Sarasin & Partners

Policy outreach, company engagement and voting report

Q3 2018

October 2018

Introduction

Investors in companies have an important shared responsibility in holding the board to account for the management of the business.

On behalf of our clients we are active in voting on matters put to shareholders, and we closely monitor investee companies and engage on issues of concern relating to corporate governance, capital structure and strategy. We do this because we believe that poor governance can adversely affect the returns for investors and, equally, good stewardship can lead to better returns over the long term.

As long-term investors, we also take an interest in the broader market environment in which companies operate. Where we perceive problems, and believe we can catalyse positive change, we will reach out to policy-makers and other key market participants to promote reform. Our objective is to shape the regulatory and market environment to support more sustainable economic growth.

Given the emphasis we place on responsible and active ownership, we aim to communicate openly with our clients and other interested parties about our activities. This report offers a window into our recent company engagement, policy outreach and voting activities.

Stewardship: Policy and company engagement

Our engagement work with companies aims to address governance failures or strategic challenges with a view to protecting and enhancing shareholder value. It often takes place in confidence, but we aim to share key points and goals of recent engagements to ensure transparency and insights on our stewardship activities to our clients.

Alongside our company dialogues, we often have a unique opportunity to engage with policy makers to improve the regulatory and market environment in which companies operate. In these cases our aim is to promote rules and market-wide practices which encourage long-term and sustainable behaviour, which in turn will underpin sustained and equitable wealth creation.

Company Engagements

ING

We resumed our engagement this quarter with the Dutch bank ING Groep, following its record $700 million settlement with the Dutch public prosecutor for weaknesses in its Anti-Money Laundering controls and compliance responsibilities. Above all, the size of the settlement reflects widespread shortcomings in ING's procedures over a number of years. The investigation, which also led to the resignation of the CFO, identified a number of instances of money laundering attributable to these failings, and posited the likelihood of others.

Through our discussions with the company, we established that the settlement protects ING from future prosecutions in the Netherlands for money laundering which may have occurred during the period covered by the investigation. This helps to provide some closure in the case. While related investigations could emerge in other jurisdictions in future, t the US Securities and Exchange Commission has concluded its enquiries without taking action. There has been no indication of interest from other parties.

Aside from understanding the potential for copy-cat fines, our engagement has also focused on how ING is addressing the shortcomings identified in its approach, not least in order to satisfy the Dutch regulator. We have gained assurances that the bank is taking steps to address the underlying causes. These include headcount increases to ensure that compliance procedures can be properly implemented, and the establishment of a dedicated "Know-Your-Customer" centre which takes over responsibility from front-office staff for approving transactions and relationships. This is now complete and should remove the risk that front-line relationship managers could neglect compliance in order to generate and retain business. The company is also considering changes to remuneration structures to reinforce the right behaviours across the bank.

Notwithstanding recent positive steps, the past failings reflect poorly on the wider management team and the Board, which has ultimate oversight responsibility. We will continue to monitor and engage, including by writing to the Board.

The future of protein production

We participated in a collective engagement programme this quarter, led by the Coller Capital-backed initiative Farm Animal Investment Risk & Return (FAIRR). Alongside other signatories, we wrote to a number of food retailers, such as Ocado, Unilever and Amazon, requesting better disclosure regarding the challenges presented by protein production.

Global consumption of animal-based foods is expected to increase 79% between 2006 and 2050, building on existing double-digit growth in recent decades. Because meat is far more resource-intensive to produce, this global trend is placing mounting pressure on our environment, leading to land degradation, water stress and biodiversity loss. The World Resources Institute claims that animal-based foods accounted for over three-quarters of agricultural land use and around two-thirds of greenhouse gas emissions from agricultural production activity in 2009, while contributing only 37% of protein consumed by people in the same year.

It is not clear whether or how companies are responding to these potentially foreseeable production constraints and environmental impacts of their supply chains. For instance, we would like to see companies play a proactive role in changing consumer preferences through product innovation. We await the companies' responses.

Market Outreach

Accounting & Audit

This was an active quarter with regards to two longstanding areas of focus in our public policy work, the audit market and accounting standards. The Financial Times published an in-depth series of articles investigating many of the issues we have been concerned with, citing our work in a number of cases.

