

F&C

Corporate Governance: Operational Guidelines

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F&C
Investments

Expect excellence

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These guidelines set out F&C Management Ltd's (F&C) expectations of companies for good corporate governance and explain how F&C exercises its votes.¹ They are relevant to all US holdings and are supplemented by global guidelines.² They should be read in conjunction with F&C's "Responsible Ownership" policy,³ which describes F&C's philosophy and general approach to voting and engaging with companies on environmental, social and governance (ESG) issues.

The guidelines are structured as follows:

- Preamble;
- Overview of key principles and approach;
- Role, structure and operation of boards;
- Board committees;
- Reporting;
- Compensation;
- Shareholder rights;
- Corporate social and environmental responsibility; and
- Voting matters.

Preamble

The following outlines F&C's Corporate Governance policies and guides its voting on all stocks. It applies to all F&C retail portfolios, and the resultant voting record is published each month, along with detailed explanations, on F&C's website.⁴

F&C's 'House' voting policies are also applied to F&C's institutional client portfolios. However, each of F&C's institutional clients has

ultimate control over the determination and execution of its voting policy. F&C will recommend a voting stance to its clients on the basis of these policies, but will defer to its clients in individual cases where these may choose to vote otherwise. In cases where an individual client's voting preference is at odds with the F&C recommended position, this will be applied solely to that client's funds, and shall under no circumstances apply to the voting instructions issued on behalf of other F&C client portfolios. Institutional clients receive a full detailed report of their funds' voting record on a quarterly basis, and have the option of publishing it if they wish. F&C's voting and governance policies underpin its engagement with investee clients, and guide its voting at both annual and special meetings.

F&C will apply these guidelines when voting on behalf of clients, unless otherwise instructed⁵

F&C expects to update this document annually, to reflect regulatory changes, evolving market practices and any other relevant developments.

1. Overview of key principles and approach

F&C has a global philosophy and approach to corporate governance and exercising its votes. Its approach is based on the overarching principles of:

- An empowered and effective board and management team;
- Appropriate checks and balances in company management structures;
- Effective systems of internal control and risk management covering all significant issues, including corporate responsibility;
- A commitment to promoting a company culture of transparency and accountability that is grounded in sound business ethics; and
- Compensation policies that reward the creation of long-term shareholder value through the achievement of corporate objectives.

Achieving best practice in corporate governance is a dynamic process between board, management and shareholders. F&C encourages companies to engage in the process of shaping and meeting evolving standards of best practice. While F&C's voting is strongly rooted in a clear set of corporate governance best practice principles, it strives to approach each company's case on its merits and relies on staff expertise, discretion, and dialogue with companies to do so.⁶ For this reason, **F&C encourages companies to contact it with information about particular governance practices, directors and challenges unique to the company.** When F&C does not vote with directors' recommendations, it writes to the company and explains the reasons why.

1. F&C votes on its own equity holdings, as well as on the holdings of third-party clients of F&C reo® (responsible engagement overlay) service.

2. General guidelines covering F&C's global approach are available on the Governance and Sustainable Investment section of the F&C web site <http://www.fandc.com/governance>

3. <http://www.fandc.com/governance>.

4. Ibid.

5. See discussion in Section 8 below on stocklending and client discretion.

6. F&C expects to vote at all company meetings. These votes will usually be by proxy, except where specific circumstances make attendance by a representative of F&C desirable.

2. Role, structure and operation of boards

Introduction

The board is ultimately responsible for the management of the company. This is achieved by delegating authority to executive management, receiving their progress reports, and reviewing their performance. However, certain matters should be reserved for the board: setting and testing strategy proposed by the executive, and succession planning of both the executive and the board as a whole.

The structure, composition and operation of boards will vary from company to company, although in the US most companies have chosen the unitary board supported by an executive management committee. Certain elements of effective boards are universal, and these are detailed below under the sub-headings:

- Roles and independence;
- Competence, objectivity and renewal;
- Effective functioning of boards; and
- Accountability to shareholders.

Other factors will vary depending on the nature of the company's business, its country of domicile, its size and complexity, its stage of development, its ownership structure, the goals of the board and the skills of the individual directors. Wherever possible, F&C will strive to reflect in its voting the individual circumstances facing each company, based on its understanding of how they may affect its long-term profitability. F&C welcomes and encourages the initiative from companies to draw its attention to specific areas where departures from F&C's standard policies are justified.

Roles and independence

Board composition and balance

The quality of the board is of the utmost importance. A board should have a majority of independent directors, but include meaningful representation of executives to ensure genuine debate. A board that is almost entirely composed of independent non-executives is not optimal because it may lead to marginalization of the board. Generally, non-executive directors should be wholly independent of the company, although in certain cases affiliated non-executives can play a valuable role.

The role of the chairman and separation of principal roles

It is best practice for different individuals to serve in the roles of chairman⁷ and chief executive officer (CEO). Ideally, these should be unconnected parties, (See "Independence of non-executive directors" below) and the chairman should not be the retired CEO or company founder. It is the CEO's responsibility to develop and implement strategy and to oversee the day-to-day working of the company. The chairman is responsible for leveraging the many talents of the board to evaluate management strategy and to review company progress in achieving the strategy. It is impossible for a chairman who is also the CEO to act independently in the interests of shareholders. F&C believes that a strong, well-functioning leadership team that splits the role of chairman and CEO produces more thoughtful, creative decisions than one individual with

excessive authority. If the roles are combined (e.g. over an unexpected transitional period), this should be explained in the proxy. F&C appreciates that this departs from commonly accepted practice in the US but believes that growing debate signals a shift in prevailing opinion.

The chairman

Where the roles of CEO and chairman have been split, the chairman should be independent at the time of appointment. The chairman sets the agenda of the board in consultation with the corporate secretary, the executives and the directors. He is also responsible for the development of the board as a whole and for leveraging the talents of individual board members for the benefit of the company. The chairman should play a leading role in the appointment, evaluation and removal of the CEO, but in cases where the chairman is also the CEO, this responsibility should pass to the entire board, under the guidance of a lead independent director.

Lead director

In cases where the CEO is also the chairman, companies should appoint a lead independent director to help establish balance. An independent lead director chairs non-executive sessions of the board, guides agenda development, may lead the board evaluation process and serves as a primary point of contact for shareholders when other channels have been exhausted. F&C rejects the argument that a lead director permits a lack of accountability among independent directors or creates inequality within the board.

Independence of non-executive directors

Independence of individual directors is valued, but a strong, well-balanced board is valued above all. F&C will support non-independent, non-executive directors where particular circumstances justify their presence on the board. F&C's criteria for the independence of directors encompass and, in places, exceed those of the New York Stock Exchange and NASDAQ, and draw on a variety of standards including other national corporate governance codes and listing rules, and guidance from the Council of Institutional Investors and the International Corporate Governance Network, among others. However, F&C's approach is principles-based rather than absolutist, as it seeks to ensure that directors are able to act as independently as possible in the interests of shareholders. Companies may wish to use reports from the board evaluation process to justify the independence of some directors or provide a much fuller discussion of individuals' independence in proxy statements.

For US public companies, independent non-executive directors should:

- Not be former executives of the company. F&C generally rejects the idea of a "cooling off" period for former executives. In the case of individuals who were employed in a junior capacity, a hiatus may be appropriate;
- Not have close family ties with the company's advisors, directors or senior employees;
- Not have served on the board for more than 12 years, as they

⁷ F&C recognizes the widespread use in the US of alternative terms to describe the role of chairman, including "chairwoman", "chairperson" and "chair". For simplicity, F&C uses the terms "chairman" and "he", "his" and "him" irrespective of the gender of the individual occupying that post.



may lose their independent perspective;

- Not hold cross-directorships or have significant links with other directors (See “Interlocking boards” below);
- Not be major shareholders or representatives of any special interest group, including government representatives in cases of state ownership or representatives of affiliated companies. For directors of US companies who have been appointed as a result of an equity stake taken by the US government, F&C will review the independence characteristics of such directors on a case-by-case basis;
- Have no significant commercial involvement with the company as professional advisers, major suppliers or customers;
- Not be entitled to performance-triggered pay or pensions. (See “Director Compensation” on page 11);
- Not normally hold other directorships in companies in a closely related industry; an
- Not be a close associate of any executives.

Interlocking boards

F&C seeks to ensure that directors are not only independent from the company, but also from their fellow directors. F&C seeks explanation regarding the independence of directors who jointly serve on two or more boards together⁸

Other associations that might impact independence

The nominating committee should also evaluate the impact that other relationships between directors might have on independence. For instance, relationships through academic institutions, charities, or social clubs could impact independence and should be reviewed during the director evaluation process, fully explained in proxy materials and actively managed to minimize conflicts of interest.

