Active ownership means using our scale and influence to bring about real, positive change to create sustainable investor value. Our annual governance report explains how we achieved this in 2014.
LGIM’s Corporate Governance and Responsible Investment team is led by the Director of Corporate Governance, Sacha Sadan. The team of eight collectively has an average of over 15 years’ investment experience.
Welcome to our fourth annual governance report. The array of topics is greater than ever and hopefully the report gives a flavour of our work. There are a lot of sections, and we have tried to make it easy to dip in and find the areas that interest you most.

2014 was a busy and rewarding year for all our activities, and it was particularly positive to see environmental, social and governance (ESG) factors get more integrated into mainstream investing. Yet again, press coverage of corporate governance matters has increased, but with noticeably fewer pay issues this year, possibly because a lot of progress has been made recently, and other significant but less well known areas have come to the forefront – as you’ll find out in this report.

Our aim is to help improve and align the assets in which we are invested. The team had 589 company meetings and covered a lot of subjects. In fact over 30% of these meetings were on environmental and social topics. We worked with government, regulators and other stakeholders. In order to facilitate change, we collaborated and listened to others who had positive ideas and influence.

As we discussed last year, the quality of management teams and succession planning are key areas for us and our clients. LGIM worked with many companies in helping to smooth transitions and support succession planning, including liaising with headhunters early and behind the scenes. Yes we were involved in changing some chairmen and CEOs, but these were exceptions rather than the norm. We wrote on the importance of board effectiveness reviews and some principles that we believe will help to improve their results.

Newer governance risks such as cyber security have become significant. We wrote a thought piece in October detailing why LGIM is engaging on this issue and prioritising it. The diversity debate is well known now and our work in this area continues. It is pleasing to see that, without enforced quotas, FTSE 100 boards are now made up of 23.5% women, up from only 12.5% three years ago. Pay is still an area that we are involved in, but a lot of the focus has continued on long-term alignment and simplifying bonus schemes.

Demand from our clients to embed ESG factors into the investment process continues. We have worked hard on our fund management integration, including active fixed income. LGIM has had positive feedback from clients and consultants on this ESG integration and we believe LGIM is at the forefront of the industry. In this report there is a piece on climate change; the discussion on stranded assets – for example, fossil fuels that can no longer be used – has rapidly gained momentum among policy-makers, investors and society. Climate change will continue to be one of our main engagement topics as it constitutes a major risk to our long-term investments.

We try to tackle emerging issues and previously we have covered areas such as auditor tenure and non-audit fees. This year we have worked on the sensitive issue of tax and what investors should be asking companies about their tax policies. LGIM has collaborated with other investors and written a detailed report on this issue.

It was pleasing to be asked to speak at an activist conference. The view that index investing means being passive is diminishing, and hopefully our work and reporting on it helps.

Finally, I’d like to personally thank Andy Banks for his superb 37 year career at LGIM, and specifically his sterling work in corporate governance. He has a great reputation inside the industry and has helped the team and the broader world of governance. I wish Andy well in his retirement and we will miss his expertise and wise counsel.

Sacha Sadan
Director, Corporate Governance
Active ownership

WHY CORPORATE GOVERNANCE MATTERS
There is still a misconception that effective corporate governance can only be achieved in active funds. At LGIM, we see things differently – index investing does not mean being a passive shareholder. We believe that real change is best achieved through being an active owner. This philosophy looks at all areas of corporate performance to reduce potential risks and maximise value for investors.

As one of the largest index asset managers globally, we recognise and respect the responsibility afforded us by our clients. We don’t consider our index-tracking funds as passively managed. Instead, we use our scale and influence to bring about real, positive and long-term change across markets and across the globe.

Companies understand that we are not interested in prompting a short-term share price jump so that we can sell at a quick profit. As a result, management and regulators are more willing to engage and adopt our suggestions on good governance principles.

We focus both on individual company engagement and on improving overall market standards. Indeed, the majority of our clients no longer believe governance measures should be applied through specific funds only. They are more interested in how companies’ activities can impact their mainstream investment portfolios and how we are managing such impacts on their behalf.

The government-backed Kay Review recommended that asset managers stop focusing on short-term single stock performance and focus on long-term improvements that enhance returns for the whole market. It’s an agenda we have supported for many years.

MANAGING CONFLICTS
A distinction of LGIM is its corporate governance structure. Sacha Sadan, Director of Corporate Governance, reports directly into the CEO and the Corporate Governance Committee which includes two non-executive directors. This structure minimises potential conflicts of interest, ensuring we always act to achieve the best outcome for all our clients.

ENVIRONMENTAL, SOCIAL AND GOVERNANCE (ESG) INTEGRATION
While the team is independent of active fund managers, ongoing communication is maintained to understand the company fundamentals, which enhances ESG and financial dialogues with the companies. What’s more, ESG factors are increasingly recognised as playing a role in determining asset prices. We therefore integrate our work with the active equity and fixed income teams in order to supplement their fundamental analysis process by identifying sector-specific risks and opportunities.

THE FUTURE
Active ownership and engagement has brought about positive changes, illustrated in this and other reports, which have added meaningful long-term financial value to clients’ investments. We will continue to push for changes at a company and a market level where we believe this would help to produce better results for our clients.
Telling you our views

SPREADING THE MESSAGE
We believe that transparency – both with clients and the wider market – is an integral part of the corporate governance process. This report demonstrates this commitment.

On some company-specific issues, communicating our views to the public in a timely manner is not always possible due to the sensitive nature of the discussions we have with companies. We also believe that the best outcomes are achieved through private and respectful conversations behind the scenes. However, we endeavour to report on such examples as soon as possible after the event.

We use a variety of channels to explain why we think that corporate governance matters and what we do to bring this to the attention of investors.

TRUSTEE EDUCATION
Our pension clients benefit from trustee education programmes that are well respected and popular in the industry. Corporate governance is one of the topics that our clients can learn about in the programme.

If you are a trustee of a scheme invested in our products and would like further information on the LGIM Trustee Education Programme, please contact your LGIM client relationship manager for further details, or see the trustee education pages on www.lgim.com.

THOUGHT LEADERSHIP
In the October edition of Fundamentals, LGIM’s flagship thought leadership publication, we looked at two relatively new aspects of corporate governance – board effectiveness reviews and cyber security – examining how these can affect company performance and how they can be addressed. We discuss these topics in more detail in ‘Highlights from 2014’, while the article can be accessed at http://www.lgim.com/library/knowledge/thought-leadership-content/fundamentals/Fundamentals_OCT_2014_ENG.pdf

We published an ESG Spotlight article on the issue of food waste. Again, we discuss this subject in more detail in ‘Highlights from 2014’, while you can access the article at: http://www.lgim.com/library/knowledge/thought-leadership-content/esg-spotlight/ESG_Spotlight_food_wasteJAN_15.pdf

PRESS ARTICLES
During 2014 we featured in nearly every major UK national newspaper on various governance topics, as well as in international publications such as Forbes and the Wall Street Journal. In line with our policy, we do not normally comment on specific companies in the press, but will present our point of view on an issue more generally.

For example, we were quoted in many sources on remuneration relating to BG Group. We highlighted that we would have concerns with any pay policy that didn’t last the first year after being supported by shareholders and that such proposals risk setting an unwelcome precedent.

As part of the follow-up to our Fundamentals article, we presented the key points to a number of journalists. We subsequently received press coverage on cyber security and board effectiveness reviews in the Financial Times, Guardian, Reuters and Forbes.

"High profile data breaches at large global companies have resulted in cyber security now getting significant attention in the press."

As long-term investors we will continue to ask more questions in this area.

The Dutch investment publication ‘The Asset’ and City AM ran profiles on LGIM’s Director of Corporate Governance. Both articles highlighted the range of issues we look at as part of our role as active and long-term owners of companies.

In October, LGIM won the Financial News “Decade of Excellence Award” for fund management. LGIM’s corporate governance efforts were recognised as a key contributor to receiving this award.

In a joint letter published in the Financial Times, we drew attention to the need to keep the vital investor protection afforded by the ‘going concern statement’. This assures shareholders that directors believe the business will be a viable entity into the foreseeable future.

Other topics covered in the press included protecting minority shareholder interests in majority-owned companies, our voting policy on diversity and our efforts to improve board independence, and corporate governance in Japan.

INDUSTRY EDUCATION
We regularly participate in seminars, conferences and educational sessions on emerging topics surrounding Environmental, Social and Governance (ESG) issues and wider investments. In 2014, this included but was not limited to the following:
LGIM’s CEO presented at the National Association of Pension Funds’ (NAPF) inaugural ‘Stewardship Accountability Forum’. This forum has been created to provide pension funds of all sizes with the opportunity to collectively question the senior figures within leading asset management firms about their approaches to stewardship.

Spoke at the ICGN (International Corporate Governance Network) conference in Tokyo, in addition to locally organised seminars to directly appeal to corporates wanting to hear the views of foreign investors on Japanese corporate governance expectations. LGIM presented our views to over 100 corporate representatives at various events. We received a positive response and saw encouraging signs that corporate governance reforms in Japan are being addressed.

Discussed the progress of executive pay in the UK, compared to the US and Canada, on a panel at the PRI conference in Montreal.

Presented at the Council of Institutional Investors’ (CII) spring conference in Washington DC. We updated attendees on the various changes in governance in the UK and European markets, such as auditor rotation and the European Commission measures on strengthening governance and long-term shareholder engagement. The CII is an important forum for us to engage with US investors and to build our networks in the US, where our reputation is growing.

Panellist at the ‘Next Steps’ 30% Club conference to discuss the next steps for shareholders in terms of continuing to accelerate change in board diversity. We highlighted the differences between the UK and US in terms of board tenure policies and gave our position on the need for further action in the US.

Panellist at the Institute of Chartered Secretaries Association (ICSA) conference, presenting to a large group of company secretaries discussing governance from an investor perspective. We highlighted the importance of the company secretarial role in maintaining good governance standards.

Presented at the Association of Investment Management Sales Executives (AIMSE) European Annual Conference on the increasingly wide range of corporate activities corporate governance covers.

**POLICY UPDATES**

During 2014, we updated our general policy to incorporate cyber security risks; UK policy to include latest positions on remuneration, diversity and AGM attendance; and US policy to include our views on the role of the lead independent director and shareholder rights in calling special meetings. We also updated our UK Stewardship Code and conflicts of interest policies. You can read more about our policies on our website: [http://www.lgim.com/uk/en/capabilities/corporate-governance/policies/](http://www.lgim.com/uk/en/capabilities/corporate-governance/policies/)

**INTERNAL EDUCATION**

Corporate governance is a continuously evolving topic and educating our own teams internally on key topics is crucial. We regularly brief LGIM teams, particularly client relationship and fund management, on the activities of the Corporate Governance team to share relevant information and knowledge.

Furthermore, our internal intranet page allows us to communicate what we are doing throughout the business. This helps our colleagues understand the value of corporate governance and how we aim to protect and maximise our clients’ investment over the long term. This is part of our ongoing commitment to communicate what we are doing both internally and externally.
The scope of our activities continues to grow, both in geographical terms but also the breadth of subjects and policies covered. This section highlights some significant areas of focus during the year.