We also submitted our response to the Government's Independent Review into the Financial Reporting Council, which is the UK's financial reporting, audit and corporate governance regulator. Led by Sir John Kingman, its terms of reference echo many of the points raised in our October 2017 position paper, 'Investors require a robustly independent audit regulator'. We call in our submission for the establishment of a public Companies Conduct Authority, with a mandate to promote the public interest by enforcing director and auditor duties under the Companies Act.

The Government also published its response to the Insolvency Service's consultation on the current framework surrounding insolvency in the UK. Prompted by recent high-profile corporate failures such as of Carillion and BHS, its purview included the legal framework governing dividends payments and the role of shareholders in holding directors to account. In responding, we reiterated the need for proper disclosure of companies' dividend paying capacity in financial statements, as required by UK Company Law, and were therefore pleased to see that a comprehensive review of the UK's dividend regime is now being considered. A briefing paper for MPs was also published by House of Commons researchers in August, acknowledging that "more prudent [accounting] standards leave companies better capitalised, and so more resilient to shocks".

Turning to the increasingly well understood failures of the audit market, we welcomed the Secretary of State Greg Clark's recent call for a review of competition and conflicts of interest, led by the Competition and Markets Authority. We wrote to Greg Clark in

May 2018 calling for clarity around the role of auditors in ensuring company accounts are True and Fair and that the UK's capital maintenance regime is being properly implemented. We continue to contribute to this momentum for reform, including through our membership of the FRC's Investor Advisory Group, which is now actively considering solutions to our concerns regarding capital maintenance

Climate Change

Are oil and gas companies overstating their positions?

Following the publication of our discussion paper with the IIGCC "Voting for better climate risk reporting: the role of auditors and audit committees", we have seen considerable interest in the notion of using votes on auditors, audit committee directors and the annual report and accounts as mechanisms to communicate shareholders' views on the adequacy of climate risk reporting; and to drive change.

During the last quarter we published a paper with more detailed analysis which provides a basis for determining votes. The paper analyses of European oil and gas company accounting disclosures and highlights that there may be a sector-wide problem of overstatement of capital and profits linked to the use of overly optimistic long-term oil and gas price assumptions. US company disclosures are generally inadequate to make an assessment – which is itself a serious problem as it means we cannot interpret their reported results.

Currently, the eight companies reviewed (Royal Dutch Shell, BP, Total, Equinor, Eni, Repsol, Cairn Energy and Soco International) assume long-term oil prices of between $70-80 per barrel (from 2020/21) in their 2017 financial statements. Putting to one side the short-term and cyclical volatility that characterises the oil market, these assumptions look structurally high.

Overstatement matters because it can lead to capital misallocation and, ultimately, capital destruction and cuts to dividends. This is particularly concerning as the oil and gas sector grapples with decarbonisation – and particularly the global commitment to reach net zero emissions by c2070. It also works against efforts to combat climate change as it will tend to encourage excessive investment into new fossil fuels.

Historically, over the period 1861-2016, oil prices averaged $35/bbl (in 2016 prices). Looking forward and taking account of decarbonisation commitments under the Paris Accord, the International Energy Agency's Beyond 2 Degree Scenario (B2DS) foresees a $60/bbl oil price in 2060[1]; the UK government uses a $55/bbl oil price from 2035; while the think-tank Oil Change International, using data from Rystad Energy, believes a $35/bbl is more realistic.

What is more striking is that the companies themselves appear to expect prices to be structurally lower. Where disclosed, the price used in the same company's strategy and capex thresholds is generally $50-60/bbl. Shell has determined that capex must cover its internal rate of return at $40/bbl; BP recently announced its plan to be break-even for its overall business at $35-$40 by 2021.

The reason this matters is that, according to the auditors and Audit Committees for the companies we reviewed, long-term commodity price assumptions are key inputs into valuations of at least 60-75% of company assets, as well as important liabilities, which in turn impact profit.

The problem is that the companies disclose limited information on the sensitivity of their results to lower commodity price assumptions. There is an urgent need for greater scrutiny of how oil and gas companies are drawing up the accounts they present to shareholders, and specifically, whether these accounts provide a true and fair view of underlying performance.

