accreditation. Boards will need to recruit specialist staff and may find themselves in direct competition with the private sector.

10. Infrastructure

10.1 Derek Mackay, the Cabinet Secretary for Finance and the Constitution (and the Scottish Minister with responsibility for the LGPS) recently made a public statement to the effect that he wished to see Funds making a greater effort to invest in infrastructure in Scotland with his preference being voluntary collaboration between funds rather than mandatory pooling. This echoed a 2015 report from the Local Government and Regeneration Committee of the Scottish Parliament which stated *"we encourage Funds to seek out opportunities to work collaboratively to benefit from shared expertise in identifying suitable infrastructure investments".*

10.2 Following discussions at Director of Finance level and accepting that Funds should only invest in a manner consistent with their investment strategy, there appears to be a broad consensus towards Funds exploring a collective approach to Scottish Infrastructure as part of each Fund's wider infrastructure allocation.

10.3 One potential model would involve:

- the participation of Scottish Funds in a collective limited partnership vehicle
- a fund size of up to £300m (i.e. about 1% of Scottish LGPS assets)

- commitments in proportion with individual Fund size (c £15m - 20m for Falkirk)
- investments would be in a broad range of Scottish infrastructure assets – incl. renewables, transport, housing
- investments would be dependent on total Fund raised and market opportunity
- fund to be managed by a single specialist manager overseen by an advisory committee

10.4 An allocation of up to £20m could be tolerated within the Falkirk Fund's overall allocation to infrastructure of 9%. Subject to Committee approval, the Chief Finance Officer can maintain dialogue with other Funds to further develop this initiative. (It should be noted that a recommendation to increase the allocation to infrastructure in collaboration with the Lothian Fund is contained in the Investment and Governance Issues paper tabled at this meeting.)

11. Corporate Governance Issues

11.1 The Fund discharges its obligations as a responsible investor by monitoring the engagement efforts of its Managers and by being a member of the Local Authority Pension Funds Forum (LAPFF).

11.2 LAPFF is supported by PIRC Ltd, who are the Forum's research and engagement partner. PIRC are also the Falkirk Fund's voting agents and advisers on ESG matters.

11.3 Q3 saw LAPFF engagement:

- succeed in persuading the **National Grid** to publish its Scope 3 emissions data
- pressurise **National Express** to undertake collective bargaining with a US Union
- extract a promise from **Sports Direct** for an independent review of work practices
- discuss women on Boards with **Weir Group** and **Tullow Oil**
- discuss tax transparency with **Unilever** and **Alphabet**
- discuss sustainability with **Anglo American**

11.4 An emerging Brexit theme from recent AGMs has been the extent to which restrictions on free movement of labour might impact on companies' ability to operate effectively.

11.5 Some examples of Q3 Manager engagement by Schroders and Newton are set out in Appendix 2.

11.6 Following the UK Government's apparent back tracking on making it mandatory to have worker representatives on company boards, proposals are being brought forward to require companies to report the pay gap between their CEOs and average employees. The Government green paper is also expected to propose binding votes on executive pay packages and measures to improve the effectiveness of remuneration committees.

12. Scotland–Wide Pensions Training

12.1 A Training Seminar for the Committee and Board members of Scottish LGPS Funds is taking place on Monday, 12th December, 2016. Venue is the Burns Suite, COSLA Conference Centre, 19 Haymarket Yards, Edinburgh EH12 5BH.

12.2 Among items being covered are Global Custody, Infrastructure and ESG.

____

pp Director of Corporate & Housing Services

Author: Alastair McGirr, Pensions Manager
01324 506333 alastair.mcgirr@falkirk.gov.uk

Date: 28 November 2016

Appendices

Appendix 1 – SPPA Pension Board Review Terms of Reference
Appendix 2 – Manager Engagement Information – Schroders and Newton

List of Background Papers:

None

SPPA
SCOTTISH PUBLIC PENSIONS AGENCY

Appendix 1

7 Tweedside Park
Tweedbank
GALASHIELS
TD1 3TE
www.sppa.gov.uk

Tel: 01896 893000
Fax: 01896 893214
Chad.dawtry@gov.scot

To:
The Scottish Local Government Pension Board

Our ref: SPPA Governance

25th August 2016

Dear Colleague

I am writing to make you aware of a forthcoming Review of the effectiveness of the operation of the governance arrangements introduced under the Public Service Pensions Act 2013.

At the time the new arrangements were established, the Scottish Government committed to review them within two years. Attached at Annex A are draft Terms of Reference for the Review, for your consideration and comment. As you will see the Terms are necessarily relatively high-level. For the avoidance of doubt, however, we will expect the Independent Reviewer to use a range of methods to ensure coverage of detailed issues. Please bear this in mind when considering the draft.

As the timetable for the Review is reasonably tight, I would be grateful if you could provide any comments you may have on the draft Terms to Lorraine Gallagher (Lorraine.Gallagher@gov.scot) copied to Lorimer Mackenzie (lorimer.mackenzie@gov.scot) by mid-September 2016.

Yours sincerely

Chad Dawtry
Deputy Chief Executive and Director of Policy, SPPA

Annex A

REVIEW OF THE OPERATION OF GOVERNANCE ARRANGEMENTS

INTRODUCED UNDER THE PUBLIC SERVICE PENSIONS ACT 2013

FOR SCOTLAND'S

LOCAL GOVERNMENT, NHS, TEACHERS', POLICE AND FIREFIGHTERS'

PENSION SCHEMES

TERMS OF REFERENCE

Introduction

1. New governance arrangements were introduced in Scotland from **1** April 2015 under the Public Service Pensions Act 2013 (the Act). These were built around a number of recommendations made by the Independent Public Services Commission. As well as new duties for the Pensions Regulator, they resulted in greater clarity around public service pension scheme accountabilities and required the creation of Scheme Advisory Boards and Pension Boards for Scotland's NHS, Teachers', Police Firefighters' and Local Government pension schemes.

