

RIVER AND MERCANTILE

## **SUSTAINABLE INVESTING POLICY STATEMENT**

Emerging Markets Industrial Life Cycle (ILC) Team

River and Mercantile LLC

May 2021

## Contents

Introduction.....	3
Sustainability Risks .....	3
Emerging Markets and Sustainability Risks .....	4
<b>ILC Approach to Sustainability Risks.....</b>	<b>4</b>
ILC Value Creation Pillars .....	4
ILC ESG Pillars .....	5
Controversial Weapons Exclusion Policy .....	6
Other Exclusions.....	7
Non-Rated Companies .....	8
Implementation & Reporting .....	9
Implementation .....	9
Voting and Engagement.....	10
Climate Change .....	11
<b>Appendix .....</b>	<b>11</b>
Proxy Voting General Principles.....	11
Voting at Company Meetings.....	19

## Introduction

### Sustainability Risks

The River and Mercantile Emerging Markets Industrial Life Cycle investment team (the “Team” or “ILC”) incorporates sustainability risks into its investment process. Sustainability risk refers to an environmental, social or governance (collectively, “ESG”) event or condition that, if it occurs, could cause an actual or a potential material negative impact on the value of the investments made by the Team (“Sustainability Risks”).

Sustainability Risks which may be considered, include, but are not limited to:

- risk principally linked to climate-related events resulting from climate change (physical risks)
- society’s response to climate change (transition risks)
- social events (e.g. inequality, inclusiveness, labor relations, investment in human capital, accident prevention, changing customer behavior, etc.)
- governance shortcomings (e.g. corporate governance malpractices, recurrent significant breach of international agreements, bribery issues, product quality and safety, selling practices, etc.)

The consideration of Sustainability Risks is integrated into the Team’s investment decision making process and risk monitoring to the extent that they represent potential or actual material risks and/or opportunities to maximizing the long-term risk-adjusted returns. Sustainability Risks are identified and assessed at an individual issuer level. The impacts following the occurrence of Sustainability Risks may be numerous and vary depending on the specific risk, region, and asset class. In general, where Sustainability Risks occur in respect of an asset, there will be a negative impact on, or entire loss of, its value. An assessment of the likely impact must therefore be conducted at portfolio level. The assets managed by the Team will be exposed to some Sustainability Risks, which will differ from company to company. Some companies, markets and sectors will have greater exposure to Sustainability Risks than others.

A wide range of Sustainability Risks apply to investments within Emerging Markets including the potential exposure to regions which might have relatively low governmental or regulatory oversight or low transparency or disclosure of sustainability factors. Governance risks can be more pronounced in Emerging Markets and can present a higher risk compared to developed markets. These risks include board composition and effectiveness, ownership structures which in turn includes controlling state interests or the controlling interests of an individual or family and management quality and incentives that do not align with the interests of shareholders.

Due to wide variations in the availability of ESG and sustainability information in Emerging Markets, there is a possibility that not all related risks will be considered. The materiality of Sustainability Risks is different to what is experienced following a Sustainability Risk event. If a Sustainability Risk event were to occur, it may result in unanticipated losses that could affect the assets under management of the Team.

## Emerging Markets and Sustainability Risks

Sustainability Risks have been a central and growing issue for Developed Market companies and governments. At present, the recognition and acceptance of Sustainability Risks in Emerging Markets is in an earlier stage of development versus Developed. Consequently, Emerging Markets trail Developed Market peers in terms of ESG practices, and this is reflected in lower average ESG scores (as measured by 3<sup>rd</sup> party rating agencies).

To promote positive change more broadly across Emerging Markets, the Team believes it is important to include Sustainability Risks in the company research processes to help drive increased adoption and improvement.

## ILC Approach to Sustainability Risks

This policy describes how the related concepts are defined and incorporated into the Team's investment process.

### ILC Value Creation Pillars

The Team's investment methodology is built upon the idea that wealth creation principles vary depending on where a company falls within its maturity cycle. Good investment ideas are present within each stage of the maturity spectrum, and the Team's process is used to identify opportunities using stage specific criteria that have been proven to create shareholder value over time.

The Team's investment approach uses a three-step process illustrated below:



#### 1. Screen

- Classify companies into appropriate maturity stage
- Value premium analysis based upon stage
- Typically yields 200-300 ideas

#### 2. Fundamental Analysis

- Avoid value traps
- Identify companies moving leftward on life cycle
- Management self-help and macro drivers are key

#### 3. Portfolio Construction

- Maximize ILC Value potential across life cycles
- Tracking error constraints used on country, sector, size
- Align macro views with stage attractiveness (OW/UW Growth)

## ILC ESG Pillars

The ILC ESG Pillars have been constructed to tighten the connections between value creation and sustainability. Sustainability Risks are explicitly incorporated into the ILC investment process in each of the three steps noted above. The data used to construct these pillars is sourced from a number of third-party providers including, but not limited to, MSCI and Bloomberg.

