

WEST MIDLANDS METROPOLITAN AUTHORITIES' PENSION FUND
COMPANY VOTING GUIDELINES 2004
(Policy Adopted in April 2004)

1. INTRODUCTION

- 1.1. The West Midlands Pension Fund has, for a number of years, been completing proxy voting forms for all UK company AGMs (Annual General Meetings) and EGMs (Extraordinary General Meetings) that are in the FTSE All Share Index and in which the Fund has a holding. This is on the basis that it has a legitimate interest in the senior management arrangements for a company in which it invests and through its voting policy can seek to add value to its investments together with improving the behaviour of the corporate world in terms of business, social and environmental ethics. It generally recognises that some basic features can be identified for the structure and running of a company at a senior level that should create a setting for a company to succeed in its business and in which shareholders have a duty to take an interest.
- 1.2. The Corporate Governance Policy compliments the Fund's fiduciary duties and is a central means of communicating with companies and holding directors accountable for their stewardship of the company. Proxy voting is a key to maintaining effective shareholder oversight of directors and company policies, a process on which the current system of UK corporate governance depends.
- 1.3. There have been major developments in recent years identifying best practice in corporate governance. The initial work of the Cadbury Committee and Greenbury Report raised awareness and formulated a framework for addressing the major concerns of shareholders and companies. More recently the Committee on Corporate Governance under the Chairmanship of Sir R Hampel has reviewed the work of Cadbury and Greenbury, and produced a report which the Stock Exchange incorporated into the Stock Exchange Listing Rules in 1998 as a new Combined Code of best practice.

The Cadbury Committee argued:-

"Voting rights can be regarded as an asset, and the use or otherwise of those rights by institutional shareholders is a subject of legitimate interest to those on whose behalf they invest. We recommend institutional investors should disclose their policies on the use of voting rights".

This recommendation has been taken up in the amendment to the Pensions Act, effective in July 2000, requiring pension funds to disclose "their policy (if any) in relation to the exercise of the rights (including voting rights) attaching to investments". The combined Code also states that "Institutional shareholders have a responsibility to make considered use of their votes". The Fund's voting guidelines are based upon this corporate governance work but in some areas applies a rigorous interpretation of best practice over and

above the standard suggested by the corporate governance reviews e.g., definition of independent directors and combining of role of Chair and Chief Executives. In addition, the Fund's voting policy reflects Agenda 21 issues.

- 1.4. It is becoming standard practice for pension funds and other institutions to develop an active approach to corporate governance. A number of more recent government instigated reports have assisted in identifying 'best practice', most recently that of the Myners Report which listed shareholder activism as one of its ten principles.

The Fund guidelines is fully updated to reflect the Higgs and Smith's reports the new Combined Code published by the Financial Reporting Council. The vast majority of UK Company's will not be required to report against the Code until 2005.

- 1.5. The corporate performance of companies and their value as investments are increasingly affected by environmental factors. In pursuance of a prudent and environmentally responsible response by companies, the Fund will encourage and support companies that demonstrate a positive response to environmental concerns. The Fund expects companies to:-

- * make a commitment to achieving environmental excellence
- * institute regular monitoring of their environmental impacts;
- * establish procedures which will lead to incremental improvements in environmental performance;
- * comply with all current environmental legislation and to seek to anticipate future legislative changes;
- * make available to shareholders regular and detailed reports of progress made towards attaining improved environmental standards;
- * take environmental matters seriously;
- * produce an environmental policy which is effectively monitored;
- * seek to take all reasonable and practical steps to minimize or eliminate environmental damage;
- * actively and openly engage in discussion on the environmental effects of their business.

- 1.6. Many of the matters raised at company AGMs, are similar and straightforward e.g. appointment of auditors and directors, adoption of accounts etc. The Fund uses the PIRC Corporate Governance Service for analysis of governance issues and executing its proxy voting rights. The approach to the various governance matters raised at UK Company AGMs and EGMs is set out below which aims to ensure consistency and fairness in voting. In addition as from February 2002 the Fund has voted on the top 300 European companies where it has an interest and where voting is possible. As from

summer 2004 the Fund will also be voting on our US holdings where they form part of the S&P500 Index. Governance issues can be complex but all are judged on their financial impact on the Fund's shareholding which is likely to be a long term holding.

- 1.7. The Directors of a company are seen as having a duty and responsibility to explain their reasons for seeking shareholding support on any matter they put to shareholders and the Fund expects full supporting information and details to be provided by the Directors to shareholders. Failure to provide such information may lead to the Fund voting against a proposal.