[1]The IEA's Paris-consistent scenario work is their Beyond 2 degrees scenario (B2DS). This has been criticised for understating the true level of decarbonisation that would be needed, and thus potentially overstating the equilibrium price.

Key votes and engagements Q3 2018

Investors in companies have an important shared responsibility in holding the board to account for the management of the business. On behalf of our clients we are active in voting on matters put to shareholders, and we closely monitor investee companies and engage with companies on issues of concern relating to corporate governance, capital structure and strategy.
Poor governance can adversely affect the returns for investors and, equally, good stewardship can lead to better returns over the long term. The table below shows how we voted on four company resolutions during the period under review. It also explains the way we voted, and whether the resolution was approved by the shareholders or not.

Key votes for 3rd Quarter 2018

Company	Date	Resolution	How we voted for you	Result
BT Group plc	11 Jul 2018	Approve remuneration report, elect directors and the auditor	Against remuneration; For directors and auditor	Approved

Since the accounting scandal in its Italian Global Services business last year, we have met with the Audit Committee Chair to discuss internal controls and discussed with the Chair of the Board a number of governance issues including pension, diversity, Italy remediation and relationships with the regulator. These engagements have informed how we voted at this year AGM.

We voted against the remuneration report as variable pay awards strike us as high given past difficulties. Despite the reduction to the Chief Executive's bonus due to the control failures in Italy our primary concerned is the high level of pension contributions made to senior executives and the shareholding requirements which fall short of expectations (we note that the CFO's shareholding remains immaterial despite his being in post for two years).

We supported both the Chair of the Board and the Audit Committee Chair as they have made meaningful progress addressing board diversity and internal control issues.

We also voted for the new auditor: we are satisfied that the tender process was appropriate and there is no significant risk of a conflict of interest although we were concerned that the Chair was formerly a senior executive at KPMG; he has since stepped down. Of greater concern to us are the questions relating to the quality of KPMG's audit work (as highlighted recently by the Financial Reporting Council). We will monitor its performance in our future engagements with the company.

Percentage of votes cast for the approval of the remuneration report: 65.8% for, 34.2% against

Percentage of votes cast for the re-election of the Chair of the Board: 98.8% for, 1.2% against

Percentage of votes cast for the re-election of Audit Committee Chair: 96.5% for, 3.5% against

Percentage of votes cast for the re-appointment of the auditor: 99.8% for, 0.2% against

Company	Date	Resolution	How we voted for you	Result
DS Smith plc	4 Sep 2018	Approve remuneration report	Against	Approved

While the Chief Executive has a significant holding in the company (worth more than 10 times his salary), we voted against its remuneration report as we seek to impose a post-departure shareholding requirement to discourage departing executives from sacrificing long-term performance for short-term gains.

Percentage of votes cast for the approval of the remuneration report: 96.8% for, 3.2% against

Company	Date	Resolution	How we voted for you	Result
Neuberger Berman Invt. Funds Plc - Uncorrelated Strategies	19 Sep 2018	Ratify the appointment of auditor	Against	Approved

We voted against the ratification of its auditor appointment because the size of non-audit fees has been greater than that of audit fees for the past three years. We believe the independence of the auditor could be compromised by excessive payments for non-audit services.

Percentage of votes cast for this resolution: data was not disclosed

Voting Summary Q3 2018

		2012	2013	2014	2015	2016	2017	Q1 2018	Q2 2018	Q3 2018
Total number of company meetings		636	638	741	969	968	1,165	188	652	69
Total number of proposals		7,448	7,184	8,090	11,102	10,387	13,244	1,881	10,525	1,652
Votes cast	for	4,720	4,986	5,807	8,288	7,728	8,570	1,182	7,727	1,254
	against	1,312	1,418	1,332	1,631	1,681	2,354	284	1,791	300
	abstain	5	56	63	118	61	101	15	97	10
		171	173	126	85	84	83	2	75	1
	did not vote[1]	1,240	551	762	980	833	2,136	398	835	87

[1]We do not currently vote in jurisdictions in which share blocking and power of attorney requirements apply.

Further details are available upon request.

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