The inclusion of ESG data is built upon Sustainability Risks that fall into the three pillars below:



### People

- Governance
- Employees
- Diversity & Inclusion
- Community
- Customers
- Supply Chain



### Innovation

- Strategy
- Process
- Products
- Change



### Environment

- Climate
- Clean Energy
- Biodiversity
- Clean Water
- Recycling

The pillars of People, Innovation and Environment are the factors which most commonly impact a company's long-term value creation potential. These pillars underpin a common framework for ILC fundamental company research. The materiality of sustainability factors varies across industries and companies, meaning there may be additional considerations on a stock-by-stock basis; here ILC utilizes the SASB materiality map (<https://materiality.sasb.org/>), and The Ten Principles of UN Global Compact, (<https://www.unglobalcompact.org/what-is-gc/mission/principles>), to guide efforts and investigate areas where third-party ESG research has flagged risks.

## People

Sustainability depends on a company's ability to create value for all stakeholders through having high levels of trust and cooperation between employees, customers, and the wider community it serves. Companies that install best practice governance, adhere to regulation, treat people equally, respect human rights and incorporate cognitive diversity (to avoid group think) and become better companies as a result.

## Innovation

A sustainable business requires constant innovation to respond to changes in market fundamentals, the environment and society. This is imperative for compounding long-term value, for the benefit of all stakeholders. ILC takes a broad view of innovation, which encapsulates changes in strategy, process, and product. This is applicable in times of success, where companies have the financial strength to reinvest, as well as in times of change, where businesses need to evolve when faced with challenge and opportunity.

## Environment

A sustainable company creates value for all stakeholders without causing undue harm to the environment or compromising the ability of future generations to avoid doing so. Acting in an environmentally responsible manner presents both costs and opportunities; this enables management to champion best-in-class and improve substandard working practices. The goal is for management to deliver effective company strategy with proper consideration for its natural surroundings and to manage their impact on the environment in support of the transition to a low carbon economy.

With the broad definitions of the Team's sustainability approach defined, the document now aims to explain the implementation of the beliefs in a greater level of detail.

There are certain products and business practices which are detrimental to society and incompatible with strategies actively advocating sustainable investing by integrating environmental, social and governance factors into the investment process and that can be avoided easily. Therefore, certain exclusion criteria are applied to all assets under management by the Team where it has full discretion.

### Controversial Weapons Exclusion Policy

The ILC team applies a norm-based exclusion list to all prospective and existing investment opportunities as part of its investment process and ESG policy, excluding any companies, with a zero tolerance, that are exposed to certain controversial weapons:

- Cluster Munitions (a munition that is designed to disperse or release explosive submunitions). The UN Convention on Cluster Munitions (Oslo, 2008)
- Landmines (mines designed to be exploded by the presence, proximity or contact of a person and which will incapacitate, injure or kill one or more persons). The Anti-Personnel Landmines Treaty (Ottawa, 1997)
- Biological & Chemical Weapons (use pathogens: viruses, bacteria, disease-causing biological agents, toxins; or use chemical substances). The Biological Weapons Convention (1975) and The Chemical Weapons Convention (1977)
- Depleted Uranium (long term radiation risk)
- Incendiary (weapons that are designed to set fire to objects or to cause burn injury to people, including white phosphorous)
- Laser Blinding Weapons
- Non-detectable (by x-ray) Fragments
- Nuclear Weapons (Non-Proliferation of Nuclear Weapons Treaty, United Nations, 1968)

For all exclusion categories, the exposure criteria may evolve over time. Clients are to be notified of any changes where applicable. Adherence to the norms-based exclusion list entails pre- and post-trade compliance checks based on exclusionary screening information, as well as ongoing monitoring of the portfolios for any breaches. A

data feed from MSCI of specific company names / identifiers to be excluded is added to a central restriction list. This is updated frequently, coded into trading systems, and made available to investment teams for monitoring, screening, and application.

## Other Exclusions

Certain Sustainability Risk flags also warrant hard exclusion requirements. ILC will exclude any company rated MSCI ESG CCC from its investable universe. Going forward, this signifies that there will be no new investment ideas added to the portfolios when they are rated CCC. If an existing position is downgraded to CCC, or a non-rated company becomes rated as CCC, the team will engage with the company with the aim to ameliorate the risk. The team will allow for one year for this improvement, and in the case where positive change does not occur, the position will be sold.