2. **VOTING GUIDELINES**

- 2.1. The Fund will vote for or oppose a resolution on the following basis:-

For Where the proposal is judged to be in the Fund's interests and meets best practice guidelines.

Oppose Where the proposal:-

- * is judged not to be in the interests of the Fund; or
- * the Directors have failed to provide sufficient information to support the proposal; or
- * is significantly short of best practice.

- 2.2. The Fund will not normally abstain but may do so if the proposal raises issues which do not meet best practice guidelines but:-

Either the concern is not regarded as sufficiently material to warrant opposition;

or an oppose vote could have a detrimental impact on corporate structures.

Against this background the specific issues relating to the voting on items usually appearing on AGMs and EGMs is as follows.

3. **THE REPORTS AND ACCOUNTS**

- 3.1. The report and accounts provides shareholders with a statement of the directors' stewardship of the company during the year. Although there are no legal requirements to do so, it is common practice for companies to put a proposal for the acceptance of the report and accounts to the annual general meeting and this is required by the Combined Code.

- 3.2. Companies should, as a matter of best practice and directors' stewardship duties, put a formal resolution seeking approval for the report and accounts to the AGM, and include relevant additional information which reflects their stewardship and significant relationship issues, for example:-

- * A statement on future corporate strategy plus an explanation to change in past strategy;
- * Key performance drivers and sensitivities;
- * Identification of significant opportunities and risks;
- * A clear explanation of dividend policy;
- * Investment and research and development policies and activities;
- * Environmental policy, implementation, and targets;
- * Community relations policies including policy on charitable donations and political involvement;
- * Ethical trading policies, codes of conduct and policies on human rights issues;
- * Policies on business ethics;
- * Employment policies, particularly consultative and representation mechanisms, equal opportunities, staff remuneration policies and training policies;
- * Any contentious issues.

3.3. The new Combined Code requires that the annual report should have full disclosure regarding the directors and the board:

- * Including a statement of how the board operates;
- * Its composition;
- * Number of meetings attended by individual directors;
- * Identifying the Independent Non-executive Directors (NED's) giving reasons for their independent;
- * Details on performance evaluation of directors and boards;
- * Details of the nomination and audit committee's work;
- * Evidence that the board understands the views of its major shareholders.

3.4. The full text of all policies and reporting on implementation need not be provided in the annual report. However, summaries should be included in the annual report and the availability of policy statements and detailed reports on particular issues (such as environmental reports) should be clearly stated in the annual report. Associated reports should be published at the same time

as the annual report. Ideally, environmental and social reports should be tabled for discussion and approval at AGMs.

Companies should identify their key stakeholder relationships and adopt an appropriate format to report on each. Specifically in relation to stakeholder issues, companies should disclose policies for managing relationships, lines of accountability, methods and scope of engagement, performance targets and measurement systems and any external independent verification procedures.

- 3.5. The new Code requires directors to report to shareholders that they have conducted a review of the effectiveness of the company's internal control. The Turnbull Committee stated that "a sound system of internal control contributes to safeguarding the shareholders' investment and the company's assets" and that it is the board's responsibility to set internal control policies.

In reporting on their risk control policies and processes, directors should go beyond the basic requirements and identify the significant areas of risk and how the company manages these. As a general point, formulaic statements are of little help, and companies should be encouraged to provide appropriate detail. Companies should interpret the reporting recommendation in as broad a manner as is consistent with commercial confidentiality. These risks should not be limited to financial issues.

- 3.6. The Fund will vote for where legal and regulatory requirements are met, including a full statement of the company's compliance with the Combined Code. The Fund will however, oppose if there are serious breaches of corporate governance/best practice or the accounts have been qualified. A failure by larger capitalised companies to make suitable disclosures on environmental, employee and community policy is judged to be a breach of best practice, whereas smaller capitalised companies are required to have at least an environmental policy statement.

- 3.7. The Fund will oppose the report and accounts on issues such as

- * the making of any party political donations
- * whether the remuneration policy has been put to the vote
- * whether there is a remuneration committee
- * whether there is an audit committee
- * the requirement for a minimum of three independent NED's on the board
- * a requirement for the remuneration committee to comprise wholly of independent NED's.

4. **DIVIDEND POLICY**

4.1. It is good practice for the directors to put a proposal to shareholders seeking approval for a recommended dividend. Failure to seek such approvals is considered a breach of best practice and will be opposed.