Extensive board service and independence

Prolonged membership on a board jeopardizes independence as directors may become close with management and overly invested in prior strategic decisions. After 12 years, directors should not be considered fully independent and should not serve on the audit, compensation or nominating committees. If a board values such a director's experienced perspective, he should be considered an affiliated director.

Effective boards rely on directors with fresh perspectives on the company's operations. Boards frequently overstate the special contributions made by directors with long tenure. Boards should strive to have a substantial majority of directors, at least two-thirds, with less than 12 years' experience on a particular board.

Proportion of non-executive directors on the board

Strong decisions arise from open and direct interplay between boards and company executives. It is important to have enough independent non-executive directors for an adequate diversity of views and to fulfill committee memberships. However, while F&C expects all large companies to have a majority of independent directors, the board should also include other executive directors in addition to the CEO. F&C's voting reflects its belief that a balance of

executives and non-executives on the board is more important than a fixed proportion of executive to non-executive directors. Boards that lack executive membership should use the board evaluation report to describe how the board achieves meaningful interaction between its directors and company executives.

Competence, objectivity and renewal Competencies and perspectives

A relevant and suitably diverse mix of skills and perspectives is critical to the quality of the board and the strategic direction of the company. Companies should strive to widen the pool of potential candidates to ensure that they draw on the richest possible combination of competencies and outlooks. The use of specialist recruitment consultants and other appropriate sources should be considered.

In all cases, candidates must be selected for their ability to enhance company performance, and boards should recruit members with the best possible combination of competencies and experience. Boards should affirm the value of individual diversity including diversity of gender, ethnic origin, nationality, professional background and many other factors that may enhance the board's overall performance. While boards cannot be transformed overnight, F&C looks for an equal opportunities policy or diversity statement, and seeks evidence that the basic principles of openness and effectiveness are achieved.

Annual election of directors

All board members should stand for re-election annually, as this provides greater accountability to shareholders. F&C rejects the argument that electing directors for multi-year terms guarantees continuity in company strategy. Rather, it believes that shareholders should have an annual opportunity to communicate concerns about the record of individual directors, or about committee and board decisions. This is particularly important in the US where shareholders are not allowed to introduce shareholder proposals that invite judgment on a particular director's competence. Further, classified boards also serve as a takeover defense, which F&C opposes (see “Shareholder rights” on page 15).

8. Such interlocking relationships can raise concerns when there is an imbalance of power between the two directors. The most common situation is when one of the individuals is an executive on the first board, and, therefore, is evaluated and compensated by his fellow director. Therefore, on the second board where he is expected to serve as an independent non-executive, his independence may be compromised.

Electing directors by majority vote

F&C considers it essential for the credibility and effectiveness of the election process that all directors be elected by a majority of voting shareholders. F&C strongly condemns plurality voting. As US boards never run more candidates than seats, and as shareholders cannot nominate their own candidates directly, plurality voting undermines the credibility of the director election process. Board policies that require a director who does not receive majority support to submit his resignation to the board for a final decision are a step in the right direction. However, F&C prefers strongly a binding standard, where the shareholder vote determines board composition.

Retiring directors and CEOs

F&C would not expect a retiring executive director retain a seat on the board as a non-executive director, except in highly unusual circumstances. Particular scrutiny would apply in the case of retiring CEOs if nominated for chairman. Although it is common US practice for a retiring CEO to assume the role of chairman, he cannot be considered independent. F&C recommends that a chairman should be fully independent (see “The role of the Chairman” on page 2).

Compromised credibility

In extreme circumstances where boards have neglected to provide appropriate oversight and failed in their duty to shareholders, F&C will consider some or all of the individuals associated with such incidents as problematic candidates for subsequent board appointments, and add them to a list of directors whose candidacy F&C will not support at other companies.

Effective functioning of boards

Board size

The board must be large enough for meaningful debate but not unwieldy. F&C would expect between five and 15 directors, depending on the company.

Board evaluation

Evaluation is an important tool for improving board performance. All boards should implement an evaluation process that considers the effectiveness of the entire board, the contributions made by each member, its systems for interacting with company executives beyond the CEO in a meaningful fashion and any areas for improvement. The nominating committee, independent chairman or lead director may oversee the evaluation process. General findings and areas for improvement should be reported publicly to shareholders. All companies should consider utilizing professional assistance to facilitate evaluations on a periodic basis, and for large companies this is essential.

Training

Newly appointed directors should receive appropriate training, and all members should receive additional training regularly. Training needs should be systematically identified through the board evaluation process. Comprehensive training should include non-traditional financial risks to the business, such as risks arising from brand, employees, health and safety, environmental performance, product safety, and supply chain management among others.

Board meetings

Boards must meet regularly in order to manage the company properly. F&C considers six meetings per year as a minimum, and more frequent meetings are often necessary. Attendance at board, committee and annual meetings is crucial for making valuable contributions to the board and fulfilling fiduciary duty. Attendance should be publicly reported. Board policies should require director attendance at the annual shareholder meeting.

Meetings of non-executive directors

Non-executive directors should meet alone (i.e. in executive session) on a regular basis, and when circumstances demand. They should also have at least one strategy meeting per year to have an unconstrained discussion away from day-to-day business matters. Such executive sessions will be more effective if chaired by either the lead independent director or an independent chairman, rather than by rotating through committee chairmen.

Non-executive directors and other board commitments

Directors must have sufficient time and energy to discharge the role properly, particularly during business situations requiring exceptional investments of time. Factors that determine the appropriate number of directorships include the size of the company, its complexity, its circumstances, a director's other commitments and the results of board evaluations. F&C considers that holding more than four directorships in large companies is likely to be excessive, even for a full-time non-executive director, especially if serving on board committees. A reasonable number would be lower for a full-time executive. Nominating committees should consider the time required for other demanding leadership roles such as the boards of private companies, large charitable organizations, etc.

Director liability and indemnification

In light of the growing litigation risk that may deter excellent candidates from serving on boards, F&C supports adequate indemnification. However, we do not support limiting directors' liability for fraud, other wanton or willful misconduct, illegal acts or gross negligence.



Accountability to shareholders

US directors can be somewhat isolated from the shareholders they represent, as measured by the availability of independent directors, overall responsiveness to inquiries and regularity of direct consultations. Directors should ensure greater opportunities for

dialogue with shareholders on substantive matters and consult institutional shareholders prior to seeking approval for potentially contentious resolutions at the annual meeting. Regular and open consultation builds understanding between management and shareholders and helps resolve issues more directly.

Voting on board structure and composition

F&C normally supports directors' recommendations for board membership. In the absence of persuasive explanations in the proxy or direct contact from the company, factors that might lead F&C to withhold support from directors include:

- Concerns about overall business performance and strategy.
- A lack of a majority of independent directors.
- Non-independent or affiliated directors serving on the audit, compensation or nominating committees. This also includes directors who may be independent from the company but not from other directors due to problematic interlocks.
- A significant number of directors with more than 12 years' tenure who sit on key committees. This relates to F&C's concern that the independence of non-executive directors can be impacted by long tenure on the board.
- A director that attended fewer than 75% of board and committee meetings.
- A director that sits on the boards of more than four large companies.
- Concerns about specific committee decisions (e.g. problems with the auditor or compensation packages that are not aligned with company performance).
- Concerns about an individual director's performance or competence.
- Board membership at other problem companies.

In instances where the board has failed to respond to shareholder concerns, F&C may escalate its opposition by withholding its support from an entire slate of directors. Failure to act upon a majority vote in favor of a shareholder proposal for

better corporate governance or disclosure would lead F&C to withhold support from the entire board, or, at the very least, members of the relevant committee.

F&C will support shareholder proposals to:

- Separate the roles of chairman and CEO or appoint an independent chairman.
- Declassify the board.
- Elect directors by a binding majority, rather than plurality or "director resignation" voting.
- Amend by-laws so that significant shareholders may nominate directors directly to the ballot.

F&C will vote in favor of board diversity proposals if these address a failure by nominating committees to establish appropriate policies and/or build boards with adequate, market-appropriate diversity of experiences and perspectives, including global perspectives.

F&C supports proposals to limit directors' liability for acts excluding gross negligence, fraud or other wanton or willful misconduct or illegal acts, but opposes proposals to indemnify directors for all acts.