The team believes that companies with this bottom level ranking of CCC have some dimension of their business that infringes upon our ESG Pillars. This exclusion is an important and measurable method to ensure that known Sustainability Risks are excluded from consideration in the portfolios. Of course, the CCC rating does not cover all Sustainability Risks. For this reason, ILC also follows the ten guiding principles of UN Global Compact and MSCI ESG Controversy. Any company with severe or very severe controversy flags on environment, human rights & community, labor rights & supply chain, customers or governance is excluded from its investable universe. Companies falling into these categories will be excluded from the new idea investment universe. Existing positions that have such controversies, or future existing holdings that encounter a new such controversy will go through a year of engagement. Some controversies take years to resolve, and the decision to divest in these cases will be made on a case by case basis.

When the team is faced with new controversies, the risks and resulting decision making are considered through the following principles of the UN Global Compact:

- Businesses should support and respect the protection of internationally proclaimed human rights
- Make sure that they are not complicit in human right abuses
- Business should uphold the freedom of association and the effective recognition of the right to collective bargaining
- The elimination of all forms of force and compulsory labor
- The effective abolition of child labor
- The elimination of discrimination in respect of employment and occupation
- Businesses should support a precautionary approach to environmental challenges
- Undertake initiatives to promote greater environmental responsibility
- Encourage the development and diffusion of environmentally friendly technologies

- Business should work against corruption in all its forms, including extortion and bribery

More often than not the exclusion of poorly rated companies, and/or companies with controversies will also lead to the omission of electric power producers and coal extraction miners with excessive climate impact. The team aims to explicitly exclude such investments based on a materiality of revenue threshold, defined for this policy as above 30% from the following:

- Mining companies that extract coal, including thermal
- Mining companies developing new coal mining and coal industry partners (e.g. equipment suppliers)
- Mining companies developing significant new coal assets
- Mining companies that extract other non-renewable energy sources with high GHG impacts: oil sands & shale energy
- Power generation companies with electricity generated by coal
- Power generation companies that plan to expand coal power generation capacity

The ILC team can over-rule this if the data is deemed to be inaccurate. Furthermore, an override of such rules must be supported by a robust transition plan. This aligns with the EU Climate Transition Benchmark which permits such investments only as part of an energy transition. If utilizing this exemption, evidence for over-ruling the exclusion shall be documented and a plan for engagement with the investee shall be created, covering rationale for holding, expectations, targets (such as emissions reduction or disclosure) and progress.

Additional exclusions may be applied at the specific request of clients (such as faith-based or other idiosyncratic), for example alcohol, gambling, pornography, tobacco, nuclear, coal, whale meat or low ESG scores from rating agencies. This is due to our clients' discretion as Asset Owners.

Sanctions and legal restrictions applicable to the jurisdictions where ILC operates are also followed.

### Non-Rated Companies

ILC aims to minimize the holding of non-rated MSCI ESG companies. However, for any non-rated company that the Team considers, the following approach is applied:

- No UN Global Compact Violations
- No severe or very severe controversies as outlined by MSCI ESG. Controversies can be manually identified within the ILC ESG Pillars

ILC may take a position in non-rated companies with the caveat of providing the company a 24-month grace period in which Team engagement will aim to encourage the company to start reporting on ESG. Within certain parts of the Team's investable universe and strategies (e.g. Emerging Markets Small Cap) this approach also takes into consideration the relative weight of the respective benchmark's holding in MSCI non-rated companies. Non-



rated companies also fall under the High ESG Risk classification and Watchlist as outlined below and are subject to additional due diligence, reporting and tracking of engagement.

## Implementation & Reporting

### Implementation

The Team runs a weekly Sustainability Risk report (“ESG screen”) incorporating ESG data from MSCI as a cross reference against all new potential ideas and all existing portfolio holdings. The report provides a high-level Sustainability Risk overview of the company holdings. This allows the Team to identify and research companies where Sustainability Risks may have changed. The report further highlights any flags relating to the Team’s Exclusion Policy and MSCI ESG Controversy indicators.

MSCI ESG ratings, Controversial Weapons Exclusion Policy and MSCI ESG Controversy indicator flags are also incorporated in the Team’s investment tools. This enables the Team to quickly identify companies that fall outside of its investable universe due to Sustainability Risks.

This custom data and reporting toolset work to integrate the key ILC ESG Pillars and Sustainability Risks into the ILC investment process. The Team evaluates Sustainability Risks and issues as appropriate during its weekly investment meeting cycle. Any changes to a company’s MSCI ESG Rating are reviewed by the Team.