4.2. Dividend policy is fundamental to a company's long-term growth; and should not be out of line with profits and investment needs of the company. Companies can be under intense pressure to maintain dividend payments in order to avoid their shares being down graded, which could have adverse consequences for the company. Directors can therefore be caught between the short-term pressure to maintain dividends, and a long-term preference to retain earnings for other purposes.

In assessing the dividend, shareholders need information on company strategy, capital expenditure, research and development, market developments and future investment requirements. Similar information is required when considering other types of distribution or return of capital such as share repurchases. Information on other distributions which have been made to shareholders should also be provided in the context of discussing dividend distributions. In certain industries, information on regulatory developments is also relevant. Information on dividend policy in relation to consumer, community or employee benefits is important in assessing whether the company has discharged its responsibilities to all stakeholders in order to maintain long term relationships.

4.3. The Fund will vote for a proposed dividend which is adequately covered by earnings or there is a clear justification from the directors that it is in the company's long-term interest.

5. **THE DIRECTORS**

5.1. Shareholders appoint directors to oversee the management of the company. Voting upon their appointment or re-appointment is therefore an important issue for shareholders at an AGM. The company should confirm that a director proposed for re-election continues to perform effectively and demonstrates commitment. The composition and effectiveness of the board is a crucial element in determining corporate performance, particularly the overall structure of the board in terms of its composition, separation of powers, the relationship between executive and non-executive directors and board committees. This should be sent out with the notice a meeting. New board members should receive indication and all members should receive ongoing training.

5.2. Full biographies should be provided for all directors including dates of appointment, ages, career history prior to and in the company (in the case of executive directors), current and recent other directorships as notified to Companies House, and significant positions in public, commercial and political life. Any regulatory or statutory breaches of professional conduct should be reported in full.

The main terms of each director's service contract or other contractual terms or letters of appointment should be disclosed. For all part-time executives or non-executives, these terms should include the time required to be spent on company business. Full copies of all contracts, including agreements with non-executives, should be made available by the company.

- 5.3. In considering supporting the appointment of directors it is important to consider the role of the board as the lead and control for business. It should establish corporate strategy, set appropriate policies for its implementation, ensure reporting and decision-making procedures are effective, select and monitor key executives, manage potential conflicts of interest for the executives, manage relations with stakeholders, determine risk management systems and hold the executives accountable for their actions.
- 5.4. There are a variety of roles to be performed within a unitary board, notwithstanding the legal position that all directors are equally responsible for the board's actions and all are equally accountable to the shareholders. In order to undertake these functions there should be a balance of executive directors and non-executive directors with broader experience who are in a position to act independently. Directors should act in the interests of the company as a whole, and not be beholden to a particular shareholder. An important shareholder role is to ensure that the balance of directors on the board is adequate to enable them to perform the varied roles expected of them. The ratio of different types of director is important as is the overall size of the board. Independent non-executives may find themselves outnumbered and outvoted on large boards where there are many executive directors. Equally, boards with large numbers of directors may become unwieldy. Fifteen is probably the maximum upper limit if the board is able to function effectively.
- 5.5. Directors appointed or proposed to the board of a company must, by law, be put forward for endorsement at a general meeting. However, once appointed, there is no legal requirement for them to stand down for future re-election. In practice, non-executive directors are usually required to stand down for re-election by rotation every three years, but many executive directors are excluded from this need to retire by rotation, a practice that is not supported.
- 5.6. Board committees of independent non-executives should be established to deal with matters where executive directors face a conflict of interest. There should be independent audit, remuneration and nomination committees. The terms of reference for each committee should be made available by the company.

Audit, remuneration and nomination committees should have a minimum of three members and should comprise solely independent non-executive directors. It may be appropriate for these committees to invite executive directors to be present at certain meetings, but committees should meet without executives present at least once a year.

Committee membership, frequency of meetings and attendance records, should be disclosed in annual reports.

Executive Directors

5.7. The Fund will vote for proposals to elect executive directors to the board where:-

- * the post is not insulated from future re-election;
- * full biographical information is provided;
- * a formal appointments process exists;
- * the service contract period is for no more than one year except if a case is made for an initial appointment of up to 2 years reducing down to one;
- * long term corporate performance is satisfactory;
- * they have attended over 50% of board meetings (where disclosed).

5.8. The role of the chairman is to ensure that the board functions effectively, that appropriate procedures and structures are in place and that relevant issues are discussed. Given the board's role in holding the executive management accountable, the board chairman should be seen as a separate role to that of an executive director with operational responsibilities. The role expected of the chairman may well also affect his or her ability to perform the function of a fully independent director, with implications for board structure. The chairman's position should be non-executive but is often regarded as not fully independent as they are often significantly involved in the company's affairs. The new code accepts Higg's recommendations that a CEO should not become chairman of the same company. The Fund has supported this view for many years.