ESG INTEGRATION
During 2014 we further enhanced our environmental, social and governance (ESG) integration work. Our proprietary scoring tool assesses the ESG risk of each company compared to its peers and aims to supplement the fundamental assessment of companies. The result is that around 11,000 companies can be easily scored against a set of criteria on an ongoing basis and each investment team can customise the tool to supplement its own process. We believe such quantitative measures are an important complement to the qualitative research and engagement process we carry out, and help to communicate the value of ESG activities to our clients.

BOARD DIVERSITY
There continued to be a focus on the issue of board diversity during 2014, as the aspirational target of 25% female representation on UK company boards by 2015 approached. Engagement in 2014 was therefore essential: we have previously articulated our revised voting policy on board diversity, and this will be active from 2015.

Our continuing engagement with FTSE companies meant that in June the final FTSE 100 Company with an all-male board, Glencore, recruited its first woman to its board.

"The industry had achieved a major milestone where there were no remaining FTSE 100 companies with all-male boards."

This was an encouraging signal that companies are firmly committed to improving the status quo due to the conviction that it makes their businesses better.

Although this significant shift in the UK’s largest companies was an important one, we continued to push for similar change amongst FTSE 250 companies. We therefore wrote to the remaining 26 FTSE 250 companies with all-male boards to ask them how they were considering this important issue, to gain a better understanding of their approach and to discuss the challenges they may face in implementing diversity initiatives. We had conversations with a number of these companies, the majority of which were positive, with the chairmen clearly being dedicated to making improvements in this space, in some cases with appointments imminent. Other chairmen were less convinced and we had to be satisfied with pushing for more robust diversity policies as a first step.

Figure 1. Women on UK boards improving trend


Aside from our company engagements, we have continued to interact with search firms and the UK government as two key parts of the chain to influence change. On our recommendation, the government strengthened the voluntary Code of Conduct for executive search firms, and an Enhanced Code was launched in September. This is an accreditation process to acknowledge those executive search firms who are at the forefront of helping boards to enhance their gender diversity. We believe this will ensure that those firms that are genuinely committed to promoting gender diversity are recognised, and that companies will be able to more easily select a search firm on this basis should they wish.

As we approach 2015 and the cut-off point for the UK’s aspirational target, we need to remain focused on pushing for continuous change at companies – we do not want to stall at 25%. This will remain a challenge for all involved. Finally, the next diversity focus going into 2015 will be ethnicity of board members. As the government begins to put the spotlight on this next crucial element of board diversity, we have begun discussions with the government on how this next issue should be approached.

BOARD DIVERSITY IN THE US
Our focus on diversity extended beyond the UK for the first time this year in a targeted engagement project. We collaborated with F&C Investments and RPMI Railpen Investments and sent a letter to 56 US companies where we felt that board diversity was poor. We requested conversations with these companies to discuss their practices to ensure maximum board effectiveness and, as part of this, board diversity. We are finding that US companies are less willing to engage on this issue, especially as it relates to board tenure, which is not limited in the US. We had conversations with several of the targeted companies, but these will continue into 2015 and it remains an issue we raise with every US company we engage with in our day-to-day meetings.
We believe cyber security is a significant risk to our investee companies. We looked at this topic in our Fundamentals piece published in 2014.

For the past few years, we have been engaging with companies on the management of cyber security and their digital infrastructure. We continued to discuss this topic throughout the year, to better understand how boards are managing this risk.

There are a number of different methods that can be employed to create a cyber-attack and the threat can come in a number of different forms. We have categorised these risks in five high impact areas – data theft, day-to-day operations, mergers and acquisitions, reputational and the insider threat. These risk factors are the key focus areas for us as investors because they can potentially destroy shareholder value by negatively affecting earnings or result in a company losing its key competitive advantage.

This includes identifying and monitoring information assets, auditing and receiving external recognition for managing risks, and company-wide communication and education to foster a cyber-awareness culture within the organisation. Furthermore, this is seen as an issue for the board of directors, not just the IT department (see figure 2).

During our discussions with company chairmen, it is clear that there is more interest in this subject. This may be a result of the UK government’s FTSE 350 Cyber Governance Health Check survey which was released during 2013. A number of companies have taken further steps to enhance knowledge in this area with presentations from their Chief Information or Technology Officer or outsourcing specialists to test their systems.

Given the rise of high profile hacks in 2014 of companies such as eBay, Vodafone, JPMorgan and Home Depot, it is clear that companies need to take more action. We will continue to engage with companies in order to safeguard shareholder value.

INVESTOR FORUM
In July 2014, the Investor Forum was formally launched following the recommendations of the Collective Engagement Working Group and the Kay Review. Sacha Sadan chaired the implementation team, tasked with establishing the Forum’s governance structures, including appointing a CEO, chairman and board.

This Investor Forum is open to all investors who have an interest in UK companies, whether based in the UK or overseas. It is a significant step towards improved shareholder collaboration. The Investor Forum seeks to contribute to long-term investment performance by promoting cultural change and enhancing shareholder stewardship.

Sacha, who sits on the Forum’s board, said:

“I am delighted to see the Investor Forum being established. The enthusiasm of the investor community to see better long-term collective engagement has been very encouraging. The Forum can be a useful additional tool in improving UK equity markets.”

MERGERS AND ACQUISITIONS IN 2014
There was an increase in M&A activity in 2014. In instances of M&A, LGIM engages with both sides of the deal to help identify the long-term benefits, with the aim of maximising shareholder value for all our clients. The proposed combination of AstraZeneca (AZN) and Pfizer provides a good example of our engagement:

- Pfizer announced potential deal with AZN on evening of 28 April
- Held conference call with Pfizer CFO 29 April
- Call with AZN chairman 30 April
- Met AZN management team 7 May with Active and Index teams
- Met Pfizer management team 14 May with Active and Index teams
The companies failed to reach common ground on an acceptable value due to the risks and uncertainties of completing the deal.

Although the deal did not complete, shareholders gained a greater insight into the long-term prospects for the business and, in November, AstraZeneca set out its path to sustainable delivery and growth. It has a target of exceeding $45bn of sales in 2023. We will monitor their performance to achieve this goal and push for these targets to be reflected in the long-term incentive plan.

AUDITOR ROTATION
LGIM was encouraged to see the European Parliament voted to approve a law to require companies to rotate their audit firm after 10 years, which can be extended to 20 years by the Member States. There is a restriction on the services that a company can receive from its auditor and a limit of 70% of the audit fee that can be spent on non-audit services. This is expected to come into force in 2016.

Research from PwC found that nearly twice as many FTSE 350 businesses were expected to tender auditor mandates in 2014 compared to 2013 (up to 56 versus 30) in response to the new regulation. Recent notable examples of companies announcing auditor changes are J Sainsbury, RBS and Diageo.

LGIM also wanted to see audit tenders opened to firms outside the Big Four audit firms. We co-signed a letter to the Financial Times, along with other long-term investors, raising the issue. The FTSE 250 company Interserve Plc decided to award their audit to Grant Thornton in a move away from the Big Four.

BOARD EFFECTIVENESS REVIEWS
As a significant investor, we want all companies in the market to undertake board reviews that are rigorous and a value-added exercise; we don’t want them to undertake a review ‘because they have to’ or ‘to tick a box’.

During 2014, we have developed our thoughts on board effectiveness reviews and the subject was featured in our Fundamentals article. The board review industry remains in its infancy; 38 different providers undertook FTSE 350 externally facilitated board reviews in 2014 (Grant Thornton, 2014). Over 40 evaluations were provided by three consultants. Given that there are no minimum standards in place for reviews at present, the large number and diverse range of providers being used inevitably results in variability of methodologies and, ultimately, quality of reviews.

In addition to the methodology, companies should provide a summary of findings and an action plan to address areas of improvements in the annual report and accounts. British American Tobacco and Marks & Spencer are good examples of best practice in terms of disclosure.

We believe that a code of practice will provide an important framework, ensuring that a minimum standard of board review is upheld and that potential conflicts of interest are managed appropriately.

Transparency with regards to the methodology undertaken is fundamental to this, albeit recognising that sensitivity around some issues may prevent full public disclosure.

As long-term investors, we want to help companies be as good as they can be. Therefore, we would like to engage with the chairman and/or senior independent director following a review to discuss the outcomes of the review for the board and its committees and processes, as well as what changes have been made and the action points to take forward.

We have been encouraged by companies’ positive experiences, particularly after initial scepticism. Board reviews are an evolving practice and LGIM will help in trying to set up a code of conduct in the near future.

Figure 3. LGIM ideas for new code of practice for board reviews

- Consultants should undertake one-to-one interviews with all board members and the company secretary
- Consultants should be allowed to attend board meetings to maximise the value of the exercise or state if they do not attend any
- Investors should know the review methodology
- Consultants should have the opportunity to attend board sub-committee meetings
- Consultants should be able to meet the executive committee to get the executive directors’ views on the board
- Consultants should be allowed access to other stakeholders such as shareholders, auditors and lawyers
- The findings from the review should be fed back separately to the senior independent director (SID) as well as the chairman
- A follow-up meeting should be held between the chairman or the board and the consultant to discuss how the action points have been / are being implemented
- The same consultant can do no more than two reviews in a row before the company uses a different reviewer
- The consultant should sign off the statement that relates to the board review that is included in the annual report
- Additional services provided by the practitioner must be disclosed and minimum periods of being offside must occur and be disclosed
FOOD WASTE
As a major investor in many food companies, LGIM conducted research into the social and environmental issue of food waste. Food waste not only reduces the amount of food available for consumption but it impacts CO2 and water consumption. There is not a limitless supply of natural resources and climate change is already having a major impact in the food industry. Droughts and floods lead to spikes in raw material prices which are not always passed onto the consumer and therefore impact the bottom line of food producers and retailers. The global food poverty crisis has left around 825 million people without sufficient food to eat and yet, in the UK alone, £12 billion of food is thrown away each year.

Although LGIM accepts that much of the waste is generated at a consumer level, we also believe that food retailers that play a big part in the lives of consumers can influence behaviour. They can also play a part to stem the level of food waste that occurs prior to it reaching the shelves of their stores. Our ESG Spotlight on food waste (http://www.lgim.com/library/knowledge/thought-leadership-content/esg-spotlight/ESG_Spotlight_food_wasteJAN_15.pdf) examined the costs to society and talked about some of the initiatives the food retailers have adopted to reduce waste.

US ENGAGEMENT VISIT
As our investments grow in the US, so do our engagement activities with our investee companies. Establishing long-term relationships with these companies, based on open discussion and trust, is imperative to encourage improvements in terms of ESG.

The technology sector in the US is one of the main sectors of focus for us in terms of engagement and understanding what these companies are doing in relation to managing their supply chains, which are often long and complex. This is particularly relevant given the significant reputational risk to companies’ brands associated with not acting in a socially responsible manner.

During 2014 we travelled to the US and undertook several company engagements, including Boeing, Abbot Laboratories, Exxon, Freeport, McKesson and Chevron. We also visited Apple and Google at their offices in Silicon Valley. With Apple we discussed the work it is undertaking on its supply chain management, as well as on conflict minerals. The meeting with Google was our first engagement with the company, where we discussed general governance structures and improvements, as well as compensation issues. We suggested some changes the company could make, including allowing its board to be elected by a majority vote system, abandoning the dual class share structure (which would allow shareholders to hold board members to account) and being more open to engagement with its shareholders.