F&C will generally oppose shareholder proposals to:

- Require two candidates for each board seat.
- Require a substantial majority of independent directors if the board is composed of a majority of truly independent directors, has fully independent committees and proper executive participation.
- Require full or partial reimbursement for expenses incurred by shareholders in mounting candidates in a contested election.

3. Board committees

Board committees

Independent audit, nominating and compensation committees are essential. Ethics, health and safety, corporate governance, and sustainability or corporate social responsibility committees are recommended. Where large companies have significant exposure to multiple social and environmental risks, such additional committees are very important.

Chairman's role on board committees

A fully independent chairman can be a member of committees. The chairman should not be a member of board committees if he is a current executive, retired executive or company founder.

Nominating committee

A nominating committee should oversee all board and senior executive appointments to the board. Its goal is to ensure well-balanced, effective and strategic leadership for a company. The committee should be composed exclusively of independent non-executives, but draw on executive advice.⁹

Nomination of non-executives and shareholder access to the proxy

Regularly appointing new non-executive directors promotes wider debate within the board. The nominating committee should consider as wide a range of candidates as possible, not just recommendations from connected parties. The committee should consider using recruitment consultants and other appropriate sources, including public advertisement (see "Competence, objectivity & renewal" on page 3).

Shareholders should have a reasonable mechanism for proposing candidates, which should be clearly explained in public materials. Boards should seek ways to communicate outcomes of shareholder nominations. In addition, F&C encourages boards to adopt a process to allow shareholders with a significant ownership stake to propose an independent director directly onto the ballot.

F&C welcomes the growing move to majority voting by many US companies, and strongly encourages all companies to follow suit (see Election of directors by majority vote, on page 4). F&C believes that US companies should define a process that allows shareholders to remove individual directors directly and definitively. This process should include open consultation with leading shareholders in the event of a loss of confidence in an individual board member. F&C strongly prefers to resolve problems related to board composition through dialogue and the use of voting mechanisms, rather than to resort to legal remedies.

Corporate governance committee

At US companies, the nominating committee is often responsible for corporate governance practices and procedures. Regardless of its committee structure, the board should strive to achieve good practice and should consult with institutional shareholders to understand best practice. In particular, the corporate governance committee should ensure that shareholders are able to vote for all

directors annually (see "Annual election of directors" on page 3) as this is a key component of board accountability.

Audit committee

The audit provides an important safeguard for shareholders and for other stakeholders that rely upon the integrity of the accounts and internal controls as a basis for their dealings with the company. Boards should have an entirely independent audit committee, with a minimum of three members. Under no circumstances should an affiliated director serve on the audit committee. At least one committee member should have recent, relevant financial experience, and all audit committee members should be financially literate.

Except in cases where a risk management committee is in place (see below), the audit committee normally should be accountable for ensuring that there are effective financial controls and that risk management levels are appropriate for the business. In addition, the committee evaluates if the accounting practices present the business fairly and accurately, with clear and transparent reports and justifications where difficult judgments are needed.

The audit committee is also typically responsible for anti-bribery and corruption systems and enforcement with related laws such as the Foreign Corrupt Practices Act. Related to this, the committee should ensure that there is an effective mechanism for the confidential reporting of wrongdoing, whether within the company itself or involving other parties, such as suppliers, customers, contractors or business partners. Business ethics control systems should include employee hotlines and other appropriate "whistleblowing" mechanisms, related to financial fraud and any other breach of company policies and ethical codes. The audit committee may serve as the body to receive such reports where no other acceptable body exists.

Systems and reports should be examined by external auditors whose independence is satisfactory to the audit committee, the board and external stakeholders. The audit committee should assure itself that its lead independent auditor is sufficiently independent by rotating the lead auditing partner. F&C recommends that the audit committee meet in executive session on a regular basis with the company's auditors and without company management. This may enable a better flow of information between auditors and the board.

Risk management

The board as a whole is responsible for framing a company's risk tolerance relative to its strategy and operations, and is also responsible for monitoring the company's performance relative to defined risks. Financial, operational and reputational risks that are relevant to the company's business should be included in this oversight, including material environmental, social and ethical risks.

Depending on the size and complexity of the company, a standalone risk management committee might be warranted. F&C does not

9. For a small cap company with a controlling shareholder F&C might support a director affiliated with the major shareholder serving on the nominating committee.



have a specific expectation that a company establish a risk management committee, but does expect that in the absence of such a committee the board can demonstrate that it is alert to, and regularly monitors, company risks on an enterprise-wide basis. A risk management committee is a common feature of large bank boards, but it need not be limited to financial institutions. In some companies risk management is overseen by the audit committee. However, a standalone risk committee may enhance board effectiveness in situations where the audit committee is already stretched. In all cases, risk functions should tie in with compensation functions to ensure that practices are mutually reinforcing. It is a healthy practice for the board as a whole to review the company's risk management as a standing item of regular board meetings.

Compensation committee

Boards should have an entirely independent compensation committee with a minimum of three members.¹⁰ The committee should strive to establish compensation packages that reward strong executive performance that builds shareholder value over time, and design severance packages that do not reward failure. The committee must consult with other board functions to ensure that pay mechanisms are well aligned with strategic goals and the corporation's appetite for risk. Finally, the committee should be attentive to compensation across the corporation to assure itself that management is driving risk and strategy properly and addressing other important issues linked to pay such as discrimination and glass ceilings.

The compensation committee should have the resources and discretion to employ specialist consultants. In addition, the committee should ensure that its consultants are free of potential conflicts of interest, particularly those arise from consulting contracts with the company. As it does with auditor fees, the board should publish the proportion of fees consultants derive from board-related work versus management-related work.

Corporate responsibility, ethics or sustainability committees

F&C believes that a corporate responsibility, ethics or sustainability committee is highly desirable and, essential for large companies exposed to multiple social and environmental risks. Such committees serve as a source of external perspectives on emerging business and societal concerns, and ensure that the company has proper internal controls to identify and manage any risks to the business.

Voting on board committees

F&C will normally withhold support from:

- Non-independent and affiliated directors who serve on the audit, compensation and nominating committees.
- The chairman or members of nominating committees who have not constructed appropriately balanced, independent boards. Indicators include: an over-reliance on long-standing members where one-third of non-executive directors have served for more than 12 years; an over-reliance on affiliated directors; etc.
- The chairman or members of the nominating committee at companies that lack either a lead or presiding director.
- The chairman or members of corporate governance committees who do not provide for the annual election of directors.
- The chairman or members of the audit committee at companies with: persistent, uncorrected material weaknesses in financial controls; evidence of inappropriate risk-taking; highly material re-statements; or that do not put the appointment of the auditor to a shareholder vote.
- The chairman or members of the audit committee at companies who are charged with violations of the Foreign Corrupt Practices Act (FCPA) or other strong indicators that internal controls have broken down.
- The chairman or members of compensation committees who sanction large compensation packages despite poor performance and/or who fail to exercise due caution.

F&C will support:

- Certain affiliated relationships where the director brings particularly desirable expertise or abilities.
- A representative of a controlling shareholder on the nominating committee of a small-cap company.
- A representative of a controlling shareholder on the compensation committee.

10. For a company with a controlling shareholder F&C might support a director affiliated with the major shareholder serving on the compensation committee.

4. Reporting

The regular review of a company's operations is an important link in the chain of accountability. While a company must fulfill its regulatory obligations, its reports should strive to embody the spirit of the law as well as its letter. In all markets, F&C favors reports that are:

- **Comprehensive:** Covering the strategic direction of the business and all material issues, including significant changes in the regulatory context and key environmental, social and governance (ESG) issues;
- **Balanced:** With even-handed treatment of both good and bad developments;
- **Transparent:** With plain English narrative text and accounting notes that provide investors with a full understanding of the circumstances underlying the reported figures;
- **Underpinned by useful metrics:** Disclosing key performance indicators (KPIs) that drive business performance, are comparable over time, and are supported by detailed information on how they are calculated; and
- **Consistent and joined-up:** With other company reporting, including the compensation report and corporate responsibility or sustainability reporting.

Nominating committee report

The committee should report annually on its activity, in particular providing a detailed discussion of its process for identifying and appointing executive and non-executive directors, and the processes that it employs to ensure that members reflect an appropriate diversity of perspectives, experiences and cultural backgrounds. The committee should consider going beyond bare minimum regulatory requirements to provide a full view of a director's experience and qualifications. Where necessary, the report should include a thorough discussion of the board's view of the independence of certain members. The report should also include high-level results of the board evaluation process.

Audit committee report

The committee should report annually on its activity, in particular on specific matters of judgment regarding accounting principles and practices, internal controls and relevant regulatory requirements. It should also comment on its process for ensuring auditor independence and supervising non-audit work.