5.9. The fund will vote for proposals to appoint a Chairman where:-

- * the role is not combined with that of Chief Executive
- * has not previously been Chief Executive within the past five years
- * there is a senior independent director (SID) to whom shareholders can address concerns.

Non-Executive Director

5.10. Non Executive Directors have two important roles on the board – supervisory and advisory. They bring an independent perspective to bear on issues where the executive directors face a conflict of interest. They also strengthen the board by expanding its range of experience. They have a crucial role to play in reviewing the performance of the executives, upon which commercial success will be substantially reliant. The new Code states that in order that non-executives can properly fulfil their role, over 50% of the board should be independent, as determined by the Board, excluding the chairman. For

company's outside of the FTSE 350, the minimum is 2 NEDS. Although the Fund believes there should be a minimum of three and will vote accordingly.

The Fund requires at least a third of the board to be independent (as determined by and not those of the company) the Fund's guidelines.

5.11. The Fund will vote for proposals to elect a candidate as a non-executive director where:-

- * there is sufficient biographical information to assess their calibre and independence;
- * a formal nomination process is in operation;
- * the candidate is deemed to be independent (see below);
- * the position is not isolated from future re-election.

5.12. The following is considered to be relevant in forming a view on the independence of candidates having regard to the fact that independence is partially determined by an individual's character and integrity:-

- * has held an executive position within the company or group;
- * is or was recently employed by, a partner in or on the board of a professional advisor to the company;
- * has a notifiable holding themselves or is a director or employee of another company which has a notifiable holding;
- * is a director or employee of a company in which the company has a notifiable holding;
- * is on the board of a significant competitor of the company;
- * has a service contract, holds share options, receives remuneration other than fees, has received consultancy payments or is eligible for pension benefits or bonus payments;
- * is or was recently employed by or on the Board of a significant customer, supplier or competitor to the company;
- * has had an association with the company of more than 9 years;
- * has cross directorships or significant links with other directors through involvement in other companies or bodies;
- * is related through blood, marriage or equivalent to other directors or advisers to the company;
- * was not appointed by an appropriately constituted nomination committee or equivalent independent process;

- * currently holds or recently held a senior position with a political or charitable body to which the company makes donations;
- * receives fees of a level which is indicative of significant involvement in the company's affairs or are significant in relation to salaries received by executive directors;
- * receives remuneration from a third party in relation to the directorship;
- * benefits from related party transactions;
- * acts as the representative of a stakeholder group other than the shareholders as a whole.

5.13. If a NED is not considered to be independent, but there are already a number of independent directors, the Fund will normally not support the election unless there are exceptional reasons that clearly benefit the company. In addition, if a director holds an excessive number of other major company board positions (more than 4), the election will not be supported.

5.14. The Fund considers boards should appoint a SID.

5.15. If the Company fails to make proper arrangements for organizing the work of the directors e.g. fails to establish a nomination committee, remuneration committee, audit committees etc, the Fund will vote against the company Report and Accounts.

6. **DIRECTORS' REMUNERATION**

6.1. Directors face a direct conflict of interest when setting their own remuneration in terms of their duty to the company, their accountability to shareholders and their own self-interest. This has caused controversies over directors' pay in recent years. It is in shareholders' interests to see this issue dealt with satisfactorily if the integrity and reputation of business is not to be undermined.

6.2. Directors' pay is not just an issue of the cost to the company, but also has serious implications for corporate performance in terms of providing the right incentives to senior management, in setting performance targets and in its effect on the morale and motivation of employees, the attitude of customers and the public as a whole. Corporate reputation among the public as a whole is also affected by remuneration practices. It is in shareholders' interests to see this issue dealt with satisfactorily if the integrity and reputation of business is not to be undermined.

For these reasons, the way in which remuneration is handled can be seen as an indicator of the overall integrity, accountability and governance standards applied by the board.

- 6.3. Remuneration policy should reflect the requirements to attract, retain and motivate executives. However, financial rewards need to be seen in the context of the director's other terms and conditions, the company's culture and its aims and objectives.

A number of best practice points can be identified for comparison as follows:-

Shareholder Voting on Director's Remuneration

- 6.4. Owing to the inherent conflict of interest for directors, shareholders have a legitimate interest in remuneration and should have the final say in approving overall policy. The widespread use of remuneration committees has not reduced concerns over conflicts of interest nor has it slowed increases in overall remuneration. Remuneration committees are often not able to act with sufficient independence in determining pay policy and packages.