US BOARD TENURE
In the US, the existence of board term guidelines is scarce. Only 3% of the S&P 500 specify a term limit for directors, while the longest term limit is 30 years. Companies without term limits may argue that they have age limits in place for directors, which will force board turnover. The other argument we commonly hear is that deeply experienced board members contribute valuable insights in turbulent times.

We agree that this is important. However, we believe that effective succession planning would allow experienced board members to be replaced by individuals who may have equal levels of experience from previous board memberships or, perhaps, a skill-set that is more appropriate to the current competitive landscape. Hence, we believe term limits help foster board refreshment, which brings a natural cycle and evolution to the board. This brings new challenges and fresh insights to be gained. Guidance for the departure of a non-executive director (NED) helps with succession planning.

The board tenure debate is one we will continue to have with US companies. The competitive landscape is always changing; new skills, fresh ideas and different perspectives are paramount in helping companies to succeed by adapting and reacting to that change.

MALAYSIA
We signed up to the Malaysian Code for Institutional Investors during 2014. LGIM endorses the principle of this code and is fully committed to it as it intends to protect the integrity of clients’ assets and enhance long-term value for shareholders.

TAX
We continue to engage on the important topic of tax management. We hosted an investor event to discuss the latest developments as a follow up to a similar event we held in 2013. We put together a discussion paper with a number of other investors based on the findings from our engagements with a range of tax professionals and companies in the extractive and consumer brands sectors.

We have been discussing the implications for investors with other global investors. We asked the PRI (Principles of Responsible Investors) to take a coordination role as political and corporate interest in tax management increases worldwide.
Case studies from 2014

BG GROUP

BG has been in the media during 2014 for a number of performance and governance-related issues. The company announced a pay package for the incoming CEO, which went outside its Remuneration Policy only recently agreed by shareholders at its AGM. LGIM subsequently welcomed the decision by the company to listen to shareholder concerns and amend the pay package, whilst still recruiting the new CEO.

WHAT HAPPENED?

Over the past three years, the company has underperformed the FTSE All Share by 50.6%. This was a result of profit warnings and downgrades following the departure of a long-serving CEO nearly two years ago. Following the appointment of a new chairman who appointed a new internal candidate, the company continued to underperform, leading to the CEO’s departure after only 16 months in the job.

In 2014, LGIM engaged with the company extensively regarding its pay policy in preparation for meeting the government’s new remuneration regulations. LGIM highlighted that the company needed to build enough flexibility into the policy to ensure that it could recruit a new CEO. At the AGM, the company received support for its remuneration policy from a majority of investors. However, in mid-October, the company announced the appointment of a new CEO following an extensive global search led by the executive chairman. The company also outlined the principal terms of the new CEO’s remuneration package, which was competitive in the international oil and gas industry. The package included a large allocation of shares based on personal performance criteria and was outside the company’s remuneration policy. A separate extraordinary general meeting was to be held in November to approve the package.

LGIM had concerns with the package. This not only included the size of the package, but justification and the soft performance conditions attached to the vesting of the share awards.

The recruitment package also received attention in the public media. LGIM and other investors engaged extensively with the company to suspend the payment and for the company to revert to the remuneration policy approved only six months previously.

Prior to the EGM being held, the company listened to its shareholders and decided to revise the pay package within its current policy. This did not affect the incoming CEO’s start date.

We will remain fully engaged in 2015 as the potential acquisition by Royal Dutch Shell proceeds.
The example of Tesco highlights why we are strong proponents of auditor rotation, rigorous and value added board effectiveness reviews, and diversity of thought on the board. During 2013 and 2014, LGIM met with various board members on 15 different occasions and we will continue to engage with the company to help it create long-term shareholder value.

WHAT HAPPENED?
In 2011, the CEO stepped down at a time of record profits. However, by 2013, Tesco’s revenues had fallen sharply, there was a supplier issue related to traces of horsemeat and questions were raised over the company’s internal controls. LGIM engaged with the chairman around concerns about skills on the board, performance, aggressive accounting and remuneration.

Underperformance continued in 2014 and LGIM held numerous meetings with Tesco board members to understand and improve performance. Following shareholder pressure, there was a change of management. The company then announced that profits had been significantly overstated. LGIM engaged with the senior independent director to discuss this and the company’s whistleblowing policy.

Tesco now has a new Group CEO, CFO, UK CEO, company secretary and two new non-executive directors with retail experience. The chairman will also be stepping down in the near future and we communicated with the board regarding his successor.
History
Online sports betting business Betfair floated on the London Stock Exchange at £13 per share in October 2010. However, financial results were below expectations and uncertainty regarding unregulated markets persisted, resulting in the shares falling below £6 by August 2011.

A new CEO joined in August 2012 and set a new strategy focusing on regulated markets and reducing costs.

2013
In mid-2013, the share price rose when Private Equity group CVC and two major shareholders bid for the company, twice raising their indicative bid from 880p a share to 920p and then 950p; this final bid represented a 35% premium to the undisturbed share price.

We engaged with the company and gave the chairman and the board our backing to reject the offer and give new management time to pursue its newly outlined strategy. The company rejected the bid and the shares fell on the announcement.

2014
We engaged with the company’s CFO and audit committee chairman to discuss the accounting error in relation to the payment of dividends. At the AGM we voted against the resolution to accept the annual report and accounts because we felt the accounting error should have been presented with more clarity due to its unusual nature. We also voted against the remuneration report, because the targets for the 2011 LTIP awards were amended downwards retroactively, without sufficient justification.

Subsequently, we held positive engagements with the chairman and the chairman of the remuneration committee. The company has stated that it will not use its discretion to retrospectively adjust performance targets for executives’ bonus schemes in future years.

Positive performance
The new strategy and management team has been a success.

"The shares in Betfair are now over 100% higher than the final offer price, vindicating our decision to support the board in rejecting the bid."

Where are they now?

BETFAIR

BETFAIR

BETFAIR

Source: Bloomberg
Where are they now?

G4S

2011
We met with the company to discuss a proposed reverse takeover with ISS, a cleaning business, valued at £5.2bn. This required the company to raise over £2bn through an equity rights issue. As the third largest shareholder in the business, we met the company twice to discuss the proposal and also talked with other shareholders. We had concerns with the shift in strategy from making bolt-on acquisitions in emerging markets to buying a large cleaning business in Europe. The share price fell by 22% on the announcement. We informed the company of our intention to vote against the transaction in advance of the vote. One day before the EGM was going to be held to approve the transaction, the company announced it had decided to abandon the acquisition.

2012
Following opposition from shareholders, which led to the collapse of the merger between G4S and ISS, we worked along with other investors to strengthen the board. In January, G4S announced that the board chairman would step down. We consulted with the company on the succession process and subsequently a new chairman and three new independent NEDs were appointed. The company also announced the appointment of new financial advisers.

2013
In our continued engagement effort with the board, the company appointed a new CEO and CFO, who outlined a review of the business. In addition, we met the chairman of the corporate social responsibility (CSR) committee to get an update on the company’s performance in the area of human rights and health and safety following negative comments in the media on how it handled government contracts, including the 2012 London Olympics.

2014
We were consulted on the company’s new remuneration structure and gave feedback to ensure its alignment with the new strategy set out by management. We also met the chairman to discuss the business model and relationship with customers such as the UK government. In an effort to improve governance, the company also announced the appointment of new external auditors.

Positive performance
Furthermore, the company has continued to improve its CSR effort, with the focus on health and safety.

"Following various changes at the board, the company has taken significant steps to simplify its business, improve cash generation and returns to shareholders."

G4S 5-year share price performance chart

Source: Bloomberg
CLIMATE IS CHANGING
Global average temperatures are rapidly rising, with 2014 being the hottest year ever recorded. In April 2014, the IPCC (Intergovernmental Panel on Climate Change) firmly concluded that the main cause for global warming is the emission of greenhouse gases (GHGs) from human activity. The results are increasingly felt with more frequent extreme weather events, such as floods, droughts and heat waves, affecting growth and prosperity globally. Changing weather conditions directly impact food, water and energy provisions, but also indirectly affect labour productivity, human health and supply chains. Many industries are already suffering, or are set to face infrastructure losses, supply chain disruptions and drops in output as a result of more frequent floods and storms. The insurance industry paid out approximately US$70 billion per year from 2010 to 2013 as a result of weather-related incidents, compared to the US$15 billion per annum it paid between 1980 and 1989.

A GLOBAL SOLUTION
Climate is a global problem that requires global action. ‘The world’ has theoretically agreed to limit global temperature increase to below 2°C compared to 1880 levels, the threshold identified by scientists and agreed by policymakers to avoid dangerous impacts of climate change. Despite many countries and regions making increasingly leading commitments to tackle this problem, the current trajectory of emissions leads us to a temperature rise of between 3.7°C and 4.8°C.

Time is running out for the tipping point of global warming. At the end of 2015, global leaders will meet in Paris to strike an agreement that will outline individual countries’ commitment to keeping the temperature increase below the 2°C.

As part of the Institutional Investors Group on Climate Change (IIGCC), we signed up to the Global Investor Statement on Climate Change in 2014. We noted the risks of unmitigated climate change as well as the contribution investors can make to finance the transition to a low-carbon economy. Collectively we stated the need for:

1. Reliable and economically meaningful carbon pricing system
2. Strengthening regulatory support for energy efficiency and renewable energy
3. Developing plans to phase out subsidies for fossil fuels
4. Ensuring that national adaptation strategies are structured to deliver investment

CHINA, US AND EUROPE HOLD THE KEYS
China, the US and the EU combined constitute nearly half of global emissions (see Figure 1).

Figure 1. Global share of GHG emissions of most polluting countries

Source: HSBC

With regards to negotiations in the past on climate change, hesitation by China and the US to strike a global agreement has left a negative impression. However the tides have shifted. China announced its intention to peak energy demand by 2030 and the US’s newly discovered shale gas/tight oil resources meant a low carbon future became attainable.

POLLUTION CONTROL - CHINA
China is well positioned to meet its 2020 carbon intensity reduction target of 40% from 2005 levels, and has publicly stated its intention to increase the share of zero emission energy sources, such as wind and solar, to 20% by 2030. Such initiatives, combined with significant pollution in all major cities, have led to an historic decline in coal demand of 2.1% in 2014 from the previous year.

We visited China during 2014, where we met with industry leaders in the energy and climate change space to better understand the latest developments in energy transition (from coal to gas to renewables). While the developmental pressures exist, the impacts of pollution from energy generation and transport were visibly felt and featured dominantly in the policy domain.

SHIFTING POLICIES – US
In a surprising China-US climate deal, US President Obama pledged to reduce emissions by 26-28% by 2025, compared to 2005 levels. In order to achieve this, the government has announced the Clean Power Plan, which aims to reduce coal generation in the energy mix from 40% currently to 30% by 2030. It also plans to introduce regulation to cut methane (which is 22 times more potent than CO2) emissions from the oil and gas industry by 45% over the next decade compared to 2012 levels.
Climate change

LEADING THE WAY - THE EU
The EU recently announced the 2030 Climate and Energy Policy Framework, which targets a 40% emissions reduction by 2030 compared to 1990 levels, a 27% increase in energy efficiency and raises the share in renewable energy consumed in 2030 to 27%.