Qualified audit statement

Any qualification of the audit statement should be fully explained.

System of internal controls and risk management

Either as part of the audit committee report or a standalone report, the company should explain the results of the board's review of internal controls, including any identified or potential weaknesses in internal controls and how the board plans to respond to these.

Compensation committee report

The committee should report annually on its activity. F&C expects disclosure that fulfils the spirit, as well as the letter, of regulations with a meaningful Compensation Disclosure & Analysis (CD&A) that avoids boilerplate language and gives shareholders a clear view of a company's unique compensation philosophy and the varied components of pay. While F&C welcomes rules for enhanced compensation disclosure (i.e. bonuses, base and variable pay, benefits, perquisites, pensions, and severance), it strongly urges the disclosure of specific performance targets that trigger awards, as well as maximum potential payouts, so that investors may judge if they are stretching.

In addition, compensation committees should thoroughly discuss change-of-control and severance provisions under different scenarios, in order to help investors gauge the extent to which compensation policies prevent contracts that reward executive failure.

Reports should name all members of industry or market peer groups against which company and executive performance is judged and discuss the rationale for their composition. US companies competing in global industries should include non-US peers in compensation comparator groups, as talent may be recruited internationally as well as domestically.

F&C also recommends that companies put the CD&A to an annual shareholder vote. F&C's experience of voting on compensation reports in other markets has shown this to be a valuable mechanism that improves dialogue and understanding between the board and shareholders and helps promote pay for performance. An advisory vote provides a clear signal to the compensation committee from investors on the comprehensiveness of the CD&A, the outcomes of the current plan and the structure of future compensation. In addition, direct accountability to the shareholders gives the committee additional authority when negotiating compensation agreements.

Corporate governance code

Boards should clearly state which principles and codes of corporate governance shape their charters and policies. They should discuss how they comply with relevant codes and provide detailed information on any areas where they depart from recommended practice.

Shareholder resolutions

Management should provide a full and reasoned response to all shareholder proposals. Proponents should be clearly identified on the ballot and the materials should be contained in full in the proxy statement.



Auditors

Appointment of auditors

The auditors' performance and appointment should be reviewed regularly. When relying on the same auditing firm for many years, it is important that new staff assume responsibility for the audit. F&C does not regard systematic rotation of audit firms as intrinsically necessary.

F&C expects that shareholders should vote on the appointment of auditors. We reject the argument that Sarbanes-Oxley's provisions that affirm the committee's absolute responsibility for the auditors negate the need for a shareholder vote on the auditors' appointment.

Fees paid to a company's auditors in addition to audit fees

All non-audit consultancy work by auditors should be clearly disclosed. F&C recognizes that a company's auditors may provide valuable expertise and services without compromising independence. The audit committee should assess whether there is a risk that the auditors' impartiality may be jeopardized. Very large non-audit fees, or non-audit fees in excess of audit fees, may be an indicator of risk.

Qualified audit statement

Any qualification of the audit statement requires the fullest explanation.

System of internal controls

In the annual report, the directors should affirm that they have reviewed the company's system of internal controls for all risk factors. The committee should employ a wide definition of risk to include all significant financial and non-financial risks (see "Effective functioning of boards: Training" on page 4).

The audit committee and risk committees should seek ways to communicate implementation and effectiveness of controls, rather than just the existence of such systems. This includes reporting on the effectiveness of the company's whistle-blowing mechanisms, closure of the number of reports made and general follow-up action taken.

Political donations and lobbying

F&C believes that active participation in the process of political dialogue and policy development is an important element of protecting and promoting companies' commercial interests and contributing to the development of an effective regulatory environment. However, F&C considers that donations to political parties or to organizations associated with political parties are inappropriate and should generally be avoided. In the US, where the practice is widespread and deeply rooted, companies should, at a minimum, report annually on donations by providing clear and comprehensive aggregated data that reveal their nature and extent. This should be based on the amounts given at the federal, state and municipal levels to candidates, parties, ballot referenda and politically-related organizations. In addition, if the amounts are substantial, companies should submit their political donations policy or the past year's donations record to an annual shareholder vote.

Companies should also disclose a comprehensive policy statement that addresses all relevant aspects of their direct political involvement, including donations, lobbying and PAC activities, as well as their indirect involvement via trade associations and other organizations active in the political and regulatory process.¹¹

Charitable donations

F&C supports charitable acts at an appropriate level, especially where donations support the company's engagement with its local community. Companies should be mindful of the legal or reputational risk that charitable donations may serve as a conduit for payments intended to obtain or retain business, or exert political influence. Therefore, companies should develop and publish clear guidelines on how recipients of charitable donations are vetted to minimize such risks. While disclosure of significant charitable donations is preferable, F&C does not support disclosure of every charitable contribution across a corporation's global operations.

Corporate responsibility reporting

As part of the system of internal controls, companies should assess their social and environmental impacts and should comment on any that are material. Large companies, and others with significant social and environmental impacts, should produce full reports that include evidence of effective management systems and meaningful data on performance. F&C expects reports to provide historical data on performance as well as forward-looking targets and goals for improvement. A balanced discussion of successes, gaps and challenges is essential for credible reporting.

11. For further details on F&C's policy with regard to political lobbying and donations, click on Public Policy at www.fandc.com/governance.

Voting on reporting and auditing matters

In general, F&C will oppose proposals:

- Asking for the appointment of auditors where non-audit fees exceed audit fees or where total fees paid are excessive.
- For the appointment of the audit committee chairman or members of the audit committee where shareholders are not given the opportunity to vote on the appointment of the auditor.
- For the appointment of the audit committee chairman or members of the audit committee at companies with: persistent, uncorrected material weaknesses in financial controls; evidence of inappropriate risk-taking; or with responsibility for recent, highly material re-statements.

F&C will support resolutions:

- Asking for shareholder approval of auditors' appointment and fees.
- Asking for the systematic rotation of auditing firms if the appointment of the auditors is not subject to annual shareholder approval.

Voting on political and charitable donations matters:

Where there is cause for concern, F&C will support proposals to:

- Improve transparency of companies' and PACs' political donations and lobbying activities. This may include reporting on local, state and municipal contributions to candidates, parties, ballot referenda and politically affiliated organizations.

- Submit political donations and lobbying policy to an annual shareholder vote.

- Improve transparency of the company's process for making charitable donations.

In general F&C will oppose resolutions asking companies to:

- Report on all charitable contributions, regardless of their significance, across global operations.
- Suspend all charitable giving.

F&C will usually abstain on resolutions that ask companies to:

- Eliminate political donations. Although F&C generally believes donations to political candidates and parties should be avoided, it recognizes that this practice is exceptionally widespread in the US, and may be difficult to discontinue without incurring commercial disadvantage.

Voting on internal controls and reporting:

Generally, F&C will support proposals asking for enhanced disclosure of companies' systems for identifying and managing significant financial and non-traditional financial risks.

5. Compensation



Compensation packages should recruit, incentivize and retain staff, and should reflect executives' contributions to the company. F&C believes that the compensation committee must maintain significant flexibility in designing appropriate packages. However, it is important for the committee to provide shareholders with a clear and accurate total picture of compensation goals and outcomes under various business scenarios.

F&C will cast its votes relating to compensation based on both the quality of disclosure and the effectiveness of compensation plans. F&C expects to see fair compensation processes and awards that reward strong performance and deter poor performance. It opposes shareholder proposals that are overly prescriptive because F&C respects compensation committee discretion.

Relationship to strategy and risk

F&C expects companies to demonstrate the alignment of their compensation policy with their overall business strategy and planning. Performance metrics should relate to the company's articulated strategy and risk tolerance. Targets should be constructed to align executive incentives to the interests of long-term shareholders, and should not create incentives for executives to undertake short-term risks that might imperil longer-term performance.

Disclosure

F&C expects to see appropriately detailed disclosure of board and management compensation packages. However, the Compensation Discussion & Analysis (CD&A) should enlighten and enhance understanding; it should not be used simply as a compliance document. Committees should write in plain English, reject boilerplate language and strive for brevity and disclosure of all relevant information. A useful CD&A provides a persuasive narrative about the company's unique compensation and how it is tied to corporate strategy. (See "Compensation committee report" on page 8.)

Director compensation

Notwithstanding the widespread US practice of awarding equity compensation to non-executive directors, F&C favors fixed director fees, and strongly discourages stock options, though it will accept the use of restricted stock. This is because directors should not benefit from temporary fluctuations in share price that may not necessarily reflect the longer-term growth prospects of the business. Where stock options are used, F&C favors long-term holding requirements.