While it is appropriate for remuneration committees to make recommendations, the remuneration policy should be authorized directly by shareholders as a matter of principle. UK listed companies are now required by law to put their published remuneration report to the AGM. When considering pay policy, remuneration committees should have access to independent advisers, separate to those used by the executives. Its term of reference should be made publicly available.

Members of remuneration committees will be held accountable for breaches of best practice on remuneration issues or failure to seek shareholder authorisation. The remuneration committee should be made up entirely of independent directors and the company chairman should not chair the committee given the likely level of their fees and the close relationship the chairman will have with the executive directors.

Disclosure

- 6.5. In order to ensure accountability over this sensitive issue, there should be full disclosure of all elements of pay. Shareholders need to be able to assess the value of the whole package. A clear valuation of benefits received during the year, including share options, other conditional awards and pension benefits, should be provided.

The performance basis of all such incentive schemes under which benefits are potentially payable should be clearly set out each year, together with the actual performance achieved against the same targets.

The full scheme rules for new and existing schemes should be available on request as well as being on display at the AGM.

Statement of Policy

- 6.6. As a matter of good practice the directors' policy on remuneration should be set out in the annual report and accounts, and should reflect principles of general integrity, equity and affordability. There should be a full or transparent disclosure of directors' remuneration.

Executive Directors' Contracts

- 6.7. The main terms of the directors' contracts including notice periods on both sides, non-completion clauses and any fixed compensation should be summarised in the annual report. Copies of all contracts should be sent to shareholders on request.
- 6.8. Lengthy rolling contracts remain a controversial issue for many shareholders. If directors are dismissed, shareholders can be in the position of paying large sums by way of compensation, even though an executive may have failed to perform. The general reduction of notice periods to no longer than one year, combined with the application of mitigation and the phased payment of compensation is a reasonable arrangement for shareholders. However, in exceptional circumstances, a longer initial fixed contract period may be necessary in order to recruit a new executive. Such circumstances may involve relocation or a high-risk move to a problem company. In such cases, the most important factor is that the directors (or the remuneration committee) explain the circumstances effectively. Fixed initial notice periods should not exceed two years and it should be clear that these reduce to a period of no more than one year after the initial period.
- 6.9. Contracts do not pay for liquidated damages in excess of one year.

Incentive Schemes

- 6.10. Incentive schemes can play an important role in contributing to company performance for the benefit of shareholders and other stakeholders. However, they must be structured in a way which links rewards with superior performance, which provides a reasonable incentive without encouraging imprudent risk-taking, and which recognises the contributions made by all employees to good performance.

Most incentive schemes of longer than one year are share-based. Directors and shareholders have different interests which can be more closely aligned by the use of share schemes. However, it should be recognised that a share scheme will not automatically create convergence of interest and that any transfer of equity to directors should be clearly justified by performance.

Equally, it should be recognised that the value of share-based rewards will be mediated by market sentiment, over which directors may have little control.

For new schemes, the following information should be provided in full in the proxy material:

- * a full explanation of the basis on which awards will be made (either of options or restricted shares), together with the level of maximum award;
- * full information on performance targets which determine exercise of options or vesting of shares together with a justification of why these are viewed as stringent;

- * full details of any re-testing provisions;
- * full details of any comparator groups used;
- * full details of any vesting scales;
- * information on change-in-control or retirement provisions;
- * information on the source of shares to be used, either newly issued or market purchased;
- * information on limits to the number of shares which can be awarded (whether new shares or purchased shares) or the proportion of equity which may be issued over various timescales;
- * a calculation of the expected value of potential awards.

Equity

- 6.11. Shareholders have an interest in a remuneration structure which rewards the efforts of all staff, since a motivated and well rewarded workforce is a key component of company performance. The remuneration structure as a whole should not be excessive. In general, annual and long term awards with an expected value of no more than 200% of salary should be made in any one year, unless targets are exceptionally challenging on base salaries low.

Bonus

- 6.12. The basis on which bonuses are awarded should be “relevant, stretching and designed to enhance the business” according to the Combined Code. In respect of bonus share offers, there is a cost to the company in terms of the difference between the award price and the market price at which the company could have issued the share in the future. Unless the directors provide a view in the accounts of the cost to the company, the cost of share option scheme is obscure and unacceptable.

Multiple Incentive Plans

- 6.13. As a general rule directors should not be eligible to benefit from multiple long term share-based incentive schemes in the same year, whether these are share options schemes, restricted share schemes or other similar schemes.