VITAL PIECE - INDIA
India may be fourth in the current emission league, but it will play a pivotal role in curbing emissions in the future, due to its huge economic growth potential. The India-US climate deal was disappointing in the eyes of climate negotiators, but highlighted India’s shift in recognising global warming and its devastating impacts. India made a commitment to provide renewables energy; 100GW, increased from previously committed 20GW in solar power generation by 2022, as well 8GW of wind power every year.

STRANDED ASSETS
Asset stranding as a result of emerging disruptive technologies is a constant phenomenon in investments. Traditional film to digital photography was one such lesson. The current discussion on stranded assets refers specifically to fossil fuel reserves which are at the risk of not being burned, as the world tries to curb emissions. Consequently the owners of such assets may not be able to make a financial return on them.

Research published by Carbon Tracker has gained momentum amongst many long-term investors as it highlights the risk of investors’ assets stranding at different temperature increase levels, 1.5°C to 3°C.

Even without an ambitious global goal commitment, energy transition trends as a result of energy security, pollution controls, geo-political risks, oil price volatility and threat of renewables take up rate all threaten the viability of fossil fuel reserves – particularly for those which are at the most expensive end of the cost curve. These include energy and cost intensive operations in oil sands, arctic exploration and ultra-deep water operations.

We recognise the potential financial risks of such reserves stranding in the face of changing macro dynamics in our investments. The oil price drop in the second half of 2014 reiterated the impacts of over-supply and lower demand for the more costly part of oil and coal production.

IMMEDIATE TARGET TO STRAND - COAL
Coal, the most carbon intense and polluting source of energy, is arguably showing signs of stranding as global demand falls due to lower growth in emerging markets, pollution controls and energy efficiency impacts. Moreover, the recent shale gas revolution in the US has provided a relatively cheap and cleaner alternative to coal for power generation. Over the last three years the Stowe Global Coal Index has lost two-thirds of its value, to the end of 2014 (see Figure 4).

Figure 2: Global emissions

Source: Energy Outlook 2035

Figure 3: Scale of possible ‘stranded’ assets in listed companies’ reserves, to meet various carbon budgets

Source: Carbon tracker & Grantham Research Institute, 2013

Figure 4: Stowe Global Coal Index since 2012

Source: Bloomberg
In September 2014, we visited Suncor’s oil sands operations in Alberta, Canada, to understand their operations from a myriad of perspectives. These included cost dynamics, dependency on new pipelines and transport routes, carbon price, air pollution controls, health impacts on surrounding areas and tailings management costs. With the average oil sands operation being 3.2 to 4.5 times more CO2 intense than conventional oil extraction, greenfield (new development) in oil sands will face an enormous array of obstacles to be financially viable.

We regularly engage with companies in the oil, gas, mining and utility sectors, discussing the impacts of energy transition, robustness of their future scenarios and impacts of internal carbon prices. We do not believe Carbon Capture Storage (CCS) will provide a meaningful solution to future emission from these companies as it continues to be under-invested in by the industry. Their assets’ viability in the face of pending climate targets is one of the key major engagement topics we will continue to have in 2015.

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In markets such as Europe, the decline in the costs of renewables, as shown in figure 5, has also disrupted the traditional utility model and put further question on the future demand for coal.

**Figure 5: Solar module costs have decreased by 85% since 2007 in Europe**

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**INVESTMENT SOLUTIONS**

Faced with such uncertainty in being exposed to fossil fuel assets, some investors have addressed this by divesting from at-risk sectors and companies. The campaign to divest started by university endowments in the US and quickly followed by other asset owners across the world, rose to a total US$50 billion being divested from fossil fuel companies by the end of December.

Many institutional owners, in parallel, expressed the desire to understand the carbon exposure in their portfolio by profiling their investments’ direct and indirect emission levels. Some have since made a decision to shift their allocation. For instance, Norges Investment Management divested from 14 coal mining companies and five involved in oil sands, as a result of such assessment and long-term financial prospects.

In response to such trends, asset managers and index providers have launched a series of indices which aim to reduce or exclude exposure to exploration and extraction of fossil fuels.

At LGIM, we also provide our clients with solutions in this space. Please feel free to contact your client account manager for further details on our offerings.

**CONTINUED CONVERSATION**

While climate change has been one of the ESG engagement topics for a number of years in the investment community, these recent macro-economic shifts have refocused the conversation between asset owners and asset managers, as well as companies and regulators.

We are committed to the preservation of our clients’ long-term assets and, therefore, are committed to addressing climate change by engaging with investee companies, policy makers and directly with our clients.
**Company engagement**

Ongoing dialogue with companies is a fundamental aspect of LGIM’s responsible investment commitment and we undertake this independently and collaboratively with other investors. We believe that voting and engagement are closely linked and complementary.

Engagement gives us the opportunity to learn about the company’s strategy, operations, financial and external challenges and opportunities, all of which are essential for us to exercise our duty effectively. Importantly, ongoing dialogue with companies means that we can express our concerns before votes are cast, which allows an exchange of ideas between us and the company.

During 2014, we had meetings with 354 individual companies. In many cases, we held multiple meetings with a company as we pushed to get a desired outcome, therefore resulting in 589 meetings held last year. This represented a material increase from 2013, where we held 480 meetings with 278 individual companies. The chart opposite demonstrates the corporate governance topics discussed with companies.

The chart on the left shows the total number of Environmental, Social and Governance (ESG) topics covered in our meetings as well as the overlap between them. We focus on the material issues which are pertinent to each company. As a result, sustainability topics are often raised in governance meetings. Financials are also discussed in most of the meetings.

For instance, we had 73 meetings which covered both governance and social topics, while 511 out of the total 589 meetings included some elements of governance in conversations with companies.

During 2014, we engaged with companies across a broad range of sectors, as shown in the chart on the right.
Company engagement

BOARD STRUCTURE
Appointing and retaining the best people to run the company on behalf of shareholders

JP Morgan
Bank
US
Mkt. cap: $230bn

We met with an independent board member to further our engagement with the company. We discussed board structure, the risk management process, employee management, as well as financial regulation and the company’s culture and emerging issues in this area. We shall continue to strengthen our discussions with the company.

Glencore
Mining
UK
Mkt. cap: £39.5bn

We engaged with the company to discuss the appointment process of the new board chairman. We had concerns with the process undertaken, given that the candidate chosen was also leading the search and had only stepped back from his chairmanship of the nominations committee in the last few months. We also expressed our concerns by opposing his re-election at the AGM. At the general meeting, 10.3% of investors who voted failed to support his re-election. We will continue to engage with the company on governance and sustainability issues.

Richemont SA
Luxury consumer
Switzerland
Mkt. cap: CHF44bn

LGIM engaged with the company to discuss our concerns with the lack of independent directors on the board. We wanted to understand the rationale of the board for its lack of refreshment. We also covered their strategy and capital allocation policies. We were satisfied that, although the company’s governance is not fully compliant, it was being run conservatively and in a manner that will safeguard long-term shareholder returns.

Cisco Systems
Technology
US
Mkt. cap: $154bn

We spoke to the company to discuss board structure, remuneration and governance issues. The company received a proxy access proposal at its AGM and we encouraged the company to think more about board turnover as there are several long-serving directors, including the Chairman and CEO. Although we feel the company should refresh its board, we did not support this proposal as it would have enabled shareholders to replace 40% of the board, which we felt would be too disruptive to the business. The proposal gained 5% support from shareholders.

Petrobras
Oil & gas
Brazil
Mkt. cap: BRL124bn

We co-signed a letter to the chairman, together with other Institutional investors, raising our concerns about changes they had made to their audit committee, specifically the replacement of the independent director with a director that is not independent and belonging to the controlling shareholder. We believe this undermines the ability of the committee to perform its defined role. We asked that this be addressed in the near term.

Sports Direct International
Retail
UK
Mkt. cap: £4.1bn

LGIM has had concerns with the governance at Sports Direct for some time and we escalated our engagement last year. Some of the concerns centred around a significant share award to the deputy executive Chairman, being the only Retailer in the FTSE not to have signed the Accord on Fire & Safety in Bangladesh, their reliance on zero contract hour employment contracts, and investments in other Retailers without strategic justification. Our engagement, both privately and collectively, with other investors resulted in a number of assurances being given. Despite this, we felt it necessary to oppose the re-election of the Chairman, the Chairman of the Remuneration Committee and the Remuneration Policy. However, by the end of 2014, we did not witness any material change in the governance of the company and the shares started to underperform due to governance concerns. We have sought a meeting with the SID to escalate our engagement to improve the governance and performance of this business.
Company engagement

FINANCIAL TRANSACTIONS (MERGERS AND ACQUISITIONS AND CAPITAL RAISING)

Maximising and protecting shareholders’ long-term interests

AstraZeneca / Pfizer  Pharmaceutical  UK/ US  Mkt. cap: £57bn / $87bn
We engaged with both AstraZeneca and Pfizer with the aim of maximising shareholder value for all our clients. The companies failed to reach common ground on an acceptable value due to the risks and uncertainties of completing the deal. AstraZeneca has set a future sales target to be achieved from its current pharmaceutical pipeline and we will monitor their performance to achieve this goal.

Ladbrokes  Leisure  UK  Mkt. cap: £1.1bn
We discussed the proposed bid for the company from Fox. The company felt that there were risks to its business from the combination. We discussed how it will move forwards from the withdrawn bid and the company explained that it would issue a new strategy in the coming months. We discussed board structure and the role of the Lead Independent Director, its remuneration policy, cyber security, the risk of piracy and the company’s energy use.

STRATEGY DELIVERY AND PERFORMANCE OF THE COMPANIES

Understanding financial fundamentals and aligning with long-term value creation

FirstGroup  Transport  UK  Mkt. cap: £1.3bn
We met the new Chairman of the company to discuss his views and plans to turn around the company following long-term poor operational performance and a large rights issue in 2013. We discussed a range of issues, including the plans for underperforming business units, the balance sheet, the board, union relations and dividend policy. While the Chairman is leaving to become the Chairman of Barclays, the board has been refreshed with the addition of three new non-executive directors. We will continue to engage with the company to enhance long-term shareholder value.

Ladbrokes  Leisure  UK  Mkt. cap: £1.1bn
During 2014, we engaged with the Chairman in April and December. We have met the company on several occasions over the course of the last few years and have discussed a range of issues, including the general management of the business, the underperformance of its digital division, regulation and capital allocation. The company has announced that the CEO will step down in 2015.

REMUNERATION

Aligning interests of company executives to those of long-term shareholders. For more detailed information on our views and principles on executive pay, please see the section ‘Executive pay’ on page 26.

Microsoft  Technology  US  Mkt. cap: $360bn
We engaged with the Chairman ahead of the AGM to discuss the succession process of the new CEO and their new remuneration structure. We highlighted our concerns with the practice of making discretionary payments and the high size of the package awarded to the new CEO. Furthermore, we explained that remuneration should be examined more closely alongside succession to ensure that large discretionary awards are not made. LGIM voted against the remuneration report, which received only 72% support from shareholders. We will continue to engage with the company.