Shareholder vote

An effective board that sets appropriate compensation is a powerful tool to ensure that shareholders' long-term interests are served by management. Therefore, the board should provide shareholders with an opportunity to vote on the CD&A, even if such a vote is advisory. At the very least, boards should communicate and actively consult with shareholders to explain and gather feedback on compensation packages. (See "Compensation committee report" on page 8.)

At companies where US law requires an advisory vote (e.g. TARP

recipients) or where the board has voluntarily introduced it, F&C will evaluate the committee's holistic approach to compensation. This will include assessing the quality of the disclosure around targets and awards, whether recent awards were well aligned with performance outcomes and the compensation committee's approach to future pay. We look for pay plans that are persuasive and fully explain the links between compensation, strategy and risk. Additional elements of good compensation are noted below.

Executive contracts and severance

Contracts should be structured so that executives can be dismissed for poor performance at reasonable expense. Contracts should not exceed 12 months, except in unusual cases, for example where an initial 24-month period is required for recruitment. In such cases, the notice period should decrease each month until a period of no more than 12 months is attained. Before approving employment contracts, the board must actively consider the potential severance package in the event of inadequate performance, and clarify the performance conditions under which such severance benefits are paid. The compensation committee should maintain authority to withhold or reclaim all or part of non-base pay (including cash bonuses, options and stock awards) from executives in cases it deems appropriate.

Holding periods and vesting

Bonus payment and long-term incentive schemes should be structured to reward long-term growth in shareholder value, and be subject to performance-vesting conditions. F&C encourages a portion of the short-term bonus to be satisfied in deferred shares. Longer-term incentive plans should be share-based, and vesting periods should extend from three to five years.

"Clawback" policies

The committee should maintain authority to withhold or reclaim (i.e. "claw back") all or part of performance-based pay from executives in cases where it deems it appropriate. This might occur following a significant restatement of accounts, where previously granted awards were paid on the basis of inaccurate figures or where the long-term outcomes of a specific strategy result in significant value destruction for shareholders.

In particular, where representations that executives made to the audit committee about the integrity of controls have been revealed to be inaccurate, or where executives have failed to exercise due caution in the discharge of their duties, the company should consider seeking the reclamation of performance awards.

Clawback policies may also be supplemented with extended deferral periods for share and bonus plans. The potential liability in a clawback arrangement may be scaled back over time to reflect evidence of sustained performance.

Performance-based pay

Compensation should reward long-term business performance. Plans should strive to balance short-term awards, long-term incentives and base salary. F&C supports extraordinary rewards for

sustained, truly exceptional performance, but is concerned that compensation levels among US companies is increasingly reaching levels that exceed those necessary to attract or retain managers of the required caliber. US compensation practices often suffer from a number of deficiencies, which F&C believes could be effectively addressed through the adoption of the following practices:

Disclose performance targets

F&C favors plans that are clear, simple and transparent, and that are designed to align executives' interest with those of the company. In general, US companies do not provide satisfactory levels of disclosure related to actual performance targets. Laundry lists of possible metrics used in setting performance-based pay provide inadequate information. Rather, F&C expects all awards to be tied to specific performance conditions and for Long-Term Incentive Plans' targets to be made public. F&C is aware that performance conditions for short-term incentive bonus plans may be commercially sensitive and confidential; in such circumstances F&C recommends retrospective disclosure of short-term targets to demonstrate that they are performance-related.

Select appropriate metrics

Committees should select the financial and non-financial (e.g. safety, diversity, etc) metrics that will best reflect the execution of company strategy and the growth of long-term shareholder value. However, committees should avoid reusing the same performance metric (e.g. EPS) for multiple performance hurdles, as this results in double-counting achievements or failures.

Utilize appropriate comparator groups

Performance indicators should measure real growth in shareholder value or strong performance relative to industry competitors or to an appropriate index. Compensation committees should construct reasonable comparator groups that include smaller and larger peers in order to demonstrate above-average performance that then triggers performance-based awards. Companies operating in global sectors should include non-US companies in comparator groups, even if pay is less in these markets. Such companies' performance is highly relevant to peer-group analysis, as international peers provide a reasonable pool of executive talent from which to draw.

Committees overseeing compensation at very large companies should evaluate critically the merits of using cross-sectoral peers in compensation comparator groups, insofar as companies are relatively unlikely to draw their next CEO from an unrelated sector, and the pay of such CEOs is not as relevant as is the pay at smaller firms within the company's sector. Such broad, unrelated comparator groups can distort base pay and incentive awards and needlessly inflate pay levels.

Use restricted stock

F&C prefers that executives be incentivized with restricted stock rather than stock options, the better to align long-term interests.

Limit awards across multiple plans

In the US, it is common practice to have multiple award plans for executives. F&C expects companies to set an overall limit for

maximum individual payouts under all plans, and to report on potential payouts.

Consult shareholders regularly on equity plans

F&C prefers companies return to shareholders regularly for approval of equity plans for employees and considers a time frame of three to five years reasonable.

Avoid unreasonable option discounts

F&C expects options to be issued at the prevailing market price at the time of issue, except under all-employee plans where the discount should not exceed 20%. F&C opposes plans that discount options using the lowest price from the beginning and end of an offering period, as this may substantially enhance the discount if the stock has appreciated.

Prohibit option timing

F&C expects options to be granted at regular, fixed dates at the prevailing market price at the time of grant. F&C opposes seeking past dates that offer the most favorable prices for executives (i.e. back-dating) or timing option grants to coincide with material company announcements (i.e. spring-loading or bullet-dodging). We welcome that the former practice is prohibited under current regulation and urge companies to apply similar prudence with regard to the later practice.

Prohibit re-pricing

Reducing the strike price of options already granted after the stock price has fallen is fundamentally unsound. In very rare cases, there may be circumstances where arrangements can be justified. In such cases companies should reach out to major shareholders and proxy voting advisory firms to explain the rationale for re-pricing.

Avoid accelerated vesting

Accelerated vesting under change-of-control agreements or by board decision fails to reward performance. Rather, equity should be rolled forward into any successor company, or vest in a time-apportioned fashion only to the extent that performance conditions are met.

Avoid other problematic practices

F&C opposes plans that replenish stock options automatically (i.e. reloading), that allow executives to use options to exercise additional options (i.e. pyramiding) or that persist indefinitely, without requiring shareholder renewal (i.e. evergreen plans). Other practices that F&C opposes include: issuing options with strike prices below current market levels (i.e. in-the-money options), making grants prior to the approval of a plan (i.e. gun-jumping grants), extending loans to directors and executives for purchasing options, and creating plans that contain many different plans within one proposal (i.e. omnibus plans).

Share plans

F&C expects companies to issue shares in a reasonable fashion without causing excessive dilution. By way of guidance, F&C would expect no more than an average of 15% of a company's equity to be used within a 10-year period for all plans, with a reasonable



annual run rate (approximately 1.5% or in keeping with peer group practice). No more than 5-10% should be available within a ten-year period for executive schemes and treasury shares should be included within these limits. Good practice is to include all shares used, whether market purchase or newly issued. F&C will deviate from these limits where it is convinced that the commercial drivers outweigh the dilution impacts.¹² In such cases, F&C invites companies to consult it in advance of the annual meeting to explain such unusual circumstances. These limits should include all awards granted even if they are subsequently exercised or cancelled. If a company is insufficiently transparent regarding the details of its plans, F&C may abstain or vote against them.

F&C will consider one-off equity awards on a case-by-case basis in light of justification provided by the company. However, frequent use of exceptional awards raises questions over the adequacy of the overall compensation strategy and effectiveness of succession planning. F&C will take particular care when reviewing equity awards granted for the purposes of retention when such awards are not linked to stretching performance targets. Barring exceptional circumstances, F&C will not support the award of free shares to executives that were overlooked for the position of CEO.

Expensing of stock options and other share-based awards

The value of executive awards should be accurately reflected in the company's accounts. F&C welcomes Financial Accounting Standards Board (FASB) rules requiring all companies to expense options.

Deferred Compensation

F&C recognizes the utility of deferred compensation plans for executives, but opposes overly generous matching grants. Matching grants should be subject to further performance conditions to vest. Where deferred compensation is held in stock, and for matching grants, F&C favors the inclusion of dividends so as to align further executives' interests with shareholders. Recipients of awards should not enter into arrangements that conflict with the principle of alignment with shareholder interests, such as hedging risk.