Motivation and Performance Linkages

- 6.14. Performance payments or awards of share options are usually linked with corporate indicators of growth. It is argued that share option awards will motivate additional effort from executive directors to reach performance targets. However, it can be argued that when a company is in difficulty shareholders depend on the ability of the executives more than when times are good. The effort expended during harsh market conditions is not

recognised by the traditional performance linkages. Additional incentive pay should only be available for outstanding performance beyond the director's normal responsibilities. Any award for media performance is viewed by the Fund as unacceptable.

Accounting Issues

- 6.15. There are concerns that the granting of executive bonus payments such as share options can give directors a personal interest in the treatment of accounts. Key assumptions and judgements in the accounts which determine the outcome of figures such as earnings per share are provided by the directors. The existence of share option awards being tied to the outcome of such deliberations introduces a conflict of interest for the executive directors.

Share-based Incentive schemes

- 6.16. Share based incentive schemes can be complex and difficult to evaluate, however, the basic requirements are as follows:-

Remuneration structure should align shareholders' and directors' interests and payments should not be excessive:-

- * Only basic salary is pensionable.
- * All elements of each directors cash remuneration is disclosed including all share incentive awards.
- * Share options conform with institutional investor dilution guidelines.
- * Expected values are disclosed for all share incentive awards.
- * LTIPs or executive options require financial commitment. Share-based incentive schemes which do not include an element of capital commitment on the part of the participant do not align the interests of participant and shareholders in terms of downside risk. We consider that there should be a real financial commitment by participants which is subject to the same investment risks that shareholders face. The simplest way of achieving this is to require participants to hold substantial numbers of shares in the company prior to participation in a scheme. Such holdings should not be achievable simply through the exercise of previously held share options. Holdings should be built up over a limited time period. A deferred bonus will be regarded as a capital commitment for such schemes, so long as participation is optional and any matched awards are subject to a suitable performance hurdle.
- * Maximum vesting targets are challenging relative to performance required. Shareholders have a reasonable expectation that directors should perform competently. Additional cash or share-based incentives should be available only for outstanding performance beyond that which may be expected of directors as part of their normal

responsibilities. In this context, performance targets should be stringent, relevant to the company and should reflect the executive's role in the business rather than external factors beyond the executive's influence. Options should never be issued at a discount.

- * Minimum vesting targets are challenging relative to performance required.
- * There are at least two performance criteria, one of which uses a comparator group.
- * Total awards under all share schemes should not exceed 10% of issued share capital in any 10 year period. 5% should be limited to executor's schemes.
- * Total potential rewards are not potentially excessive. Often the existence of multiple long term share based incentive schemes will provide excessive rewards and performance targets will be the key issue. Incentive rewards should not be excessive in terms of delivering potential value which is out of line with the real contribution made by individuals and senior executives, or which is regarded as excessive compared to the performance required, base salary, market norms or rewards available to other employees.
- * Performance conditions for long term incentive schemes are disclosed. Share-based incentive schemes should measure performance over the long term. The performance criteria chosen and the targets relating to the criteria plus the reason for their choice should be disclosed.
- * Maximum awards for long term incentive schemes are disclosed.

6.17. Directors' remuneration should take account of pay conditions within the company ensuring:-

- * Pay policy aims are fully explained in terms of the company's objectives.
- * Duration of contracts and compensation payments are disclosed
- * There is information on employee remuneration policy including that of the NEDS.
- * Average salaries are broadly in line with the sector.
- * Pay elsewhere in the company is considered in determining directors' remuneration.
- * All employees benefit from business success.

Voting Recommendation for share-based incentive schemes

6.18. In general, the Fund will vote for new schemes where the company has adopted best practice as follows:-

- * Executive remuneration is determined by a formal and independent procedure.
- * There is a full and transparent disclosure of directors remuneration.
- * Longer term incentives provides rewards scaled towards superior performance.
- * The remuneration structure is not excessive.
- * Contracts policy balances potential costs to shareholder with directors interest.

Election of Remuneration Committee Members

6.19. In companies where there are concerns over aspects of the company's remuneration policy and the remuneration committee report is not put to shareholders, the Fund will not support the election of such members to the Board of the company and will vote against the Report and Accounts.

7. AUDITORS

7.1. Shareholders are required by law to appoint auditors annually and determine by what method they should be paid. Auditors have a responsibility to carry out a series of checks on the financial statements produced by the directors. Reporting should be objective and comprehensive.