2. The Act prescribed certain requirements, including:

2.1 Scheme Advisory Boards must exist to advise the responsible authority, at the authority's request, on the desirability of changes to the scheme.

(Note: The responsible authority for the governance arrangements in the scope of this review are the Scottish Ministers, with the Cabinet Secretary for Finance and the Constitution operating as Scotland's Minister for public service pensions.)

2.2 Pension Boards must exist to assist the scheme manager with securing compliance with: i) the scheme regulations and other legislation relating to the governance and administration of the scheme; ii) requirements imposed by the Pensions Regulator; iii) any other requirements specifically set out in scheme regulations.

(Note: the scheme manager for the Local Government Pension Scheme (LGPS) is the relevant local fund authority (of which there are eleven) and is the Scottish Ministers, delegated to the SPPA, for the NHS, Teachers' Police and Firefighters' pension schemes.)

2.3 Pension Boards must include "employer representatives and member representatives in equal numbers".

3. The Scottish Government had discretion as to who should serve on the boards, broadly what business boards should conduct, when and where they should meet and, in the case of the locally managed LGPS, how many Pension Boards there should be. Five Scheme Advisory Boards were established (one for each scheme above) and fifteen Pension Boards (eleven for the distributed Local Government Pension Scheme (LGPS) and one each for the other four pension schemes). As public service pension policy advisers to the Scottish Government, the Scottish Public Pensions Agency (SPPA) oversaw the development and delivery of these new arrangements though the terms of reference for and composition of the Scheme Advisory Boards and Pension Boards were agreed in partnership (SPPA/employer/trades unions).

4. Across Scotland, around two hundred and fifty people are directly involved as members of these various boards. Others will be actively involved in the preparation and presentation of papers to boards (in some cases these will already exist, but some will be specifically created for board consideration) and in providing secretariat services. With boards typically meeting around four times/year, this represents a significant human resource investment. In 2015, on Ministers' behalf, the SPPA committed to review the effectiveness of the operation of the new arrangements within two years of their introduction. It has been agreed that the review should be carried-out by suitably skilled and knowledgeable independent resource to ensure that improvements are reflective of: i) wider best practice; and ii) stakeholders' ability to fully reflect on what has and has not worked well.

Objectives

5. The objectives of this Review are:

5.1 to review the effectiveness of the operation of the Scheme Advisory Boards and Pension Boards set up in Scotland under the Act in light of:

5.1.1 the requirements of the Public Service Pensions Act 2013 (including, but not restricted to, s. 5(3) on the effective and efficient governance and administration of the scheme);

5.1.2 the recommendations of the Final Report of the Independent Public Service Pensions Commission;

5.1.3 other legislative requirements or formal guidance, for example, The Pensions Regulator' Code of Practice No. 14;

5.1.4 good practice in the operation of relevant comparator governance arrangements;

5.1.5 lessons learned in the first year of operation of these governance arrangements, in particular (but not exclusively):

i. the quality of board member induction and continuous development, specifically in relation to the requirement for Pension Board members to have sufficient knowledge and understanding to fulfil their role;

ii. clarity of Board purpose and collective (Board) and individual roles and responsibilities;

iii. the adequacy of scheme member representation (active, deferred, pensioner and prospective scheme members);

iv. the diversity of Board membership;

v. the effectiveness of board management & administration;

vi. the leadership, chairing and conduct of meetings;

iv. the frequency and location of meetings.

5.2 by 31 December 2016, to prepare a detailed report of related conclusions, options and recommendations on how to optimise the value of existing governance arrangements;

5.3 by 28 February 2017, to provide advice and recommendations to Ministers on how to optimise the value of existing governance arrangements and how to communicate any related changes;

5.4 by 30 April 2017, to initiate the necessary changes in governance arrangements desired by Ministers.

Scope

6. This Review covers:

6.1 The composition and operation of the Scheme Advisory Boards for Scotland's NHS, Teachers', Police, Firefighters' and Local Government pension schemes and related governance arrangements including, for example, interaction around approved Work Plans.

6.2 It is noted, in particular, that the Work Plan for the LGPS Scheme Advisory Board includes a structural review of the LGPS. Work is already underway to scope and initiate that review, subject to its detailed approval by the Cabinet Secretary for Finance and the Constitution. To the extent that that specific review bears on this review, it is within the scope of this review.

6.3 The composition and operation of the Pension Boards for Scotland's NHS, Teachers', Police and Firefighters' pension schemes and related governance arrangements.

6.4. The composition and operation of the eleven Pension Boards for the LGPS in Scotland and related governance arrangements.

6.5 Interaction and communication between:

6.5.1 the various boards on an intra-scheme basis;

6.5.2 the various boards and related governance arrangements (for example, the relationship between the Pension Boards for Scotland's NHS, Teachers', Police and Firefighters' pension schemes and the SPPA's Corporate Board and the relationship between the Police Scheme Advisory Board and the Police Negotiating Board for Scotland);

6.5.3 the various boards and respective scheme stakeholders;

6.5.4 Scheme Advisory Boards and SPPA policy officials, who are responsible for advising Ministers on public service pensions policy, including the views of the Scheme Advisory Boards;

6.5.5 Pension Boards and officials engaged in the day-to-day management of the pension scheme in question.

Exclusions

7. The following are excluded from the scope of the Review:

7.1 <u>Other than under 3.5.1.2</u>, the operation of the SPPA's Corporate Board and Audit & Risk Committee.

7.2 **[Add other relevant exclusions]**

Deliverables

8. Deliverables will include:

8.1 procurement of an independent resource to lead the review and achieve objectives 3.1.1 and 3.1.2 (by end August 2016);

8.2 a finalised terms of reference for the review (by end September 2016);

8.3 a method statement and project plan, setting-out how the contractor will approach the review, including a formal plan for the engagement of key stakeholders in the review (by end September 2016), including:

8.3.1 a formal plan for the participation of key stakeholders in the review, covering, for example, taking evidence and attribution/anonymity;

8.3.2 a formal plan for the use of related research.