Golden parachutes

Excessive payments to former executives waste shareholders' money. Severance payments of one time base salary should be sufficient, and shareholders should be asked to vote on all packages in excess of this amount.

Pension benefits and supplemental executive retirement plans

Standard pension plans as well as Supplemental Executive Retirement Plans (SERPs) should be reasonable and in line with company peers. Shareholders should be asked to vote on retirement arrangements that provide pension benefits for senior executives beyond the company's regular tax-qualified plan. F&C prefers companies to seek prior shareholder approval but, at the very least, would expect to see the agreement come to a vote within one year of the executive's employment agreement.

Executive compensation tied to non-financial performance

F&C encourages the inclusion of social, environmental and other non-financial goals in performance payments where these factors benefit the company. Compensation committee reports should disclose such targets and discuss how non-traditional financial goals are established and evaluated.

Employee ownership

Widespread employee ownership can positively contribute to shareholder value as it further aligns employees' interests with shareholders. Such devices should not be instituted as anti-takeover devices. Discounts on employee-wide stock option plans should not exceed 20%, options should be discounted from the prevailing market price on the day of grant, and shares issued should be included within company-wide dilution limits.

Pay ratios

F&C opposes proposals that ask for reporting on the ratio of pay between highest and lowest paid workers, as well as the setting of absolute limits based on such a ratio. However, we may support the use of other types of metrics such as comparing the CEO's pay to the executive level directly below him, as these ratios are designed to encourage effective succession planning and retention of second-tier executives.

Voting on compensation

At companies where US law requires an advisory vote (e.g. TARP recipients) or where the board has voluntarily introduced it, F&C will evaluate the committee's holistic approach to compensation. This will include assessing the quality of the disclosure around targets and awards, whether recent awards were well aligned with performance outcomes and the compensation committee's approach to future pay. We look for pay plans that are persuasive and fully explain the links between compensation, strategy and risk. Additional elements of good compensation are noted below.

Performance conditions: F&C supports resolutions that:

- Enhance the link between pay and performance, by making bonus, stock and option grants conditional upon achieving performance hurdles.
- Ask companies to consider links to non-financial performance factors such as health and safety, diversity, labor standards, human rights, environment, community relations and other relevant business issues as an integral part of an effective performance-based compensation plan.

F&C will oppose the re-election of the chairman of the compensation committee or its members if:

- Executive compensation is not aligned with company performance or is overly weighted to short-term stock price performance rather than the creation of long-term value.
- Executive and/or director compensation, including pension benefits, is dramatically higher than at reasonable peer companies.
- Executives receive substantial guarantees for annual bonuses, stock and option awards or raises rather than variable awards based on company performance.
- One-off equity awards or retention bonuses are too high or not adequately justified.
- Dilution rates are too high and the company has not fully justified them.
- Equity is awarded at an unreasonably rapid pace
- The company lacks a far-reaching clawback policy despite recent material restatements.
- Directors and executives receive loans or unnecessary perquisites.
- Stock options have been re-priced recently.
- The company has been involved in problematic stock option pricing practices such as back-dating, spring-loading or bullet-dodging.
- Disclosure is extremely poor.
- The choice of comparator companies is not adequately justified, and yields compensation levels that raise concerns.

Compensation limits: F&C will generally oppose resolutions that seek to:

- Set absolute limits on executive compensation.
- Abolish share-based compensation devices such as stock options.
- Use inappropriate formulas to set compensation such as the ratio of highest to lowest paid worker.

F&C supports proposals that seek to:

- Replace option plans with ones based on restricted stock.
- Utilize appropriate metrics to measure and compare CEO pay.

Equity incentive plans:

F&C will oppose poorly constructed plans that may include some of the following:

- Executive option plans that F&C judges to be excessive in light of past performance and future expectations, or that fail to provide adequate disclosure of future performance targets.
- Plans for non-executive directors only.
- Evergreen plans.
- In-the-money options.
- Omnibus plans.
- Plans supporting gun-jumping grants.
- Pyramiding.
- Reloading.
- Re-pricing.
- Plans that include loans to exercise options.
- Plans that are likely to lead to excessive dilution or with exceptionally high annual grant rates.
- Plans that allow for accelerated vesting.

ESOPs: F&C will support measures that seek to enhance employee ownership such as the creation of Employee Share Option Plans (ESOP) unless these are primarily instituted to serve as an anti-takeover device.

Severance: F&C will support proposals asking that golden parachutes be put to a shareholder vote.

Shareholder voice: Shareholders rarely have enough opportunity to provide feedback on executive compensation. F&C supports proposals asking that compensation packages, including severance agreements and supplemental executive retirement plans, be put to a shareholder vote. F&C strongly encourages companies to consult their largest shareholders prior to such votes to ensure shareholder support.

Bundled shareholder resolutions: F&C generally opposes bundled resolutions (see "Bundled resolutions" on page 19). However, in exceptional circumstances, F&C may abstain on or support a shareholder resolution on compensation that contains a demand that it does not support if other important requirements are included.



6. Shareholder rights

Liaison with shareholders

Companies should be willing to enter into dialogue with institutional shareholders. They should be proactive in imparting important news, subject to regulatory limits, and should react helpfully to appropriate questions.

Independent directors should be available to meet and speak directly with large or influential shareholders. While corporate staff plays an important role in interfacing with shareholders, directors should demonstrate regular and open contact with company shareholders in order to obtain unfiltered information.

Voting rights

F&C favors a share structure that gives all shares equal voting rights. F&C does not support shares issued with impaired or enhanced voting rights, and it is likely to oppose capital-raising by companies with a structure that involves unequal voting rights. Normally, F&C will support the issuance of stock, such as preferred stock, with impaired voting rights when the stock is effectively a fixed-interest instrument.

Cumulative voting

F&C does not see cumulative voting as a method for protecting minority shareholder rights, but as an approach that may allow damaging influence to special interest groups. Cumulative voting should not form the basis of a systematic policy to redress imbalances in board nomination and election processes. Rather governance should be reformed to protect shareholders' interests. However, F&C may support cumulative voting at controlled companies or companies with substantial government stakes.

Acting by written consent and calling special meetings

Shareholders should have the right to take action by written consent and call special meetings. These allow suitably qualified shareholders to put resolutions to all shareholders, either in a company meeting or by expressing their intentions through the mail, effectively a virtual meeting. All companies should make provisions for shareholders with a minimum of 5% to call special meetings;¹³ as this is a threshold that allows substantial access while preventing abuse.

Mergers and acquisitions, spin-offs and other corporate restructuring

Bids and corporate restructuring help maintain an efficient and competitive environment. However, some bids do not add to shareholder value, so in some contested takeover bids, F&C will seek additional information from management and the bidder. F&C expects boards to conduct thorough due diligence prior to pursuing any merger or acquisition and to seek to maximize shareholder value in any deal. F&C will normally support incumbent management, provided the financial terms, synergistic benefits, and management quality are sound.

F&C considers social and environmental risk implications of any corporate activity as part of its assessment, particularly in high-impact industries. It likewise expects the board to evaluate any potential social, environmental or ethical risks or liabilities of any

business combination. F&C expects companies to take appropriate consultative measures with employees and communities affected by corporate restructuring.

Pension and other similar significant corporate liabilities

Companies should be aware of, and report to shareholders on, significant liabilities such as those arising from unfunded or underfunded pension commitments, or liabilities for medical cover. The extent of the liability should be reported and the principal assumptions used in calculating such amounts should be disclosed. Companies should also detail the plans, if any, that they have to cover the deficit, including a reasonable time scale for action.

Pre-emption

F&C believes that a company's shareholders are best placed to support their company in capital-raising. F&C strongly supports pre-emption rights for existing shareholders.

Offshore re-incorporation

F&C considers that for companies with US headquarters, incorporation in the US is conducive to greater management accountability to shareholders. In general, F&C opposes re-incorporation of US companies in offshore tax havens, and it supports re-incorporation in the US.

Poison pills

Preferential share issues or other plans, such as blank check preferred stock that allow incumbent management to block a bid for the company, are referred to as poison pills. They are generally not in shareholder interests however they can provide protections in certain cases. Companies' best defense against takeover is strong management, a successful strategy and good communication with shareholders. F&C supports proposals that request revoking a poison pill or shareholder approval prior to deployment. At the very least, shareholders should be asked to approve deployment of a poison pill at the annual meeting following a pill's introduction or extension.

Dual or multiple classes of stock

Dual classes of stock are almost always created to act as a poison pill, and as such F&C will oppose them.

Greenmail

F&C strongly believes in equal rights for all shareholders and opposes paying certain shareholders a premium for their stock in order to avoid a takeover.