7.2. The Cadbury Committee called the annual audit the cornerstone of corporate governance and recommended that companies establish an Audit Committee comprising a minimum of three independent NEDS with a majority of independent non-executives to review the financial statements provided to the auditors and to provide an opportunity for the auditor to meet privately with directors over issues of concern. It is vital that the audit process is seen to be objective, rigorous and independent. The audited accounts remain an important channel of communication between a company and its shareholders and other stakeholders.

Cadbury also recommended that the senior partner conducting an audit be rotated in order to promote independence of approach.

The Fund actually requires a rotation of audit firms at least every five years.

7.3. The audit committee should be the body responsible for overseeing the company's relations with the external auditor, as recommended by Smith. The new Code requires that at least one member has recent and relevant financial experiences and it is now required that all members be NED's. Again for small company's it only requires 2 NED's. The Fund considers best

practice to be a minimum of at least 3 members, all of whom are independent.

- 7.4. The Fund's view of best practice is that all of the members of the Audit Committee must be fully independent and must have written terms of reference. The Committee has the ability to engage external advisors.
- 7.5. Financial reporting should be as transparent as possible, with results represented in a way that captures all material issues. Accounting policies and judgements that have a material impact on results should be clearly identified in the annual report and accounts.
- 7.6. Auditors should not be employed simultaneously by the directors to provide non-audit services and by the shareholders to undertake the audit because it would be seen as compromising their objectivity. There are clearly concerns over the question of commercial interest. Auditors may be compromised in their ability to confront the directors on difficult issues if they have other consultancy contracts to protect. Auditors should not be expected to sign off accounts which may be based on their own consultancy input in areas such as taxation advice. In effect, the auditors would be providing a purportedly "objective" assessment of figures over which their own staff may have had an influence as advisers which is not acceptable.
- 7.7. The Fund will vote for the appointment of auditors which are judged to be independent in terms of level of fees for audit, and non-audit work (not to exceed more than 25% of the audit fee or £200,000 for a FTSE 100 company) and in terms of individual personal connections with the board.

The Fund may oppose the appointment of auditors if there are concerns over the status and role of the audit committee or failure to disclose fully all non-audit fees paid in the Audit fee.

- 7.8. It is recognised that by law shareholders have to approve the auditor's fees, but it is acceptable for authority to be given to the directors to determine the fees as is the normal practice.
- 7.9. The new Code requires the audit committee to facilitate 'whistle blowing' to further protect the company from serious risks.

8. **CHANGES TO MEMORANDA AND ARTICLES OF ASSOCIATION**

- 8.1. From time to time companies propose changes to their memoranda and articles of association. There is a need on a one-off basis to ascertain their impact on shareholders rights and interests and vote For only if the proposals are in the medium to long term interests of the Fund and its general corporate governance policy. The Fund will vote for single and not bundled resolutions.

9. **SAVE-AS-YOU-EARN SHARE OPTIONS SCHEME**

- 9.1. Involving all employees in the business through encouraging share ownership is considered to have many advantages. SAYE share option schemes which enable equal participation by employees is a proposal that could be supported. However, these schemes are not considered an equivalent all-employee benefit to discretionary (executive) share option schemes, since SAYE schemes require a saving commitment.
- 9.2. The Fund will vote for SAYE share option schemes where the resolution relates to the establishment, renewal or extension of employee sharesave schemes open to all employees. All schemes should follow usual dilution guidelines.

10. **SCRIP DIVIDENDS**

- 10.1. Scrip dividends are a useful way of companies assisting their cash flow and cutting tax liabilities. However, depending upon whether shareholders decide to accept shares or cash, there may be a dilution of their holding.

* the Fund will generally vote for scrip dividend proposals.

11. **SHARE REPURCHASES**

- 11.1. Companies must seek permission from shareholders to buy back their own shares. Resolutions seeking permission have become a standard feature of AGM agendas, although the authority is not necessarily always utilised. Stock Exchange Listing Rules limit market purchases of shares to 15% of the issued share capital and require disclosures relating to the directors' intentions, the method of purchase (if known) and the price to be paid. As best practice share repurchases should be authorised by Special Resolutions.
- 11.2. The usual purpose in buying back shares is to increase earnings or net asset value per share. They can also be used to boost a share price which the directors feel is artificially low or as a means of returning value to shareholders if the company is cash-rich with few immediate prospects for the use of that cash. These proposals can be useful for shareholders. However, it is important the directors provide a full justification for why a share repurchase may be the best use of company resources rather than investment acquisition, or alternative means of returning value to shareholders such as a special dividend.
- 11.3. Equally, share repurchases (and other forms of value transfer) should not solely benefit shareholders at the expense of other stakeholders such that long term relationships are jeopardised. The boost to earnings per share following a share repurchase can have the effect of assisting in meeting bonus or incentive scheme targets for executive directors. In these circumstances, the performance targets for annual or longer term plans should be adjusted to take account of the impact of the buy-back in much the same way as they would be adjusted to take account of other capital changes such as rights issues or consolidations.