8.4 a final report of review findings (by end December 2016);

8.5 presentations of findings to Scheme Advisory Boards (by end January 2017);

8.6 summary policy advice to Scottish Ministers (by end February 2017);

8.7 communication on resultant decisions taken (by end April 2017).

Project approach

9. The Review will be managed in line with Scottish Government guidance on Managing Successful Projects.

10. The Senior Responsible Officer for the Review will be the SPPA's Deputy Chief Executive, who is also Director of Policy.

11. The Project Manager will be SPPA's Deputy Director of Policy, who will also be responsible for deliverables 8.6 and 8.7.

ends

Company engagement

Our ESG team had 103 engagements this quarter with the 78 companies listed below, on a broad range of topics categorised under "environmental", "social" and "governance". They included one-to-one meetings, joint investor meetings, conferences, teleconferences, written correspondence and collaborative engagements.

For further details about the issues discussed and company responses, please contact your Client Director.

Company	E	S	G
Consumer Discretionary			
Berkeley	✓		
Burberry		✓	
Informa			✓
John Wiley	✓		
Pearson			✓
RELX			✓
Taylor Wimpey	✓		
Topps Tiles			✓
Truworth	✓	✓	
Whitbread		✓	
WPP			✓
Consumer Staples			
Associated British Foods		✓	
Coca Cola	✓	✓	
Dairy Crest			✓
Hengan	✓		
Imperial Tobacco		✓	✓
Kerry		✓	
Morrisons		✓	
Tate & Lyle			✓
Tesco		✓	

Company	E	S	G
Unilever		✓	✓
Wessanen		✓	
Energy			
BP	✓		✓
Chevron		✓	
ENI			✓
Lukoil	✓	✓	
Statoil	✓		
Wood Group	✓		
Financials			
Admiral		✓	✓
Assura	✓		✓
Bank of America		✓	
Barclays		✓	
Citigroup		✓	
Discover		✓	
HSBC		✓	
Intesa Sanpaolo		✓	✓
Investors Capital Trust			✓
JP Morgan Chase		✓	

Key: E: Environment S: Social G: Governance

The stocks mentioned above are for illustrative purposes only and not a recommendation to buy or sell.

Source: Schroders as at 30 September 2016

Company engagement

Continued...

Company	E	S	G
Just Retirement			✓
Lloyds		✓	✓
Paragon Group		✓	✓
Prudential		✓	✓
Royal Bank of Scotland		✓	
Tai Cheung			✓
Unicredit	✓	✓	✓
US Bancorp		✓	
Wells Fargo		✓	
Health Care			
Amgen		✓	✓
Bayer		✓	✓
BTG			✓
Celgene		✓	✓
Essilor	✓	✓	✓
GlaxoSmithKline			✓
Shire			✓
Teva	✓	✓	
Vectura			✓
Industrials			
Cobham			✓
De La Rue			✓
G4S		✓	

Company	E	S	G
Galliford	✓		
Gujarat Pipavav Port			✓
Polypipe			✓
Rolls-Royce			✓
RPS Group			✓
SIG			✓
Speedy Hire			✓
Information Technology			
Chroma			✓
Fiserv	✓	✓	
Sepura			✓
Materials			
BHP Billiton	✓		
Goldcorp	✓	✓	
LyondellBasell	✓	✓	
Orica			✓
South32	✓	✓	✓
Synthomer			✓
Telecommunication Services			
BT			✓
Vodafone			✓
Utilities			
Centrica		✓	

Key: E: Environment S: Social G: Governance

The stocks mentioned above are for illustrative purposes only and not a recommendation to buy or sell.