Opt out of state anti-takeover law

Shareholders should be able to assess each takeover bid on its merits without being subject to any legal limits. F&C believes that good management is the best protection against a hostile bid. F&C will usually support proposals for changes allowing a company to opt out of state anti-takeover laws, and it will oppose proposals requiring companies to opt into state anti-takeover statutes.

13. At small cap companies, F&C might support a higher threshold of 10%.

Increase authorized stock

F&C will support the authorization of stock for issue in line with the anticipated development of the company, and to support reasonable executive share incentive plans. Where a major change of strategy, such as a substantial acquisition for stock, is contemplated, then the company should seek specific authorization. Companies should thoroughly justify requests to increase authorized stock by more than 100%. In general, F&C will oppose authorization of stock to support a poison pill or if less than 50% of existing authorized shares are outstanding and the company has not provided a specific use for the stock, such as a stock split or acquisition.

Charter and bylaws

Amendments to corporate charters or bylaws are considered on a case-by-case basis, and evaluated against shareholder value considerations. Charter and bylaw changes often reflect changes in current practice, or in legal requirements, which F&C will usually support.

Supermajority requirement

Supermajority requirements often serve to frustrate takeovers or protect incumbent management, F&C will oppose them and will vote for their removal.

Tracker stocks

Tracker stocks present challenges to governance: either the activity that is the subject of the stock is completely distinct, in which case it should be de-merged, or it is not, and the creation of the tracker creates potential conflicts of interest. F&C would normally oppose the creation of tracker stocks, but is prepared to consider each case individually.

Voting on shareholder rights

F&C supports:

- A share structure that gives all shares equal voting rights.
- The rights of shareholders to act by written consent and to call special meetings.
- Retention or re-introduction of pre-emption.

F&C will generally oppose:

- Share issuances with impaired or enhanced voting rights.
- The creation of dual classes of stocks.
- Cumulative voting provisions, except in the case of controlled companies or those with substantial government stakes.
- Specific directors who refuse to meet with shareholders directly.
- Capital-raising efforts by companies with a capital structure that involves unequal voting rights, or where the use of additional capital is not specified.
- Excessive capital-raising where the purpose is unknown.
- Stock issuances when less than 50% of authorized shares are outstanding.
- Requests to increase authorized stock by more than 100%.
- The payment of greenmail.
- Re-incorporation in offshore tax havens.

Voting on anti-takeover devices

F&C opposes provisions that provide unwarranted protection to existing boards and management, including:

- Supermajority voting provisions that act as a poison pill.
- Capital issuance authorization for poison pills.
- Opting into anti-takeover laws.
- The introduction of blank check preferred stock.
- Any other device that acts as a poison pill.

F&C will support:

- Proposals requiring shareholder approval of poison pills or shareholder rights plans.
- The elimination or redemption of poison pills.
- Proposals asking companies to allow shareholders to call special meetings or to lower the threshold required for shareholders to call such a meeting.
- Opting out of anti-takeover laws.
- Anti-greenmail provisions.
- Proposals asking companies with US headquarters that are incorporated in offshore tax havens to re-incorporate in the US.

F&C will consider on their merits resolutions that seek:

- Issuance of tracker stock.
- Proposals to amend or change the corporate charter or bylaws.
- Individual mergers and acquisitions.



7. Corporate social and environmental responsibility

Social and environmental factors can present serious risks to corporations and impact the bottom line. A well-run company should have formal systems to identify, assess and manage significant risks including those associated with social and environmental factors. Companies should provide appropriate public disclosure of such factors, and give shareholders a proper accounting of their record in managing them, as well as evidence of strategies and targets to achieve good practice.

The US has an open filing process that results in a wide variety of advisory shareholder proposals, particularly on social and environmental issues. The quality and nature of such proposals varies substantially. In general, F&C evaluates proposals based on the relevance of the issue in general and the desirability of the specific action requested in the “resolved” clause. F&C recognizes that some proposals may identify important company risks even if the proposal is poorly constructed. In such cases, F&C votes to encourage companies to identify, mitigate and report on its risk management approach.

Sustainability reporting

F&C believes disclosure of significant social and environmental risk factors should be included in the Annual Report. F&C also favors appropriately detailed sustainability reporting that enables analysis against comparable companies. It recommends disclosure in line with internationally accepted standards of best practice, such as the Global Reporting Initiative (GRI). F&C generally supports shareholder proposals asking companies to report on implementation of social and environmental policies where there is reason for concern.

Audit of social and environmental management systems

F&C appreciates that auditing and assurance practices for social and environmental systems require further development, but it considers third-party auditing of sustainability reports to be best practice. It encourages companies to move towards third-party verification, and will generally support resolutions calling for it where there is reason for concern.

Labor standards

Companies may incur extraordinary risks as a result of the employment practices (e.g. health and safety, anti-harassment, etc.) of their own operations and those of their suppliers and sub-contractors. Codes of conduct that address such risks, and include detailed and effective procedures for their supply chain, are usually in companies’ best interests. Where there is cause for concern, F&C favors codes based on internationally recognized standards (e.g. core conventions of the International Labor Organization), independent monitoring or auditing of implementation, and reporting of aggregate audit results. F&C looks for regular, public reporting on code implementation.

Human rights

Companies may incur extraordinary risks to their operations, staff or reputation as a result of operating in conflict zones or in locations at risk of human rights abuses. Where there is cause for concern, F&C

supports resolutions asking companies to develop and implement policies and management systems addressing human rights and security management. These policies should reflect internationally recognized standards (e.g. United Nations Universal Declaration of Human Rights) and should apply to suppliers and sub-contractors.

HIV and AIDS

The current HIV/AIDS pandemic in Sub-Saharan Africa has begun to damage local productivity and sales due to employee absenteeism and turnover, and may affect companies’ reputations and strain community relations. For companies operating in this region, as well as those with operations or expansion plans in areas with rapidly rising infection rates (e.g. parts of Eastern Europe, Russia and Asia), F&C may support resolutions asking for reports on the impact of HIV/AIDS on business prospects and on how management is responding.

Diversity and equal employment opportunity

Recruiting and hiring from the widest possible talent pool is in the best interests of companies, as is maintaining a diverse workforce. F&C generally supports efforts to strengthen non-discrimination policies, achieve diversity objectives and address “glass ceilings” at executive and board levels. Where there is cause for concern, F&C may support resolutions calling for the introduction of practices to this effect. But F&C does not support rigid quota systems to achieve diversity objectives nor proposals that seek to roll back non-discrimination standards, including domestic partner benefits.

Charitable and political donations

Charitable and political donations should take account of the risks that companies face relating to their social and environmental performance. (See “Political donations and lobbying” on page 9.) F&C does not support proposals that seek to stop charitable giving. F&C believes that companies that undertake charitable giving should have transparent policies and undertake charitable giving programs with due regard for the interests of shareholders.

Environment

Companies should determine how key environmental drivers fit into their core business strategy and open up opportunities to add value – or avoid costs for shareholders. As part of this process companies should identify, assess and manage their environmental impacts. This may include minimizing key environmental impacts, reporting on environmental management systems and performance, and discussing related financial impacts. It may also include participating in internationally recognized initiatives (e.g. EnergyStar, ClimateWise, etc). Where there are matters of concern, F&C may vote in favor of resolutions seeking improvements in reporting and/or management of environmental practices.

Climate change

Some companies may be exposed to business risks stemming from the effects of climate change either directly on their business operations, or indirectly through taxation, regulation or changing patterns of customer demand. Where relevant, companies should describe how their business strategy addresses the question of

climate change. They should report on their emissions of greenhouse gases, and detail their targets and goals to optimize these emissions in light of regulatory and voluntary initiatives to reduce global levels of atmospheric CO₂. Where there are matters of concern, F&C may support resolutions calling on companies to improve their public disclosure of climate change-related policies and practices. F&C also encourages companies to support policy initiatives aimed at accelerating the shift to a low-carbon economy. It does not support proposals from climate skeptics seeking additional corporate justification for robust climate change programs.

Products

F&C will vote on all other matters pertaining to the social, environmental, ethical and brand implications of a company's products, production processes and activities, in accordance with its understanding of shareholders' long-term interests. A company's policies and processes are important in evaluating the risk, and F&C strongly encourages companies to provide detailed disclosure of their systems in the management section of the proxy statement and in annual reports. F&C looks for evidence that companies are well prepared for changes in regulation and customer demand that could have profound implications for their business.