Freeport McMoRan  Mining  US  Mkt. cap: $22bn
The company has improved its remuneration policy by reducing base salaries and implementing a new long-term incentive plan, which links better to performance. However, we expressed our concerns with the retention payment of $35m in equity to the longstanding CEO. We felt this payment was excessive and with a short holding period of only six months after retirement, we questioned whether this was an effective retention incentive. Despite the company making great improvements to its remuneration plans, we voted against the ‘say on pay’ due to this large equity payment and the company received only 62% support from shareholders for its remuneration plans.
Company engagement

The financial crisis highlighted problems in banks’ risk management practices and the regulatory framework. The Capital Requirements Directive is EU legislation to implement the ‘Basel III’ recommendations on banks. One aspect deals with remuneration and bonus caps. After engaging with major UK and European banks, LGIM decided to support the arrangements to limit variable pay to 200% of fixed pay, with a significant element in shares held for a long period. This is to enable EU banks to remain on a competitive level with banks which operate in North America or the Far East.

Oracle
Technology
US
Mkt. cap: $193bn

Our engagement with the company has been ongoing on board effectiveness, poor governance and misaligned incentives. Despite the reduction in equity awards for the CEO, the company suffered a third failed ‘say on pay’ vote. We voted against the plan because we have continual concerns that pay is not sufficiently linked to the performance and the amount is excessive. We also voted in favour of the proxy access proposal as we feel that the board composition remains an issue due to the CEO’s historical role at the company, despite the recent changes of appointing a co-CEO and his stepping down to executive chairman. This proposal received 44.6% support from shareholders.

SUSTAINABILITY

To mitigate negative environmental and social impacts while taking advantage of emerging opportunities

Apple
Technology
US
Mkt. cap: $752bn

LGIM visited the company’s offices in California to discuss various ESG issues. The company has worked hard around its sustainability framework, particularly in terms of the management of its supply chain. In addition, the company has made a transition towards a structure that is more socially responsible. LGIM will encourage the company to continue this improvement and to communicate this story more widely. We also had an open discussion on remuneration and will follow up with the chair of the compensation committee to discuss these issues in more detail in 2015.

KAZ Minerals
Mining
UK
Mkt. cap: £1.1bn

LGIM engaged with KAZ Minerals, focusing primarily on health and safety issues, considering the high rate of fatalities experienced by the company in the past. The company, as a result of its restructuring plan, is modernising its equipment, as well as providing extensive training to its employees and linking health and safety to management compensation. Despite considerable reductions in fatality rates – from 32 in 2010 to 14 in 2014 – the goal of zero fatalities remains remote and the company is still considered a laggard among its peers. Hence, we will continue to monitor its performance and intend to meet the company in 2015 to assess its progress and discuss other important areas related to the sector, such as water management.

Oil sands
Canada

LGIM visited Fort McMurray, Alberta, Canada to observe the oil sands operations in the area. We met with Pembina (a think tank working to improve standards in oil sands operations), Suncor (oil sands operator) and representatives from the native first nations. We learned about a range of environmental impacts, such as tailings management, carbon reduction, air pollution, water contamination and land management, as well as social impacts on local communities. We also discussed the role of oil sands in the mix of overall global oil supply and costs of transport to various markets in the future.
Associations and collaboration

We recognise that working with others can be a powerful tool which can quickly influence change. There are various ways of collaborating, including group meetings and co-signed letters. Working with other investors can help to produce better results for our clients.

COLLABORATIVE ENGAGEMENT

Our combined assets carry even greater weight with companies and mean we can achieve significant change. It also helps us to generate the best solution by combining our knowledge and experience. We participated in a number of multi-investor meetings with companies including Apple, Google, Petrobras, bwin.party digital entertainment and Soco International. Such meetings provide an excellent opportunity for us to learn about the companies and align our views with investors.

We also had conversation with non-government organisations (NGOs) and think tanks in the industry to share knowledge and to understand other approaches to various topics. We find it a valuable exercise that can bring mutual benefits by keeping communication channels open.

NETWORK MEMBERSHIPS

Collective work is an extremely effective method of engagement, but one that requires enormous amounts of resources and organisation. In order to facilitate this process, we are members of industry-wide associations and networks. Below are a few examples of our activities during the year. A full list and further details on each are outlined on our website:


Investment Association

During the year, the Investment Management Association and the Investment Affairs division of the Association of British Insurers (ABI) merged to create The Investment Association (IA). The merger has created a broader membership of investors, which manage more than £5 trillion for clients. We continue to be on the IA’s corporate governance and engagement committee and the remuneration committee. The guidance to companies on remuneration issues was reviewed in 2014 and a change was made to require clear justification for any payment of ‘allowances’ as part of fixed pay.

Asian Corporate Governance Association (ACGA)

We continue to support the work of ACGA, which is an organisation that pushes for governance reforms in 11 Asian countries. We attended their conference in Hong Kong and joined their delegation to visit Chinese companies in mainland China in November. We regularly follow their lead in pushing for changes at stock exchanges and company engagements in various Asian countries such as Hong Kong, Malaysia and South Korea. Their contribution has been vital for the Japanese corporate governance changes that have taken place in 2014.

International Corporate Governance Network

LGIM presented at the ICGN conference in Tokyo on foreign investors’ expectations of Japanese corporate governance.
Associations and collaboration

Council of Institutional Investors (CII)

LGIM presented at the Spring conference of the CII in Washington DC. We updated attendees on the various changes in governance in the UK and European markets, such as auditor rotation, and the European Commission measures on strengthening governance and long-term shareholder engagement. The CII is an important forum for us to engage with US investors and continue to build our networks and reputation in the US.

Institutional Investors Group on Climate Change (IIGCC)

- **EU’s Carbon Emissions Trading Scheme (ETS)**
  ETS has had a volatile and disappointing impact in regulating the greenhouse emission levels in the UK, as a result of over-supply of allowances that were supplied in the market. As part of IIGCC, we had been calling for the back loading of surplus allowances, which was finally approved. In 2014, IIGCC published its Statement on climate change and energy priorities, which was delivered to over 100 of the most influential EU policy makers on climate and energy policy in the new EU Commission. Many of the recommendations were taken up by the newly elected parliament.

- **Climate target**
  As part of IIGCC, we pushed the European Union to have ambitious targets in regards to the 2030 Climate and Energy Policy Framework. We successfully advocated a more ambitious emissions reduction target of 40% by 2030 compared to 1990 levels.

- **Global investor statement**
  We signed up to the Global Investor Statement on Climate Change, which was signed by 365 investors representing more than US$24 trillion in assets. Collectively we stated the need for 1) Reliable and economically meaningful carbon pricing system, 2) Strengthened regulatory support for energy efficiency and renewable energy, 3) Developed plans to phase out subsidies for fossil fuels and 4) Ensuring that national adaptation strategies are structured to deliver investment.

PRI

LGIM attended the Principles for Responsible Investment (PRI) conference in Montreal, where 600 global practitioners gathered to discuss the latest developments in responsible investment. We spoke at a panel on executive pay to discuss the progress on the topic in the UK, compared to the US and Canada.

- **ESG and Pay**
  We continued to be involved, together with other global investors, in the project to integrate ESG performance into executive pay packages led by the PRI. Building on our published guideline in 2012, which outlined broadly why and how ESG should be embedded into pay structure, we looked at two specific sectors – extractives and utilities. The sector supplements summarise current practices, the standards demonstrated by leading companies, as well as the alignment and discrepancies between what is already integrated and what the key risks are for each industry. The broad guidelines notes and a brief summary on sector findings can be found on the links below.


- **Fixed Income**
  We were part of the PRI-led initiative to address ESG risks in corporate and government bonds. While attention in ESG tends to focus primarily on equities, as a large fixed income investment manager with more than 60% of assets invested in both corporate and government bonds, we believe that meaningfully identifying ESG risks from a bondholder perspective is an area of great interest to the market. The PRI published its findings, which can be found on the following link.

At LGIM we believe that positive change can be brought about by responding directly to industry and regulatory consultations. This means that we can express our views constructively and enable industry level change. By doing this, we hope to facilitate and share best corporate practices to protect, align and maximise our clients’ interests.

CONSULTATIONS
During 2014, we submitted detailed responses to the following consultations:

FCA Sponsor Conflicts – December 2014
In this consultation, we highlighted concerns from an investor point of view on the ‘integrated banking model’ and how conflicts may arise from the various services provided to companies. We stated the need to mitigate these risks by enhancing disclosure on transaction fees, providing prescriptive measures to address conflicts of interest, and greater scrutiny of the behaviour of integrated banks from the market and regulators.

Review of Initial Public Offering (IPO) Bookbuilding Process – October 2014
Lord Myners undertook an independent review for the Secretary of State for Business of the IPO bookbuilding process. The review was called to consider lessons from the privatisation of Royal Mail. In our submission to the review, we highlighted the role that index funds can play in IPOs and made several suggestions on ways to enhance the current process. For example, we suggested bringing back variable incentive fees for investment banks based on who had done a good job on the entire deal process, decided by the participating institutions. Also, involving index funds earlier in the IPO allocation helps increase stability and long-term success. This, and other, helpful solutions are contained in the ABI’s (now the Investment Association) ‘Encouraging Equity Investment’ document on page 26: https://www.ivis.co.uk/media/5926/ABI-Encouraging-Equity-Investment-report-July-2013.pdf.

FCA Enhancing the Listing Regime – February 2014
For the past two years, we have supported the work carried out by the FCA on enhancing the listing regime. We responded to the FCA’s consultation on a package of measures to enhance the protection of minority shareholders in premium listed companies where a controlling shareholder is present. Although we broadly supported the measures, we requested greater transparency in circulars on director appointments, and higher voting thresholds for approval, given the influence they have on voting outcomes.

FRC Review of the Corporate Governance Code – June 2014
A regular review by the FRC was conducted on the UK Corporate Governance Code. We submitted a response and suggested areas where wording could be more prescriptive and tightened to provide better guidance on investor expectation of good corporate governance practice. For example, on remuneration relating to performance-related elements, we felt that wording that linked pay to strategy and better transparency should be included to avoid the usage of boiler plate language.

Law Commission on Fiduciary Duties – January 2014
Many investors believe that their fiduciary duty to maximise investment returns is in direct conflict with incorporating ESG in their mandate. We have long been making a case that ESG is a financial issue that has not yet materialised, with different degrees of impacts depending on the timeframe of investments. Hence, we argue that integrating ESG factors into investment decisions lies firmly within the bounds of fiduciary duty. More precisely, it is against fiduciary duty not to incorporate financially material ESG concerns. In this context, ESG should also not be confused with other investment strategies such as socially responsible funds, ethical funds, etc., which may have different investment return expectations.

To this end, our engagements with the Law Commission and the Minister of Pensions to push for better clarity on the purpose and role of ESG in fiduciary duty have culminated in our consultation submission, where we emphasised the need for better clarity on the interpretation of the law.

We were pleased with the clarification provided by the Law Commission which stated that “[the]risks to the long-term sustainability of a company’s performance may arise from a wide range of factors, including poor governance or environmental degradation, or the risks to a company’s reputation arising from the way it treats its customers, suppliers or employees [...]. Where poor business ethics raise questions about a company’s long-term sustainability, we would classify them as a financial factor which is relevant to risk.”