Source: Schroders as at 30 September 2016

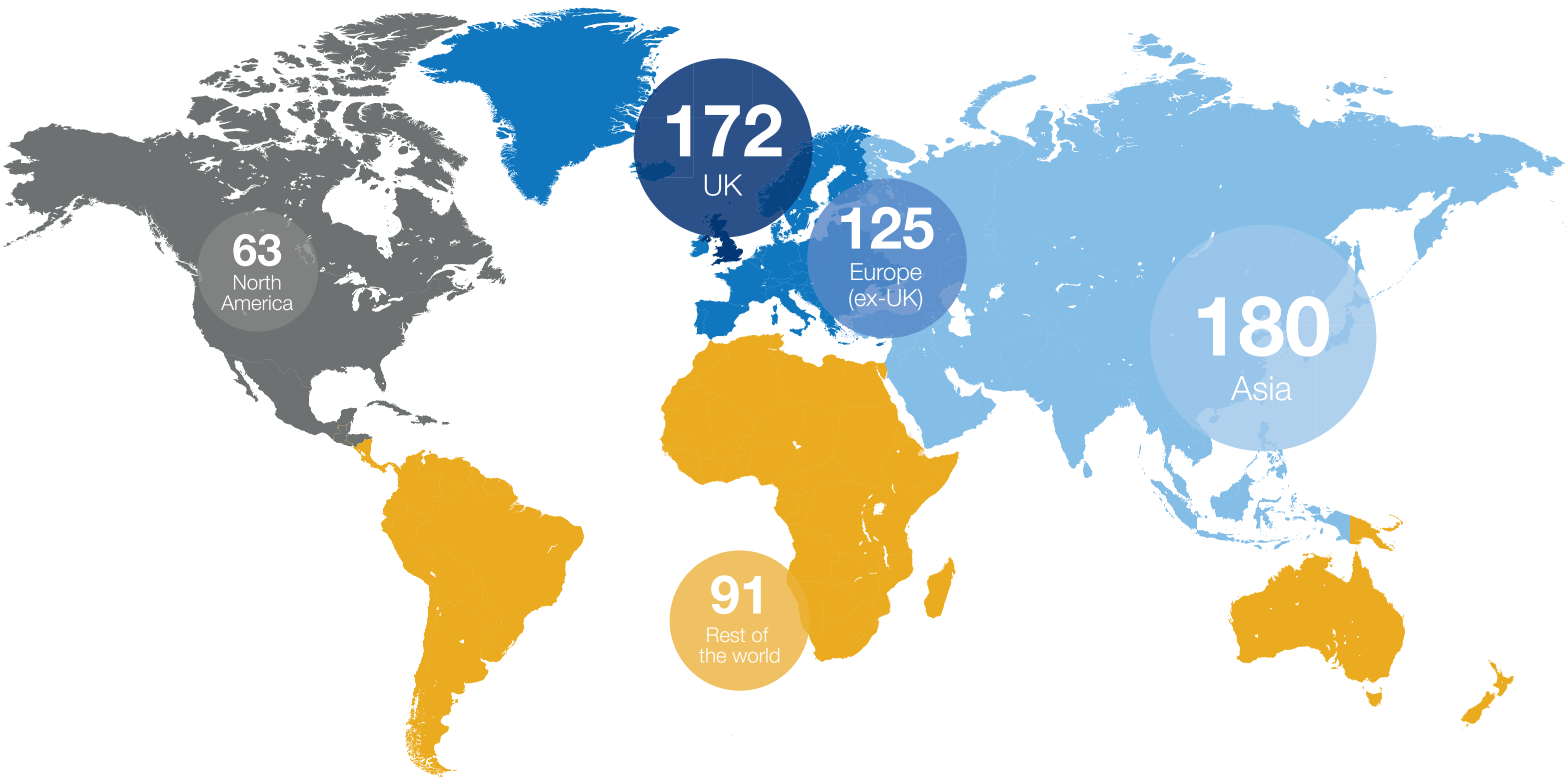
Shareholder voting

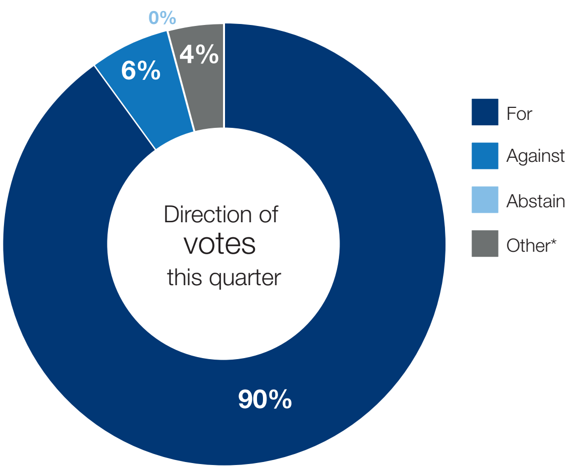
We believe we have a responsibility to exercise our voting rights. We therefore evaluate voting issues on our investments and vote on them in line with our fiduciary responsibilities to clients. We vote on all resolutions unless we are restricted from doing so (e.g. as a result of shareblocking).

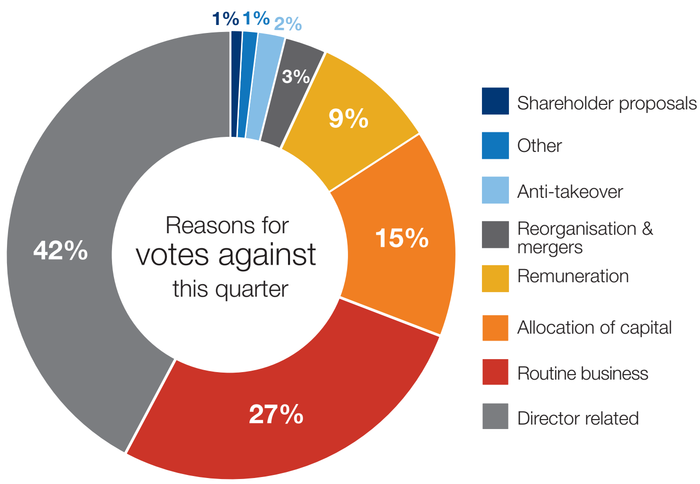
This quarter we voted on **631 companies and approximately 96% of all our holdings**. We voted on 24 ESG-related shareholder resolutions, abstaining on zero and voting against 4.

The charts below provide a breakdown of our voting activity from this quarter. Our UK voting decisions are all available on our website at **www.schroders.com/responsibleinvestment** under "Voting".

Company meetings voted





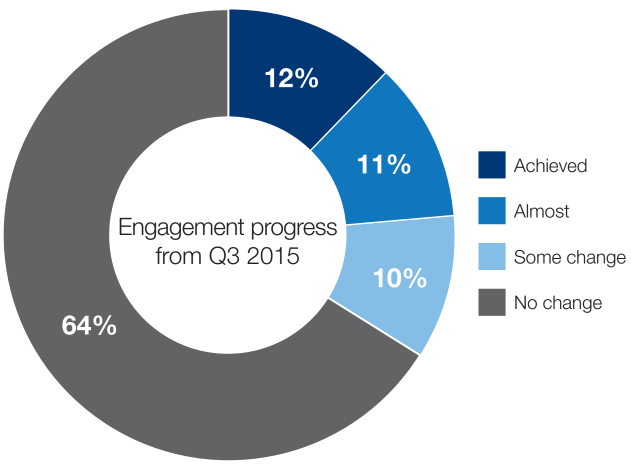


Source: Schroders as at 30 September 2016.
*Includes withheld or unvoteable resolutions, for example due to shareblocking.

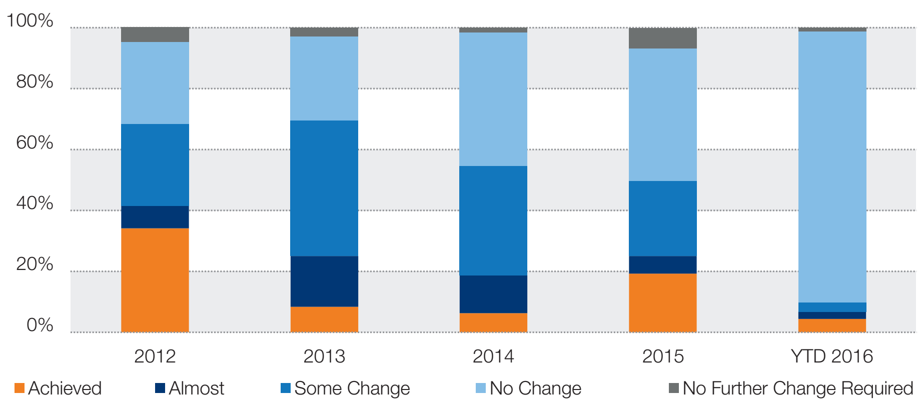
Engagement progress

This section reviews any progress on suggestions for change we made a year ago, in this case the third quarter of 2015. There are four possible results: “Achieved”, “Almost”, “Some Change” and “No Change”. Of a total number of 97 “change facilitation” requests made, we recorded 12 as Achieved, 11 as Almost, 10 as Some Change and 64 as No Change.