Supply chains

As part of standard social and environmental management policies and systems, companies should clarify the extent to which their operational standards and performance expectations apply, or do not apply, to their suppliers. This may include anti-corruption, environmental, health and safety, human rights, animal welfare and climate change policies, among others.

Voting on corporate social, environmental and ethical matters

In recognition of the fact that some shareholder resolutions may raise important concerns but make inappropriate demands, F&C will vote in favor, abstain or vote against according to particular circumstances, and inform the company of its concerns and expectations. F&C will apply particular scrutiny to proposals that request by-law changes related to social and environmental issues.

Where there are matters of concern, F&C may support resolutions asking companies to:

- Prepare a sustainability report in line with internationally accepted guidelines.
- Carry out social and environmental audits.
- Adopt codes and policies for company operations and suppliers. F&C generally favors:
 - Codes based on internationally recognized standards.
 - Independent monitoring of these codes.
 - Regular, public reporting on code implementation.
- Report on the business and operational impacts of significant current or emerging risks (e.g. water scarcity, HIV/AIDS epidemic) and management's response.
- Introduce policies, procedures or disclosure standards aimed at improving equal employment opportunity and diversity of the workforce. This may include:
 - Publication of Equal Employment Opportunity (EEO) data.
 - Reporting on efforts to address glass ceilings.
 - Expanding existing non-discrimination statements to prohibit discrimination based on sexual orientation and gender identity.
- Demonstrate best practice standards in managing environment-related risks to their business by:
 - Improving disclosure of relevant environmental management systems, performance and strategy.
 - Minimizing key environmental impacts.
 - Reporting on climate change strategy.
 - Measuring and disclosing greenhouse gas emissions and reduction targets.

F&C generally opposes shareholder proposals to weaken non-discrimination standards and equal opportunity practices, or to justify or impede climate change programs. It also opposes proposals to stop charitable giving, but supports transparency regarding companies' charitable donations policy. (See "Reporting" for more information on political donations and charitable giving.)

8. Voting matters



Annual meetings

There should be an annual physical meeting of the shareholders, and all the directors of the company should attend. Web-based transmission of the meeting is encouraged, as is a specific time for shareholder questions.

Disclosure of voting results

F&C expects companies to disclose the voting results of the general meetings on their websites with a detailed breakdown of votes for and against as well as abstentions.

Voting record

F&C believes that companies have a right to know how their shareholders have voted and writes to all companies to explain votes that did not support management's recommendations or were the subject of concern.

In the spirit of transparency, F&C also makes available to both its institutional and retail fund customers a comprehensive record of its voting by publishing its aggregated voting record on its website on a monthly basis. Companies held in all F&C retail or institutional funds may also check their results on this web page. A summary of F&C's voting record can be found in its quarterly Responsible Engagement Overlay (*reo*®) report, its annual Responsible Investment report and its annual Corporate Responsibility report.¹⁴

F&C attendance at annual and other company general meetings

F&C expects to vote at all company meetings. These votes will usually be by proxy, except where specific circumstances make attendance by a representative of F&C desirable.

Stocklending

Stocklending is a widespread market practice involving the sale and contractually pre-agreed repurchase of a stock, collateralized by a basket of securities. Insofar as title to the stock passes from the "lender" to the "borrower", this transaction is not, in fact, a loan, and the voting right that attaches to the underlying stock cannot be readily detached and retained by the lender. Stocklending is an important factor in preserving the liquidity of markets and in facilitating hedging strategies; it also provides investors with a significant additional return on their investments because the sale-repurchase transaction includes a profit margin. Importantly, however, if the term of the "loan" coincides with an annual or extraordinary general meeting, the transfer of the voting right impairs the ability of the underlying shareowner to exercise his voting rights. In rare instances, this has led to abuse, where borrowers have deliberately entered into transactions to sway the outcome of a shareholder vote without any intention of owning the stock long-term.

F&C considers that the balance to be struck between stocklending and voting is a matter for individual decision by clients. For those clients wishing to be involved in stocklending, F&C's policy is to accommodate this while retaining a minimum shareholding at all times, thereby ensuring that a vote is cast and any concerns are expressed directly through a letter to the company. Where significant voting issues arise, F&C will stop any further lending of stock, and, if necessary, will seek, on a reasonable-efforts basis, to recall all lent stock over the voting period. F&C also accommodates clients who do not wish to engage in stocklending at all, should they prefer to vote all stocks at all times.¹⁵

Voting systems

F&C encourages the introduction of electronic voting systems that are accurate and provide an effective audit trail of votes cast. Furthermore, F&C encourages companies to disclose an aggregate record of how votes have been cast at shareholder meetings at, and subsequent to, these meetings.

Bundled resolutions

Resolutions put to company meetings should cover single issues, or issues that are clearly interdependent. Any other practice potentially reduces the value of votes, and can lead to opposition of otherwise acceptable proposals. F&C will normally oppose resolutions that contain inappropriately bundled provisions.

Advanced notice requirements

The SEC-defined process for filing shareholder proposals provides companies with adequate notification of shareholders' intentions. F&C will normally oppose management proposals for notice periods greater than that required by the SEC.

Any other business

F&C expects to vote on resolutions whose contents have been made clear to shareholders and are in the interests of the company and its shareholders. Where a resolution invites shareholders to vote on an "any other business" resolution, F&C will vote against.

Certain voting matters

F&C will generally oppose resolutions that:

- Do not allow F&C to express its opinion on unrelated matters individually (a.k.a. "bundled resolutions").
- Ask for additional notice of shareholder proposals.
- Request shareholder approval of "any other business".

14. Available on <http://www.fandc.com/new/aboutus/Default.aspx?id=63889>.

15. This applies to funds directly managed by F&C. For clients of F&C's responsible engagement overlay service (*reo*®) service in cases where F&C does not manage the fund - clients will need to coordinate with their fund managers with regard to stocklending policies and practices.

Appendix: Sustainability Reporting and Disclosure

F&C expects high standards of transparency from the companies in which it invests. This should include a narrative account within the annual report about the trends and factors affecting the performance and future development of the business. So-called “narrative reporting” is an important mechanism for improving the quality of dialogue between companies and their owners, covering the full range of factors underpinning long-term profitability. This includes areas that have not been traditionally covered in annual reports such as material environmental, social and governance

(ESG) issues. In high-impact sectors, we also expect companies to publish a comprehensive sustainability or corporate social responsibility report that provides more detailed information for a wider group of stakeholders such as employees, local communities, non-profit organizations, and government representatives. While F&C recognizes that ESG reporting will vary across geography and sector, F&C has identified some general best practice guidelines, set out below.

F&C’s 12 Steps to Best Practice ESG Reporting

Basic

- Establish and explain board accountability for ESG issues.
- Identify significant ESG risks and opportunities for the business.
- Set out policies for significant ESG issues and explain how they are implemented and monitored.
- Establish and disclose key ESG targets and Key Performance Indicators covering global operations.
- Describe systems for training board members and staff on ESG issues.
- Report on performance against policies.

Best practice

- Explain how ESG policies link to key operational and financial drivers.
- Describe procedures for consulting key stakeholders and provide feedback on the range of views.
- Discuss challenges and set-backs as well as success stories.
- Describe procedures for verifying data including external verification.
- Take account of widely-accepted reporting standards such as the Global Reporting Initiative.
- Describe how ESG objectives are embedded into the corporate culture, including how they are reflected in remuneration policies and other performance management tools.

Winning gold with F&C

Delivering highly effective investment strategies is just one part of the service we provide. As principled asset managers, we are determined to lead our industry in all aspects of our business.

In 2009 F&C were voted winners of the 'Gold Standard' in the Fund Management category for the fourth year in succession. Only a few companies have been privileged enough to win a Gold Standard award, and as such, this is an exceptional achievement. The Gold Standard Awards aim to identify financial services companies that excel not just in service but in five key areas important to consumers of financial products and services:

Financial strength

Ability to meet and exceed customer expectations

Capability

Outstanding expertise and aptitude as a fund manager

Service

Ability to maintain and grow an effective post-sales relationship

Fair value

Assessing whether customers receive great value for money

Trust

Ability to instil confidence in consumers

As a result, the Gold Standards are one of the hardest, most sought after awards in the financial market place.



WINNER



Products

F&C offers a wide range of investment opportunities for pension funds, charities, financial institutions, corporations and other organisations. We offer segregated and pooled portfolio management through a range of onshore and offshore vehicles. These cover developed and emerging markets in equity, bond, cash and property funds.

Please contact us for further details or visit our website at www.fandc.com

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Important information. All data is as at 31 December 2009, unless otherwise stated.

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