We continue to believe that further clarification in the law is needed to give extra comfort to our clients, and are therefore committed to continuing to engage on this topic.
Shaping the governance landscape

FCA Proposed amendments to the Listing Rules in relation to sponsor competence – May 2014
Following various consultations last year by the FCA regarding the IPO process, a review was issued regarding sponsor competence. We responded to this report as sponsors are considered to be one of the important entities acting as ‘gatekeepers’ to the market. We highlighted a number of key issues for consideration, including better disclosure and transparency on fees paid, track record of listings, management of conflicts of interest and aligning incentives with IPO performance.

FSA Japan Stewardship Code – February 2014
We submitted our views on the newly formed Stewardship Code in Japan in January. We welcomed FSA’s progressive stance in adopting many of the principles practised by other developed markets. The draft firmly outlined the responsibility of investors to monitor investee companies, engage in constructive dialogue with them and use votes to exercise shareholder rights meaningfully, while committing to the end beneficiaries to disclose their activities. In addition, we pushed very strongly for the addition of collaborative actions amongst investors to enhance dialogue with and send coherent messages to companies, which got included in the final draft as an additional explanatory point. We became a signatory to the Japanese Stewardship Code as it came into force in May.

FRC Risk Management, Internal Control and Going Concern Basis of Accounting – January 2014
As an investor, we provided a response to the FRC, highlighting issues with the revised proposals on ‘going concern’. We felt the focus on principal solvency and liquidity risks were too narrow as we believe that a framework which encourages appropriate corporate behaviour would be more effective. This included supporting better risk decision making, ensuring all stakeholders are well protected from those risks and sustaining an environment in which directors recognise, acknowledge and respond to economic and financial distress sooner rather than later. Furthermore, we requested that an explicit statement about the use of ‘going concern’ by directors is made.
Executive pay

Last year marked the first year that shareholders in the UK were given a binding vote on executive remuneration policy. This posed challenges for companies and their shareholders.

In general, companies complied with the requirements of the regulations and the guidance issued by the GC100 and Investor Group. Although the policies were long, they were transparent and informative. Somewhat counter-intuitively, there was an increase in the number of times LGIM registered a vote against remuneration-related issues in 2014 – rising to 160 from 120 in 2013 – with this due to the additional vote on the policy, rather than a deterioration in executive pay.

Some of the early adopters experienced difficulties by not introducing a cap on recruitment, and by not defining the way in which discretion would be applied. In total, 34 companies had to release a public statement to provide more clarity and we welcomed these increased explanations. During the course of the year, as these shortcomings became known to companies, caps were introduced and more guidance was provided on how and when discretion would be applied.

Areas of concern

In our view, there were two areas of the regulations that were seldom addressed. The first was a lack of explanation on how the performance metrics selected to drive remuneration would also drive their long-term strategy. The other area was the requirement to place a cap on the level of salary increase that would be granted each year. On the latter aspect, many companies chose to state that salaries would increase in line with the general workforce, unless there were changes to the role of the individual. LGIM supported companies in doing so as we did not want companies to set aside a higher number than was necessary to cover all bases, which would then lead to unintended consequences. On recruitment policy, LGIM prefers companies to use exceptional limits under long-term incentive plans (LTIPs) to incentivise appointees. New internal hires that lack the relevant experience should be placed on a lower salary with staged increases agreed subject to good performance both by the individual and the company.

The number of companies that received a negative vote fell from the levels experienced in 2013. Only one company, Kentz Corporation, failed to gain support of shareholders for their remuneration policy. That said, votes against cast by LGIM and other investors resulted in a vote of over 30% against the policies at: Carnival Corporation, Standard Chartered, ICAP and Investec. Only two companies, Kentz Corporation and Burberry Group, failed to gain majority shareholder support for their remuneration reports. Burberry became contentious due to significant one-off awards being granted to its newly recruited CEO.

Clarity remains key

We have been vocal in our dissatisfaction about the use of share-matching plans. Our efforts were successful in that, throughout 2014, we saw a number of companies removing share-matching plans and simplifying their remuneration structures. This shift appears to be continuing into 2015 and we welcome the change.

"Since 2012, LGIM has been asking companies to simplify their remuneration structure to have a salary, bonus and one long-term scheme."

Another area where LGIM has been pushing for change is around the types of performance measures used in long-term incentive arrangements. Companies are encouraged to consider measures that are more closely geared to delivery of the long-term strategy. A study conducted by Deloitte shows that companies are listening in that 75% of the FTSE 100 companies are no longer relying on only earnings per share and total shareholder returns as the basis of rewarding executives for their long-term performance. Some of the measures companies have introduced into their long-term plans include: return on invested capital or return on capital employed, free cashflow, revenue underpinned by a profit target and delivery of other strategic milestones. We welcome this shift and hope that other companies continue to consider the benefits of a more aligned remuneration strategy.

All companies have now sought shareholder support for their remuneration policy which is binding for three years. LGIM does not want to see many companies continuing to amend their remuneration over the next two years. We are closely monitoring this and will consider our voting position if we witness companies changing their remuneration in each of the two subsequent years.
Executive pay

Our remuneration policy hasn’t changed over the course of the last year but is provided below for reference.

**LGIM will oppose the approval of the Remuneration Report where:**

- There is insufficient disclosure regarding key elements of pay
- An incentive plan is in use that we have previously not supported
- Recruitment policy is vague or provides unlimited or substantial headroom over and above existing plans
- Termination policy guarantees payments such as bonus/LTIP without time pro rataing
- Performance targets are undisclosed and all deemed commercially sensitive and without sufficient explanation
- There is insufficient disclosure regarding the use of discretion
- The link between performance measures and strategy is not explained
- Service contracts are for more than one year with no timescale for their reduction
- Shareholding guidelines are not present and/or its calculation is not in line with best practice
- Salary increases are out of line with the general workforce, without a valid reason for the additional uplift
- Bonus is uncapped
- Bonus is paid during a year when the company’s overall performance has been poor
- Disclosure surrounding bonus payments is unclear
- A discretionary bonus is paid for financial transactions (such as a disposal) that we consider an everyday part of the role
- Discretion is exercised to allow a bonus or long-term incentive to vest without sufficient justification
- A new matching plan or other plan previously opposed is in use
- There is inadequate disclosure of long-term incentive plans
- Targets set for incentive arrangements are not sufficiently stretching
- The pension of a retiring director is augmented without justification
- Actual payments made on recruitment/exit are not in line with best practice
- There are retrospective increases in remuneration

We continue to oppose the chair of the remuneration committee where we believe there have been persistent concerns on executive pay policy and where engagement has not provided a solution.
Voting activity

As one of the UK’s largest asset managers, we have a responsibility to exercise client voting rights and influence change efficiently and effectively.

LGIM votes in all developed markets and the main emerging markets. In 2014, we reported on our voting activity in emerging markets, continuing to extend our coverage in this region in 2013.

Voting is a significant part of our daily activity where we exercise the rights of shareholders to hold board members accountable for the successes and failures of their businesses.

Our voting policies can be found at: http://www.lgim.com/uk/en/capabilities/corporate-governance/policies/. Our policies are continually evolving and reviewed regularly to reflect changing corporate landscapes.

Figure 1. Breakdown of equity assets by region.

Voting summary

The table summarises the number of companies we voted at during 2014, broken down by the number of meetings and resolutions by region. Our policy is to minimise abstentions in all regions. In the North American market, the ‘withhold’ vote is used where a company has a plurality vote standard in place and voting is single choice. This typically means that shareholders only have the option to vote ‘for’ a resolution. If we are not in favour of the resolution, this means that an ‘against’ vote is not a valid option and we have to withhold.

*Againist includes abstain/withhold votes – LGIM abstained 136 times in 2014, the majority of which were in North America where the option to vote against a resolution may not be available. Therefore, a withhold voting instruction is placed on the item.
**Voting activity**

The nature of the topics that we voted on in each region is summarised graphically below.

**Total votes cast internationally broken down by topic**

![Graph showing voting activity by region and topic]

**UK VOTING ACTIVITY**

We vote on all UK holdings listed in the FTSE All Share Index as well as some on the AIM Index on an ad hoc basis. We minimise abstentions and in 2014 we did not abstain on any resolution. We have developed our own policy on what we consider to be best practice. Our policy can be found on our website, [http://www.lgim.com/library/capabilities/UK_Corporate_Governance_Policy.pdf](http://www.lgim.com/library/capabilities/UK_Corporate_Governance_Policy.pdf).

We apply this policy when considering how to vote. Where a company’s practices do not meet with our policy, we look to their explanation for any departure. We will also consider previous engagement with the company.

Remuneration continues to be a key area of concern for LGIM in the UK. This includes issues with compensation structures not being aligned with performance or shareholder interests. For a more detailed analysis of remuneration, please refer to page 26. We voted against 164 remuneration-related resolutions in 2014.

The re-election of directors was the second biggest area for negative votes cast during the year. LGIM takes a pragmatic approach when assessing the election of non-executive directors at the AGM. A reason for lodging an adverse vote against a director would be because they are not considered independent and they sit on a key independent board committee. Furthermore, if there are concerns over the performance of the director we may express our views through a vote against.

In line with our voting policy, we opposed the re-election of the chairmen of the remuneration committees where continuous issues on remuneration had not been satisfactorily resolved. Many issues were resolved but where not we voted against nine directors.

Besides independence, we have also been pushing for other issues on the board through engagement. This includes succession planning of management, board refreshment and diversity. We continue to meet with companies given our significant position in the UK and encourage early engagement to discuss governance related matters.

**UK: votes against**

![Pie chart showing percentage of votes against by topic]
A sample of votes in the UK market is described below to demonstrate the nature of some of the issues that we voted on:

### Remuneration

<table>
<thead>
<tr>
<th>Company</th>
<th>Industry</th>
<th>Country</th>
<th>Market Cap (£m)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Standard Chartered</td>
<td>Banks</td>
<td>UK</td>
<td>24.3bn</td>
</tr>
<tr>
<td>Burberry</td>
<td>Luxury goods</td>
<td>UK</td>
<td>8.5bn</td>
</tr>
<tr>
<td>Sky</td>
<td>Media</td>
<td>UK</td>
<td>18bn</td>
</tr>
<tr>
<td>bwin.party digital entertainment</td>
<td>Gaming</td>
<td>UK</td>
<td>660m</td>
</tr>
</tbody>
</table>

Following the regulations that came into force on 1 October 2013, shareholders now have a binding vote on a company’s remuneration policy. Subsequent to several engagements with the company on the matter, we voted against its remuneration policy because overall remuneration is weighted too highly towards short-term performance conditions rather than the long-term. Over 40% of shareholders voted against the resolution, one of the largest votes against a remuneration policy among FTSE 100 companies. Subsequently the company has made amendments to the policy.

LGIM voted against the remuneration policy due to the discretion to make awards to a newly appointed director of up to 12x salary and the annual limit on salary increases being set at 15%. LGIM voted against the remuneration report due to the one-off award granted to the new CEO, which followed a number of previous one-off awards.

LGIM voted against the remuneration report due to the complexity of the LTIP, concerns with the performance measures and the lack of transparency surrounding discretion applied. 11.2% of investors voted against and 19% abstained.