Below we provide details on our successes.



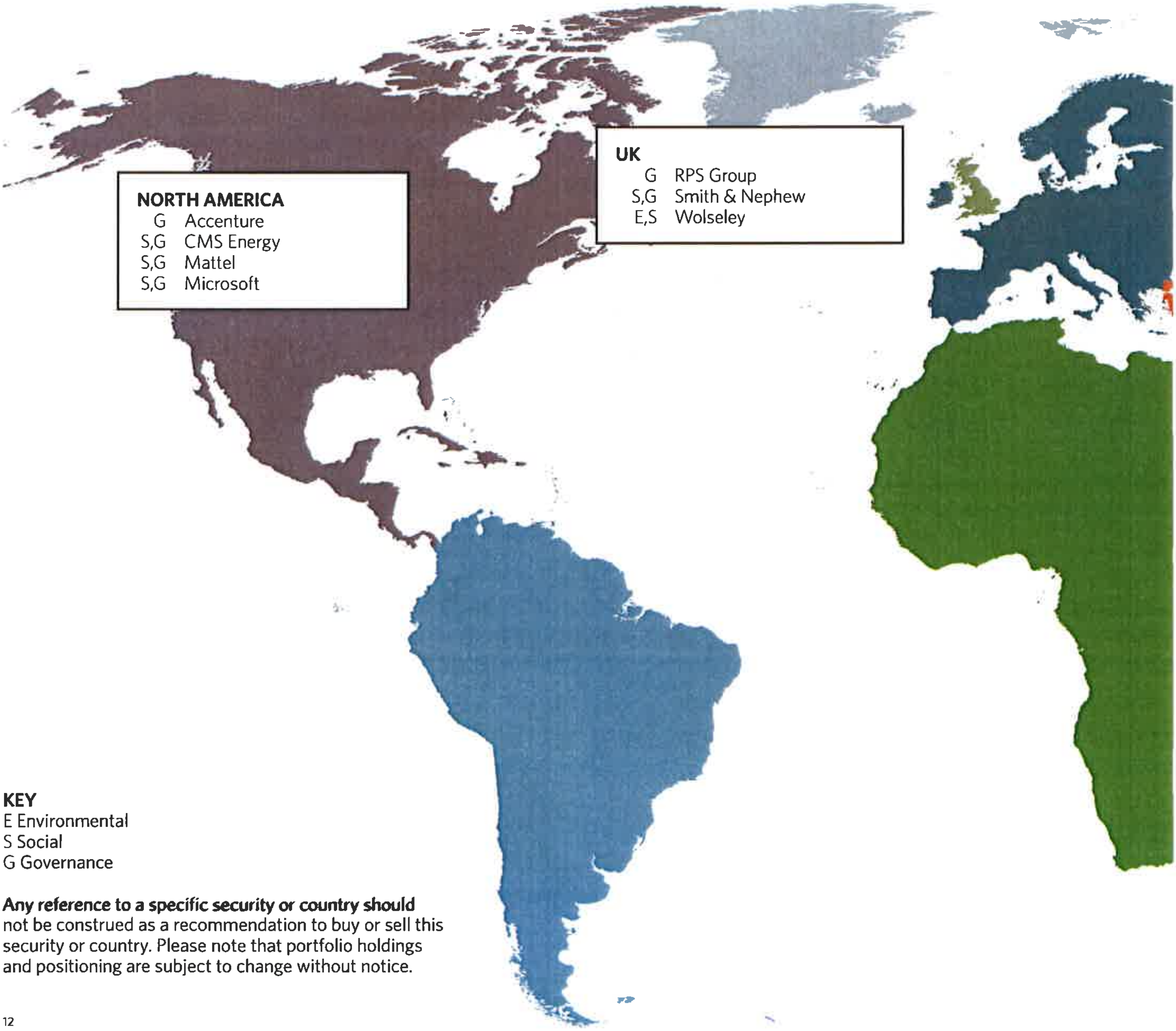
The chart below shows the effectiveness of our engagement over a five-year period. We recognise that any changes we have requested will take time to be implemented into a company’s business process. We therefore usually review requests for change 12 months after they have been made, and also review progress at a later date. This explains why there is a higher number of engagement successes from previous years.



Source: Schroders as at 30 September 2016.