The Fund will vote for share repurchases where:

- * the authority is limited to 15% of the share capital and Listing Rule disclosure requirements have been met;
- * justification is provided for a share repurchase in terms of the use of company resources;
- * an assurance has been received that adjustments to any relevant performance targets will be made in the event of any exercise of the authority;
- * the authority is sought via a Special Resolution.

12. **AUTHORITY TO ISSUE SHARES**

12.1. Companies are required by law to seek shareholders' authority for a specified period if they wish to issue any new shares. Shares issued under such a general authority must be offered to existing shareholders first by means of a rights issue. There are guidelines issued by the Stock Exchange and institutional investor bodies which should be followed.

12.2. The Fund will vote for authority to issue shares with pre-emption rights where:-

- * The proposed issue is the lesser of the unissued but authorised share capital or one third of the issued share capital, having taken into account amounts reserved for issued under share schemes, or in relation to warrants or convertible shares;
- * disclosure in the shareholder circular comply with listing rule guidelines.

13. **DISAPPLICATION OF PRE-EMPTION RIGHTS**

13.1. If directors wish to issue shares for cash, other than to existing shareholders, they must seek permission from shareholders. A typical reason for seek authority to issue shares without pre-empting rights is to raise small amounts of capital for acquisitions or to fund share option schemes.

13.2. The Fund will vote for authority to issue shares for cash where:

- * the proposed issue is limited to 5% of the current issued share capital;
- * disclosures in the shareholder circular comply with Listing Rule guidelines;
- * the purpose of the authority is clearly set out and is not in conflict with any other corporate governance issue or long term interests of shareholders.

14. **NON-ROUTINE RESOLUTIONS**

- 14.1. All non-routine resolutions will be assessed on their merits but are more likely to be supported if board recommendations have been subject to rigorous oversight by independent directors. However, resolutions on the following issues have occurred at a number of companies and the Fund's approach is as set out below:

Political Donations

- 14.2. In law, companies must report retrospectively on any political donations made over £200. However, whilst companies can legally make political donations, local authorities cannot and therefore the Fund will oppose any political donations.

Shareholder Resolutions

- 14.3. Shareholder resolutions are an integral part of the corporate governance process. They enable shareholders to take the initiative on issues which directors may be unwilling to address or where directors may face a conflict of interest.
- 14.4. Shareholder resolutions provide shareholders with a mechanism through which they can address other members of the company, and they allow shareholders to focus on a particular area of concern without the wholesale challenge of voting against directors or selling their shares.
- 14.5. Shareholders resolutions are not seen as a no-confidence vote on the board (unless that is specified) but should be judged on the merits of the specific issue addressed.
- 14.6. Resolutions will be supported that are evaluated as being in the medium to long term interests of the Fund.

15. **COMPANIES WITH CONTROLLING SHAREHOLDERS**

- 15.1. Particular corporate governance safeguards are required for shareholders in companies where there is a controlling shareholder, defined as one which holds more than 30% of the voting rights. Controlling shareholders typically are able to appoint directors to the board and sometimes these are insulated from re-election. When the controlling shareholder holds more than 50% of the shares, these representatives are effectively entrenched.
- 15.2. Notwithstanding their common law duty to act in the interests of the company as a whole, representatives of controlling shareholders on board may face conflicts of interest.
- 15.3. The companies with controlling shareholders should comply with the normal best practice guidelines and, additionally, that safeguards for minority and non-controlling shareholders should be built into board structures and company articles as follows:-

- * there should be disclosure in the report and accounts of all connections and relationships past and present between directors and controlling shareholders;
- * the existence of any relationship agreements should be disclosed;
- * directors appointed by controlling shareholders should use their votes to ensure the company retains its independence from the controlling shareholder;
- * a majority of the board, or the board chairman, should not have any connection to the controlling shareholder;
- * a majority of the non-executives should be independent;
- * all directors, including appointees of controlling shareholders, should be subject to retirement by rotation;
- * where the controlling shareholder owns or controls, singly or jointly, more than 50% of the voting rights, the controlling shareholder should abstain from voting on the election of any director unrelated to the controlling shareholder.

15.4. The Fund will oppose the election of directors where the above guidelines are not followed.