### Board

St. Modwen Properties | Real estate | UK | Market Cap (£m) |
-----------------------|-------------|----|-----------------|

We undertook a collaborative engagement with other shareholders prior to the AGM focusing on performance, strategy and board composition. At the AGM, we voted against the re-election of an NED because he was not independent and was no longer appointed under a relationship agreement as he had been previously. Before the AGM the company announced that the director would step down from the board at the conclusion of the 2014 AGM.

### Accountability

National Express | Transport | UK | Market Cap (£m) |
-----------------|-----------|----|-----------------|

We have been engaging with National Express for the last three years regarding enhancing controls over the management of unions and adherence to internationally recognised labour standards such as ILO. At the AGM, we supported the shareholder resolution to expand the remit of its existing safety and environment committee. We felt that a more formalised approach to managing its human capital at the board committee level would not be detrimental to the operational success of the company. 13% of shareholders supported or abstained on the resolution.

We subsequently engaged with the Chairman on this matter and note that the company has added a non-executive director to the board who has significant experience of working for companies which have a large and international workforce like that at National Express.
**EUROPEAN VOTING ACTIVITY**

We vote in the major developed continental European markets including: Austria, Denmark, Finland, France, Germany, Ireland, Italy, The Netherlands, Portugal, Spain, Sweden and Switzerland.

Proposals on board nominations and remuneration now account for more than 40% of all resolutions voted by shareholders, mainly driven by the impact of regulatory changes. Resolutions on remuneration reached the highest level in 2014, due to the legal developments on the introduction of ‘say on pay’ votes in various countries. This was the first year that ‘say on pay’ proposals were required at most French companies and in nearly 30% of cases, there was a negative vote of over 10% of votes cast on remuneration.

The EU Shareholder Rights Directive, which aims to standardise disclosure, came into effect for all Member States in 2012. There are still some discrepancies between the disclosure practices of Member States due to the Directive’s transposition in national laws, which allows flexibility. The launch of a proposal to revise the Shareholder Rights Directive earlier this year by the European Commission is expected to pave the way for further improvements regarding transparency. We are in collaboration with investors and regulators to make the new revisions as positive as possible.

A major change in France was the adoption of the controversial Florange Act in February. This will allow registered shares held for two years to automatically acquire double-voting rights. Previously, French companies were allowed to grant double-voting rights to registered shareholders after a minimum of two years, only when they had a bylaw provision specifically allowing for it. French companies are able to propose bylaw amendments to remain in line with the one-share, one-vote principle that we advocate, but there were no such proposals in the 2014 voting season. We will consider how we will vote from 2015 at companies who don’t prevent these provisions automatically being put in place. We remain supportive of one share one vote.

The introduction of the Minder Initiative in Switzerland in January meant that certain decision making powers were transferred from the board to shareholders. These include the approval of the remuneration of a company’s board, with a binding ‘say on pay’ vote. Companies are still coming to terms with this change and are keen to engage with us. In Germany, the new gender quota means that, from 2016, around 100 listed companies will need to ensure that at least 30% of their supervisory board positions are filled by women.

In line with our focus on the key European countries in turn, we wrote our first governance and voting policy for Spain, which will be implemented from 2015. We have also been liaising with the Italian asset management association, Assogestioni, to enable us to get involved with proposing board members to Italian companies in the ‘Vota di Lista’ process.

A sample of votes in the European market is described below to demonstrate the nature of some of the issues we voted on.

<table>
<thead>
<tr>
<th>Company</th>
<th>Industry</th>
<th>Country</th>
<th>Mkt. cap: €</th>
<th>Resolution Details</th>
</tr>
</thead>
<tbody>
<tr>
<td>ThyssenKrupp</td>
<td>Industrials</td>
<td>Germany</td>
<td>13.5bn</td>
<td>We voted against the discharge of a former member of the supervisory board, as did 30% of shareholders, due to oversight concerns relating to compliance of the management board and key senior staff.</td>
</tr>
<tr>
<td>Telecom Italia</td>
<td>Telecommunications</td>
<td>Italy</td>
<td>19.9bn</td>
<td>Following the contentious meeting at the end of 2013, this AGM was to elect a new board for a term of three years. Since December 2013 the company has taken effective steps to address the conflict of interest on the board and we decided to support the Findim (one of the largest shareholders in TI) slate of directors at the meeting as we felt that the candidates were the best qualified in terms of knowledge of the telecoms sector.</td>
</tr>
<tr>
<td>EDF</td>
<td>Utilities</td>
<td>France</td>
<td>45.7bn</td>
<td>LGIM voted against four resolutions related to the amendment of company bylaws. In particular, the company had proposed maintaining a mandatory combination of the duties of Chairman and CEO in its bylaws, despite the new French legislative framework providing for the possibility to separate the roles. We also voted against the election of all the nominated directors as the proposed duration is in excess of recommended guidelines, and only 17% of the board is independent.</td>
</tr>
</tbody>
</table>

LGIM, Source: LGIM
Our engagement with US companies continued to increase in 2014. We held 94 company meetings during the year versus 59 in 2013. Alongside this, our access to board members also increased. We always encourage companies to include board members in our discussions and sentiment here is shifting in part due to the SDX Protocol, a set of guidelines which provide a framework for shareholder-director engagements. Our conversations again covered many different ESG topics, with remuneration, board tenure, effectiveness and diversity, cyber security, supply chain management and climate change the most frequent.

The 2014 season was also accented by several contested meetings, although activity here slowed as engagements resulted in settlements. Campaigns to vote against directors were not as high profile this year and the main drivers for votes against incumbent directors were a failure to address mandates related to past majority votes of shareholder proposals and directors taking actions without shareholder approval. Company requests to engage with shareholders on remuneration increased this year. Those companies that suffered in 2013 and incorporated shareholder feedback into their pay programme gained more support this year.

There was also considerable action from activist funds with some notable campaigns being Darden Restaurants, Apple, Cliffs Natural Resources, and Allergan. The size of the targets were larger this year compared with last and dissident directors enjoyed some success in gaining seats on the boards of target companies.

Remuneration continued to be a key engagement and voting topic this year, and pay for performance issues remained the principal driver of shareholder opposition to pay programmes. Shareholders’ most common concerns were the granting of only time-based equity, insufficiently challenging performance conditions, and awarding discretionary one-time payments. We consistently give companies feedback on these issues as well as helping them to improve the disclosures made in their proxy statements. Disclosure plays an important role in earning shareholder support for 'say on pay' proposals. We also engaged heavily on board tenure and succession planning as well as board evaluation processes, which all feed into board effectiveness, a key component in the successful management of a business.

Environmental and social issues were the focus of shareholder proposals during the year. There was a significant increase in resolutions asking companies to be more proactive on combating climate change. This increase was mainly driven by stranded assets campaigns prompted by reports that suggest fossil fuel companies will be unable to burn their reserves if climate temperature increases are to be limited to less than 2°C. Sustainability reporting and human rights issues also featured, especially in terms of companies’ supply chains.

Again, proposals addressing corporate political spending and lobbying activities were frequent, with calls for enhanced transparency and disclosure of such activities. It seems that this issue will continue to be on the agenda going forward and some proposals are becoming more complex where they are asking for more specific disclosure of public policy positions and lobbying at companies in certain sectors. We will continue to discuss this issue with companies and to encourage improvement in disclosure so that shareholders can understand a company’s public policy position and how this may affect its business and our investment.

Of the governance-related shareholder proposals, the most prevalent were board-related proposals calling for board decategorization, majority voting for director election, independent chairs and proxy access (the ability for shareholders to place their nominees for directors on a company’s proxy card). Shareholder support for these was similar to last year but proxy access gained a jump in support and one management proposal by a company to allow proxy access even passed, gaining nearly 70% support. We don’t expect this trend of proxy access to slow in 2015.

The 2014 season was also accented by several contested meetings, although activity here slowed as engagements resulted in settlements. Campaigns to vote against directors were not as high profile this year and the main drivers for votes against incumbent directors were a failure to address mandates related to past majority votes of shareholder proposals and directors taking actions without shareholder approval. Company requests to engage with shareholders on remuneration increased this year. Those companies that suffered in 2013 and incorporated shareholder feedback into their pay programme gained more support this year.
The table below demonstrates how we voted For and Against shareholder proposals:

<table>
<thead>
<tr>
<th>Proposal Type</th>
<th>Against</th>
<th>For</th>
</tr>
</thead>
<tbody>
<tr>
<td>SH-Soc./Human Rights</td>
<td></td>
<td>10%</td>
</tr>
<tr>
<td>SH-Routine/Business</td>
<td>20%</td>
<td>80%</td>
</tr>
<tr>
<td>SH-Other/misc.</td>
<td>30%</td>
<td>70%</td>
</tr>
<tr>
<td>SH-Health/Environ.</td>
<td>40%</td>
<td>60%</td>
</tr>
<tr>
<td>SH-Gen Econ Issues</td>
<td>50%</td>
<td>50%</td>
</tr>
<tr>
<td>SH-Dirs’ Related</td>
<td>60%</td>
<td>40%</td>
</tr>
<tr>
<td>SH-Corp Governance</td>
<td>70%</td>
<td>30%</td>
</tr>
<tr>
<td>SH-Remuneration</td>
<td>80%</td>
<td>20%</td>
</tr>
</tbody>
</table>

Source: LGIM

As we go into 2015, we see many of the issues mentioned above, such as proxy access, cyber security, climate change and board tenure of directors to be of continuing focus.

A sample of votes in the North American market is described below to demonstrate the nature of some of the issues we voted on.

Yahoo Technology US Mkt. cap: $41.3bn
We voted against the company’s remuneration report due to the recruitment policy in place as this is not in line with best practice. It includes short vesting periods of awards which calls into question the retention element of these contracts, especially in light of the company’s continued efforts to attract senior candidates from other companies. Subsequent to the AGM, we participated in a collaborative call with the Chairman where we discussed talent management, the management team and remuneration issues.

Cliffs Natural Resources Mining US Mkt. cap: $1bn
Casablanca Capital, an activist investor, proposed to replace the entire board at Cliffs due to the company losing focus on its core business, with the result being a drop in share price recently. We spoke to both Cliffs and Casablanca and decided to support Casablanca as we felt the company was undervalued and needed a clearer strategy to focus on its core strengths, which the new board proposed. The whole Casablanca slate was approved by shareholders at the meeting. The new management team is taking proactive steps to maximise value, in the midst of tough iron ore pricing.

Darden Restaurants Leisure US Mkt. cap: $8bn
Starboard Value, an activist investor, proposed to replace the entire Darden board due to poor strategy at the company. We engaged with both Darden and Starboard to discuss the proposed board changes and decided to support the new board proposed by Starboard as we felt that this new leadership would establish a better strategy at the company and improve company value over the long term. The proposed board members won all 12 board seats at the AGM. Since the new board was installed, shares have risen over 30%.

News Corp Media US Mkt. cap: $10bn
We continue to be concerned with the board structure at the company and the protection for minority shareholders as there is a dual class share structure. LGIM voted against all directors due to a poison pill being put in place without shareholder approval. Given the voting power is already concentrated with Rupert Murdoch and his family, this continues to block outsiders who wish to increase their voting rights and have a greater say in the company’s governance structure. At the meeting, directors received between 63% and 73% support from shareholders. We also voted in favour of the elimination of the company’s dual class capital structure, which received 47% support from shareholders.
JAPANESE VOTING ACTIVITY

Japan continued to show remarkable progress, both at a corporate and a regulatory level during 2014. The highlight was the introduction of the Stewardship Code in May which 160 domestic and global investors signed up to. LGIM not only contributed to the contents of the Code, but signed up to its principles at inception.