Examples of ESG engagement

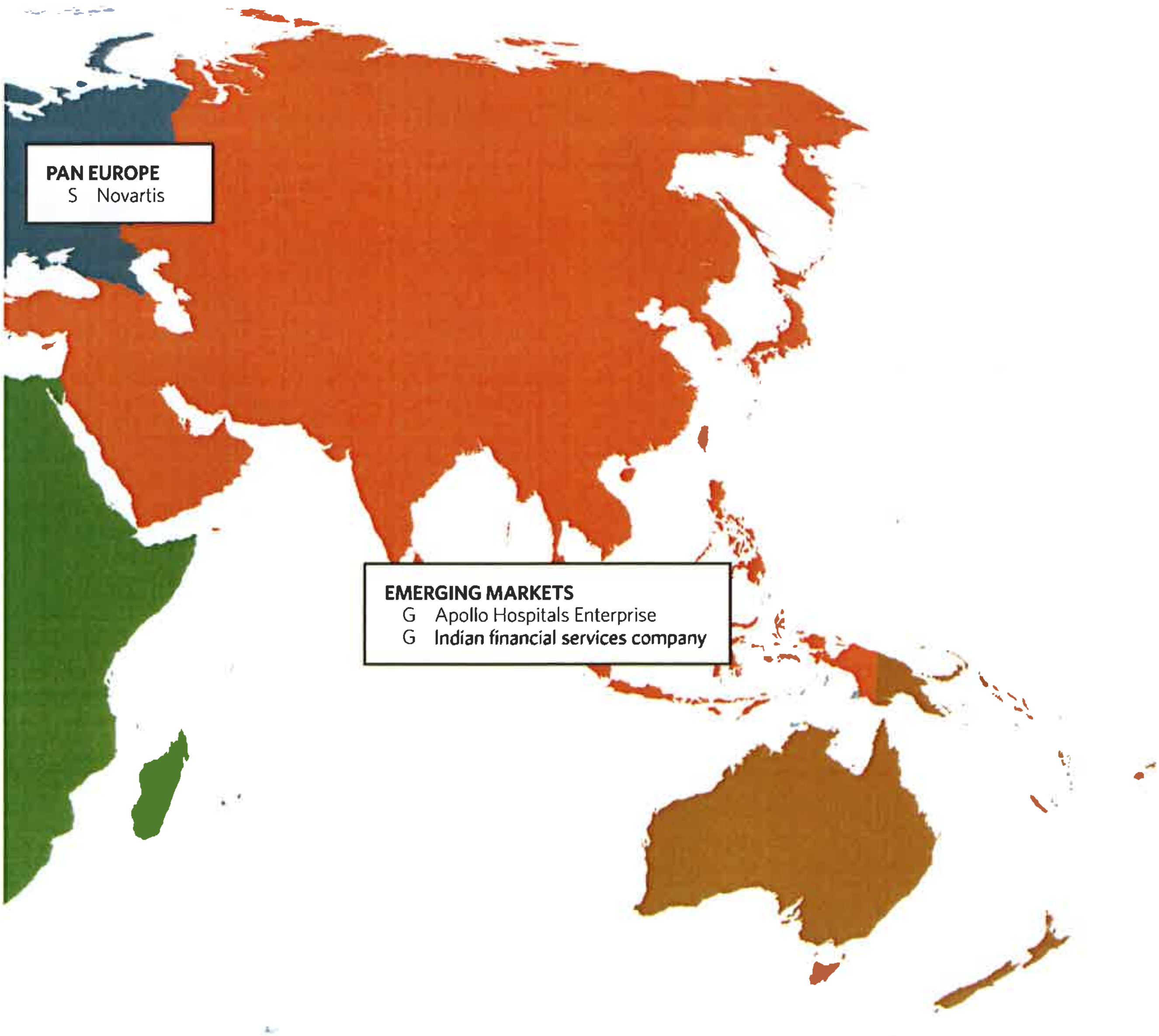
Newton is a global thematic investment manager, with a well-established approach to responsible investment. This is integral to our investment process given our belief that responsibly managed companies are best placed to achieve sustainable competitive advantage and provide strong long-term investment opportunities. For this reason, we engage companies on a variety of environmental, social and governance matters.



KEY
E Environmental
S Social
G Governance

Any reference to a specific security or country should not be construed as a recommendation to buy or sell this security or country. Please note that portfolio holdings and positioning are subject to change without notice.

The map below provides a geographic breakdown of the companies included in this Q3 2016 responsible investment report.



ESG engagement

The following pages describe examples of environmental, social and governance engagement we undertook on behalf of our clients during the quarter.

For certain engagements, we do not disclose the company's name. Instead, the country of incorporation and sector of operation are provided, such as 'UK bank'. By not identifying the company involved in the engagement activity, we encourage openness and the sharing of information by the company's representatives during discussions. In addition, we can report on the specific discussions undertaken during the engagement rather than providing a simple summary of the subject matters discussed.

Under each example of ESG engagement, the asset class (or classes) to which the engagement relates is indicated.

Accenture

Equity Holdings

We had a call with the company to talk through a number of its governance arrangements.

Board effectiveness

The roles of chairman and CEO are combined at the company. The board maintains the position of Lead Independent Director to provide independence at the top of the board. These roles can differ significantly in remit and effectiveness, and we had a helpful conversation exploring how the role works at the company. It is clear that the position is empowered to offer support and challenge to the CEO as well as to assist in running the board.

Remuneration

We also discussed aspects of the company's compensation arrangements. The company stands out positively in the US market in that a significant portion of its long-term incentive scheme is tied to performance measurement. In certain areas its disclosure is also more helpful than many; however, it does not disclose the performance targets for the majority of the long-term awards. We suggested that disclosure of the targets once the awards had vested would be helpful in order to provide external accountability in the process while avoiding concerns about commercial sensitivity.

Shareholder rights

Proxy access, whereby investors are able to nominate directors to a company's board, is a recent feature in the US market. The company adopted this feature in its bylaws earlier in the year. We exchanged views on the likelihood of proxy access to drive real change and increase accountability in US boardrooms. While the provision is relatively new for the company, and its impact is hard to assess, we have a positive view on the company's approach to shareholder rights.

Apollo Hospitals Enterprise

Equity Holdings

We had a helpful call on governance with the company on a broad range of topics. While we do not have any immediate concerns, there are a number of areas that we will follow up on, particularly in relation to board structure, related-party transactions and audit matters.

Board

Given the significant dominance of the founder and executive chair, extended through the family's 35% shareholding in the company and its dominance of key management positions, we explored the systems of checks and balances in place to represent and protect minority shareholder interests. The board appears to be comprised of individuals with useful and relevant skills and experiences, including one director who has experience of working at similar controlled companies. We suggested the creation of the role of Lead Independent Director to formalise a governance arrangement for the representation of outside investors.

Related-party transactions

The company disclosed a number of transactions with businesses related to the founder and his relatives, but gave no detail on the nature of the business being conducted. In our discussions, the company provided further insight into the background of these transactions and explained that its fundamental approach is to achieve better service or value from its related parties than it would otherwise be able to from their competitors. An accounting firm provides an independent opinion to the board, which offers some reassurance on this issue, but it would be helpful to have some public disclosure.

Remuneration

We talked through the company's executive compensation, which has recently been reviewed. Key performance indicators now measure management's performance, tailored to each executive for half of the bonus, which is determined once the annual budget is set. Given the significant controlled stake in the company, no equity awards are made. The founder and executive chairman can be awarded up to 1% of profits each year; the overall amount is determined by an assessment of brand enhancement, the reputation of the company and shareholder returns over one- and three-year periods. This resulted in a reduced pay-out last year.

Audit and controls

We discussed the main audit priorities for the company. As the company grows, there are opportunities to revisit the application of internal controls and documentation, as well as to centralise oversight and implementation to ensure more regular application. It appears that the company is addressing this currently with the assistance of an accounting firm that is helping to formulate a risk management policy and framework. The company plans to put its external audit out for tender in the near future, and we discussed potential conflicts of interest should the same firm the company has been using for risk consulting subsequently be appointed.

We also explored recent news of organs allegedly being removed for sale in one of the company's hospitals. The company was keen to stress that this was an issue of fraud by individuals involving doctored documents, and that it has implemented an independent committee, headed by a Supreme Court judge, to make recommendations for improvements to its processes. The police are also investigating; the company will provide an update when more detail is available.

Tax
We talked through the details of a tax investigation at the company that saw 250 inspectors descend on 50 different sites earlier in the year. The hospital system in India as a whole appears to be a target for the Income Tax Department to investigate given the opportunity for cash to be received, which is then not declared, and for doctors to receive additional payments aside from what is paid to the hospital. On both these points the company appeared confident that it is not significantly exposed and continues to co-operate fully with the investigation.

CMS Energy

Equity Holdings

We held a useful call with the company secretary, head of human resources (HR) and the deputy head of HR to explain our negative voting decision at the company's latest AGM.

We explained that our negative voting decision had been a result of the long-term incentive scheme's time-based awards, and emphasised our preference for awards to vest subject to the achievement of performance conditions, thus aligning executives with long-term shareholders' interests. We also suggested including health and safety metrics in the short-term compensation scheme.

Indian financial services company

Equity Holdings

We had meetings with the management team and also the chair to understand better the company's approach to various aspects of corporate governance. Areas discussed included board structure, controls, bribery and corruption, remuneration and related-party transactions.

Mattel

Equity Holdings

Under the new CEO/chair, the company is focusing on expanding into e-commerce. This was cited as one of the company's main risks given the lack of relevant corporate experience and the need to ensure online safety for children.

The company's approach to governance has been improving over recent years, and it is marginally better positioned than many of its US peers (as exemplified by the willingness of non-executive directors to meet shareholders).

Management changes
The last 18 months saw a near wholesale change of management, including the CEO/chair. The then-lead director of the board led these changes, owing to the board's lack of confidence in management. Despite the conflict of the lead director's appointment as CEO/chair, the changes were welcomed and they demonstrated good board strength.

Given the new CEO/chair's long service at the company, he was quickly able to redefine the company's purpose, mission and goals. He recognised and carried out necessary management changes with the board's consent. He has also been working to reduce the level of bureaucracy in an effort for the company to become more efficient and flexible in the fast-moving consumer goods sector.

A new succession planning policy and practice is being developed, and the company has been using external advice to ensure its success. Encouragingly, 15% of annual bonus awards for senior management are determined by 'management of people'.

Remuneration
A new compensation structure was introduced in 2016 for all staff. Clear individual goals are now set and need to be achieved to receive a bonus – previously, bonus awards to less senior staff were not linked to performance.

Executive remuneration has been simplified. The level of performance-based long-term incentive (LTI) awards has been increased; a third of LTIs now vest for Earnings per share (EPS) performance.

A significant level of long-term remuneration remains that is not subject to performance, as well as over-reliance on benchmarking to determine compensation levels.

Human Capital
For the first time in three years, an employee engagement survey, with a commendable 92% participation rate from the top 15,000 employees, has just been undertaken. The results are being gathered.

Understandably, staff turnover increased during the significant management changes but, for 2016, it is expected to stabilise and reduce by a third to approximately 6%.

Litigation
In light of ongoing legal action, we discussed the company's approach to addressing legal challenges. The company explained that its approach to litigation is less aggressive than previously and that commercial matters are now considered more deeply. Intellectual property will continue to be robustly defended.

Bribery and corruption

Given the company's effort to increase its presence in Russia and China, ethics and conduct were raised. Encouragingly, the company has heightened its approach to avoid negative instances, and has been reaffirming its policies with local staff through senior executives giving personal onsite support to messaging and training.

Microsoft

Equity and Bond Holdings

We met the company's chair.

Board composition, succession planning and evaluation

The chair demonstrated a commendable knowledge of the individual board members and the skills each brings to the company. He described his satisfaction with the recent recruitment of two high-quality non-executive directors, and believes no skills gaps now exist. This said, succession planning is continually reviewed and a headhunter is retained.

The chair has little appetite for employing an external firm to conduct a board evaluation. He justified this view by noting the board's track record of dismissing underperforming board members.

Share buybacks

An annual strategy meeting is held in June to discuss capital allocation. The company's strategy surrounding dividends and share buybacks is a key area of focus at these meetings.

Corporate culture and human capital

The chair was of the view that significant improvements in corporate culture are testament to the CEO and his humility. He admitted that the company has a long way to go, but said that the direction of travel was positive. Enhanced employee relations and customer loyalty were cited as areas of expected improvement.

Remuneration

The company continues its transition towards increasing the level of performance-based remuneration. This transition is being conducted sensitively given the challenges that exist in shifting to performance-based compensation versus assured compensation.

Novartis

Equity Holdings

We participated in a conference call to receive an update on the company's corporate responsibility strategy. This confirmed our positive view of the company's performance in a number of areas and provided a helpful update on its management of corporate culture and ethics.