In March, we were asked to speak at the ICGN (International Corporate Governance Network) conference in Tokyo, in addition to locally organised seminars to directly appeal to corporates wanting to hear the views of foreign investors on Japanese corporate governance expectations. LGIM presented our position to over 100 corporate representatives at various events, receiving a positive response and noticing encouraging steps to address corporate governance reforms in Japan.

We have been in discussion with a number of global investors about our expectations on governance reform in Japan and our voting policy changes. In May, we came together as 20 global investors, from USA, Canada, The Netherlands, UK, Sweden and Switzerland, with joint assets of US$4.6trillion assets, to write to Japanese companies. In our letters, we reinforced the value of strong governance, the need for robust independent oversight and our commitment to vote against companies for not having the board consistent of independent directors by 2017. We also wrote to the Prime Minister, FSA (Financial Services Authority) and TSE (Tokyo Stock Exchange) to reiterate our message and ask for the establishment of a corporate governance code.

After the peak of voting season in June, investors were presented with the introduction of a great number of new outside directors. The chart shows the increase of outside directors on Japanese boards of FTSE Japan Index constituents from 2010, when we started to vote in this market, as well as the change from last year. The number of companies with zero outside directors has fallen from 182 to 46 between 2010 and 2014.

The political momentum of Abenomics was also re-energised by the re-election of Prime Minister Abe. The appetite for changing and improving the corporate governance framework led the FSA and TSE to set up a committee to develop a Corporate Governance Code. We were very supportive, having pushed for such a code for a number of years. The Code will be finalised and incorporated into the listing rules by June 2015.

We continued to lead the joint investor push to companies with individual and collective engagements to make sure our messages are received and voting policy change impacts are understood. Additionally, we wrote to the FSA, TSE and the Ministry of Finance to ask that the process to establish the Code incorporates the view of foreign investors. We also submitted our views on how the timings of companies’ general meetings should be more spread out to allow for meaningful dialogue between companies and investors to the METI (Ministry of Economy, Trade and Industry).
We are pleased by the positive changes taking place in Japan. While challenges remain, we are still optimistic for further progress and continue to participate in important market discussions.

**Japan: votes against**

<table>
<thead>
<tr>
<th>Company</th>
<th>Industry</th>
<th>Country</th>
<th>Market cap</th>
<th>Vote</th>
</tr>
</thead>
<tbody>
<tr>
<td>Nippon Steel &amp; Sumimoto Metal Corporation</td>
<td>Metals &amp; Mining</td>
<td>Japan</td>
<td>¥2.7tn</td>
<td>5,671 votes</td>
</tr>
<tr>
<td>Kintetsu Corp</td>
<td>Travel &amp; Leisure</td>
<td>Japan</td>
<td>¥797bn</td>
<td>75%</td>
</tr>
</tbody>
</table>

A sample of votes in the Japanese market is shown below to demonstrate the nature of some of the issues that we voted on:

We voted against the re-election of the president of Nippon Steel & Sumimoto Metal, as the company has consistently failed to put its poison pill renewal to a shareholder vote. Even though the majority of Japanese companies with non-approved pills have either decided to put them to a vote, or abolish them altogether, the company has never sought shareholder approval for its unilaterally adopted poison pill since 2006. Our concerns were further exacerbated by the lack of board independence, as only one of the 14 directors is independent, whereby the poison pill could be used to entrench management to the detriment of minority shareholders.

The company proposed at the AGM in June to increase its authorised share capital by 25%, in order to have the capacity to issue enough shares through its poison pill plan to discourage a hostile takeover. Although Kintetsu received shareholder approval to renew its takeover defence plan in 2013, we opposed the increase in authorised share capital, as the board of directors is not majority independent and hence is not in a position to ensure that the poison pill would be used to enhance shareholder value and not merely to entrench itself. Moreover, as minority shareholders we were worried about the significant dilutive impact that the increase in authorised share capital entailed.
Voting activity

ASIA PACIFIC VOTING ACTIVITY

Our voting coverage in the Asia-Pacific region spans Australia, Hong Kong, Korea, New Zealand and Singapore.

Hong Kong
Numerous corruption incidents have plagued companies listed in Hong Kong in recent years. As a result, the New Companies Ordinance was ratified and came into effect in March 2014, with the objective of increasing transparency and enhancing corporate governance. According to the new law, board directors of Hong Kong listed companies have to declare any transaction which is of significance to the company’s business and in which directors have material interests. Moreover, directors are not allowed to receive loans from individuals that have business connections with them.

Other provisions include the abolition of par value of shares, whereby companies are no longer able to set a nominal value for shares issued, and the reduction of the threshold for demanding a poll, so that shareholders holding at least 5%, instead of 10%, of the total voting rights can demand a poll.

South Korea
In 2014, the concentration of AGMs at Korean listed companies further increased, with nearly 97% of meetings taking place in March and 80% of meetings held over just three days. This, combined with the fact that the deadline for filing proxy materials in Korea is only two weeks before the AGM, does not provide shareholders with sufficient time to make an informed decision. Shareholders have voiced their concerns on this issue, which resulted in an increasing number of large-cap companies, including Samsung Electronics, releasing their proxy materials one month before the AGM.

Historically, Korea has been criticised for the leniency afforded to large, family-controlled conglomerates, the so-called “chaebol”, that committed corporate crime. However, in 2014 the heads of two chaebol groups were each sentenced to four years in prison for misappropriating large amounts of corporate funds and tax evasion. These recent events may symbolise the end of past practices and the shift towards a more transparent market environment.

Australia
The excessively long tenure of independent directors has been a main issue in Australia. In 2014, however, an increased number of directors classified by companies as independent received high percentages of against votes because of their long tenure on the board. This trend followed the publication of the ASX Corporate Governance Recommendations and Guidelines, which outlined factors relevant to assessing the independence of a director. According to the new guidelines, a company should regularly assess whether a director has become too close to management after serving for more than ten years on the same board, thereby compromising their independence.

Asia Pacific: votes against

- Capital structure
- Directors Related
- Remuneration
- Reorg. and Mergers
- Routine/Business
- SH-Dirs’ Related
- SH-Health/Environ.
- SH-Other/misc.

Source: LGIM
A sample of votes in the Asia-Pacific market is described below to demonstrate the nature of some of the issues that we voted on.

**Australia**

**Harvey Norman Holdings Ltd.** Retail Australia

We did not support the remuneration report, which granted the CEO and wife of the founder of the company an increase in fixed pay of 44.4% compared to the previous fiscal year without adequate explanation to shareholders. Moreover, the amount of fixed pay exceeded considerably the median fixed pay for CEOs of Australian listed entities of similar size and the new LTIP was not structured in line with market practice.

**Newcrest Mining Ltd.** Mining Australia

We opposed the re-election of nominee Richard Knight, as he was a member of the audit and risk committee during the period in which Newcrest Mining was found guilty of having breached its continuous disclosure obligations, as confirmed by the company’s financial settlement, which amounted to US$1.2 million, with the Australian Securities and Investments Commission. Moreover, we did not support the remuneration report, which included an excessive fixed pay package for the newly appointed CEO compared to his predecessor and the company’s peers.

**Hong Kong**

**Zhuzhou CSR Times Electric** Industrials Hong Kong

At the EGM, we voted against the provision by Zhuzhou CSR Times Electric of an entrusted loan of RMB1 billion to CSR Zhuzhou, the controlling shareholder of the company, which had already borrowed RMB500 million from Zhuzhou CSR Times Electric shortly before. Both entrusted loans, totalling RMB1.5 billion, had an interest rate 10% lower than the benchmark lending rate and represented almost the entirety of the proceeds raised by Zhuzhou CSR Times Electric through a dilutive private placement of shares at a discount of 8.76% to the market price. We believe that the company, with the provision of entrusted loans, was not only exposing shareholders’ capital to the credit risk of its parent company, but also engaged in transactions that benefited the controlling shareholder at the expense of minority shareholders. Similar related party transactions are very common in Hong Kong. Therefore, we will continue monitoring such issues closely.

**South Korea**

**SK Holdings** Oil & Gas Korea

One month before the AGM at the end of March, the Chairman and co-CEO of SK Holdings, Chey Tae-Won was sentenced to four years in prison for misappropriating KRW43.9 billion of corporate funds from the company and its subsidiaries. Although Chey Tae-Won stepped down from the board of SK Holdings immediately after the sentence on 27 February and is no longer eligible to receive compensation from the company, SK Holdings failed to adjust the remuneration limit which currently stands at KRW12 billion for one executive and three independent directors, significantly above the company’s peers. Hence, we opposed the total remuneration of board directors.
EMERGING MARKETS VOTING ACTIVITY

We voted in the main emerging markets, including China, Brazil, India, Indonesia, Malaysia, Mexico, Russia, South Africa and Taiwan.

In September 2013, we submitted a letter to the Indonesian Financial Authority (OJK) suggesting a number of improvements to the proxy voting framework in order to make it more investor friendly. The OJK took on board our comments and those of other investors and in February 2014 produced the ‘Indonesia Corporate Governance Roadmap’ towards better governance of issuers and public companies. Subsequent to this, in December 2014 the OJK published a new set of regulations, which included the following improvements in Indonesia’s voting rules:

- Increasing the final AGM notice period from 14 to 21 days
- Private companies now have to disclose the name of directors and commissioners and their biographies
- Ballots are disclosed afterwards if AGM is held in Indonesia
- Proxy material available in English on company website

We welcome these improvements. While they were required under the Corporate Governance Roadmap set out in February 2014, they indicate that the Indonesian government is moving forward on that part of the Roadmap, as promised.

As discussed in the ‘Highlights from 2014’ section, we signed up to the Malaysian Code for Institutional Investors. The application of the code by institutional investors such as LGIM will create stronger pressure for companies to raise their corporate governance standards.

In Brazil, international shareholders continue to face challenges related to the lack of timeliness of this information, as minority candidates may be presented up to the time of the meeting and cumulative voting requests can take place up to 48 hours prior to the meeting. We are in the process of customising our voting policy in Brazil to address the governance landscape in the country.

Approximately 50% of our votes against were director related, the majority of which were director re-elections. This is a result of independence levels on boards in emerging markets being below best practice. The next highest in terms of opposed votes cast were linked to capital structure, such as resolutions to approve the issuance of equity without pre-emptive rights where our shareholding would suffer significant dilution.

Emerging Markets: votes against

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Emerging Markets: votes against

After engaging with the company, we supported the re-election of a NED with 50% board attendance following assurances regarding future meetings. The NED adds important experience on sustainability and environmental matters, which is a key issue for the company. However, we voted against the approval of the stock options plan grants because the company did not disclose the exercise price or pricing formula at which the options will be issued.

Source: LGIM
CONTACT US

For further information on anything you have read in this report or to provide feedback, please contact us at corporategovernance@lgim.com. Please visit our website www.lgim.com/capabilities/corporate-governance where you will also find more information including frequently asked questions.

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