Access to medicines

Over the year, the company launched its Access programme, focused on 15 on- and off-patent medicines that address non-communicable diseases in lower-income countries. This programme sees Novartis sell medicines to governments, NGOs and institutions for USD1 per treatment per month, as well as collaborating with governments and NGOs to improve diagnosis and treatment. The company is also working with a university to define a methodology for reporting on the impact of its Access programme for 2016 (on which it has committed to report transparently), as well as expanding the programme's geographical reach and product coverage. The company believes it reached around 66 million patients through its Access initiatives in 2015.

Ethics and compliance

Following the extension of its Corporate Integrity Agreement by the US Department of Justice in 2015, the company has been further strengthening its ethics and compliance programmes. Under the guidance of new internal leadership on the issue, a number of initiatives have taken place. These include the use of real-life case studies on ethics and integrity to ensure examples are disseminated across the company, culture workshops and further revisions to sales associates' pay, which has seen their variable compensation reduced and more emphasis placed on values. The company has also recently revised and tightened its code of conduct and is looking at the agreements it has with suppliers to see whether there are areas that could also be addressed. While the company is positive about these changes, it is clear that there remain some challenges. The company is also developing a dashboard internally that will help it bring together data from different areas of the business to assist in monitoring the issue. The company indicated it would not view a reduction in the number of employees being investigated or more employees being dismissed for related issues as signs of success, rather that issues should be identified sooner and remediated more quickly.

RPS Group

Equity Holdings

We had a useful meeting with the senior independent director (SID) and the company's remuneration consultant on pay and strategy. In 2015 the company received a 22% vote against its remuneration report owing to poor disclosure, and is keen to understand our thoughts on the new long-term incentive scheme (LTIP). We were supportive, but continued to push for more transparent and focused remuneration metrics, particularly in relation to successful acquisition integration. At present, there is no measurement for this within remuneration, despite several recent acquisitions.

Remuneration and succession planning

We applauded the company for the introduction of a long-term incentive (LTI) scheme. The absence of such a scheme had made the company an outlier among peers. As metrics for the bonus and LTI targets are currently disclosed retrospectively, we pushed for forward-looking disclosure. Part of the CEO's and CFO's bonuses are measured against 'personal objectives', which we learnt means a mix of continuity and strategic key performance indicators. Given that four acquisitions were made between 2015-2016, we questioned why there were no metrics in place to measure and ensure their success. The SID argued that while this is a top priority for executives, it is heavily reliant on regional businesses to ensure success and not a standalone focus for the company. We emphasised that a metric for integration within the bonus and LTI schemes would be appropriate, particularly in light of current market turbulence.

Succession planning is underway for the chair, who has been in the role for 18 years, and further board members. The next chair and board members should be time-rich, have commodities experience, and provide more diversity in terms of international and female representation.

Smith & Nephew

Equity Holdings

Following the company's 2016 AGM, at which the remuneration report received less than 50% support from shareholders, we met the company's chair to discuss executive compensation and other topics.

Remuneration

The AGM marked a significant breakdown in communication between the board and investors, resulting in one of the largest shareholder dissents on compensation of the 2016 AGM season. Shareholder dissent resulted from the remuneration committee's decision to exercise its discretion by allowing awards to vest despite the performance hurdle not being achieved. We suggested that we were broadly comfortable with the structure of the incentive schemes, but that downward discretion should be exercised should the opposite of the company's reasons for exercising upward discretion occur.

Succession planning

The company has faced recent challenges, with the CEO becoming ill and the CFO resigning. The company assured us that it has interim plans for a CFO, and a permanent replacement is expected next year. Both of these incidents have focused the board's mind on succession planning, with headhunters appointed to help identify potential internal candidates. This is an area we will continue to monitor.

Tax

While not specifically concerned with the company's tax rate, in this instance, we were interested to understand the board's approach to this key topic. As a policy, the company wants to pay its fair and equitable share of tax, which results in it not pursuing aggressive avoidance strategies, but it also wants to be sure it is not an outlier in the industry in maintaining a high tax rate. Certain choices can be informed by tax implications, but the company does not make location-based decisions, such as choosing where to base manufacturing, on the basis of tax treatment.

Compliance and controls

Over the last few years, the company has made a number of improvements to its ethics and compliance oversight. In particular, there has been a step-up in quality assurance, with a new head of manufacturing and a more structured quality control function. Oversight is maintained by the ethics and compliance committee, which includes a member of the board who used to hold the position of Deputy Commissioner at the US Food and Drug Administration and who brings helpful expertise in this area. There has been a focus on the use of distributors, with acquisitions posing a particular challenge as often partners of acquired businesses do not live up to the company's own standards. There has been much more emphasis on certain countries, with on-the-ground consultants used to help the company understand local ethical and cultural nuances. Additionally, every general manager now has to be personally certified against the company's ethics policy, which helps to ensure that the strong tone from the top infiltrates through the business.

Cyber risk

In its annual report, the company mentions cyber security as a principal risk, with the main exposure being through patient records and hospital data. Intellectual property security is also a concern. While we do not believe the company to be as exposed as others in the sector, we were pleased to note that the board is likely to look at revising its governance arrangements in order to incorporate its consideration of this key risk more formally.

Wolseley

Equity Holdings

We provided feedback to the head of sustainability and company secretary on the company's sustainability reporting. We encouraged the chair to mention sustainability activities in his opening annual report letter, and advised that only material issues should be highlighted in the report. The executives agreed and confirmed these changes were underway. We questioned the relevance of certain topics raised within the 'people' section, and underlined that targets and deadlines were necessary for all sustainability initiatives, particularly those in environmental areas and health and safety. The business has now established 2020 targets for many activities, and will publish these in 2017. We requested further information on diversity, as an overwhelming majority of employees are men. We asked about the regularity of global bribery and corruption training. Finally, we recommended better disclosure on cyber security issues, and the head of sustainability confirmed this would occur in the next annual report.