The Team also considers the following activities high ESG risks which are subject to a High ESG Risk Watchlist, but where the Team retains full discretion over investing:

- Civilian firearms
- Tobacco manufacture and production.
- The WHO Framework Convention on Tobacco Control (2003) is referenced as applicable as a broad range of tobacco control measures
- Contributing to ground or water contamination
- Negative impacts to biodiversity or cruelty to animals (including processing of whale meat)
- Predatory lending operations
- Poor waste or water awareness / management
- Contributing to deforestation
- Poor local community relations or business ethics at the company, including supply chain
- Weak governance indicators on how a company is run
- Occurrence of controversies or other poor conduct

- Companies within these specific GICS classifications: 10101010 Oil & Gas Drilling, 10101020 Oil & Gas Equipment & Services, 10102010 Integrated Oil & Gas, 10102020 Oil & Gas Exploration & Production, 10102050 Coal & Consumable Fuels
- Significant harm in one of the six environmental objectives identified in the EU Taxonomy

In addition, the Team runs a quarterly report showing the aggregate MSCI ESG Ratings and Carbon Emissions Intensity for each managed portfolio and its respective benchmark. The report shows portfolio exposure to companies with positive and negative rating trends (directional change), absolute and relative trends on environmental, social and governance and Sustainability Risks, as well as the portfolio's business involvement exposure. Key themes such as climate change, pollution and waste, human capital, corporate governance, and behavior are also highlighted. This report is helpful in managing the top down ESG allocation risks in both an absolute and benchmark relative perspective.

Apart from the Team's ESG portfolio reporting suite as highlighted above, the toolsets used to perform individual company due diligence have been integrated with the ILC ESG Pillars. The Ten Principles of UN Global Compact are also evaluated.

As part of any company analysis performed, the Team compares a company to its peer group and monitors relative progress. The Team aims, to the best of its ability, to address weak sustainability areas directly with management and/or by supporting shareholder proposals at Annual General Meetings.

Furthermore, where material ESG concerns arise (low score from pre-investment analysis, climate exception risks, etc.), an enhanced due diligence process shall be followed:

- Detail is shared with the relevant Managing Director and River and Mercantile Group's ESG and Group Risk functions
- Enhanced due diligence performed to validate and add to the ESG inputs in the research and evaluation stages
- Additional approvals or mitigating steps will be provided, including placing the asset on the High ESG Risk Watchlist maintained by the River and Mercantile Group ESG function and reviewed quarterly at the River and Mercantile Group ESG Committee for more active monitoring or engagement, or other solutions leading up to divestment

## Voting and Engagement

The ILC team follows a proxy voting and related engagement approach that aligns with the ILC ESG Pillars. Voting and engagement will be focused upon encouraging improvement for existing positions. Emphasis is placed upon companies that have:

- MSCI ESG controversy flags

- Any weak areas within ILC's 3 ESG Pillars of People, Innovation, and Environment
- MSCI key metric and indicator flags that are relevant to the company and are not addressed through controversy flags or the ILC ESG Pillars

A company is given a 12-month opportunity to address any concerns or issues. In cases where the company is not addressing such concerns, or management is unwilling to change, the Team shall either sell an existing holding or decline to invest further.

Proxy voting is also considered a form of engagement. ILC uses a third party, ISS Corporate Solutions ("ISS"), to implement a custom voting policy, and overrides ISS recommended actions when they differ from our General Principles on standards for good corporate governance and management ILC aims to vote on all proxies. Further detail of our General Principles for proxy voting can be found in the appendix of this document.

## **Climate Change**

The Team measures climate related risks primarily through Carbon Emission Intensity at both the underlying company holding and aggregate portfolio level. The goal is to reduce the portfolio's absolute Carbon Emission Intensity and its relative Intensity compared to its respective benchmarks. However, Carbon Emission Intensity for the portfolios may fluctuate from time to time and can be higher than that of its respective benchmarks, depending on the portfolios exposure to investment opportunities to maximize the long-term risk-adjusted returns. In general Carbon Emission Intensity at the underlying company holding level is assessed by the Team as part of its research and due diligence process, while aggregate Carbon Emissions Intensity at the portfolio level is tracked as part of the Team's quarterly report as highlighted above.

## **Appendix**

### **Proxy Voting General Principles**

This section outlines the beliefs and principles behind the Team's proxy voting approach.

Companies should disclose accurate, adequate, and timely information, in particular meeting market guidelines where they exist, to allow investors to make informed decisions about the acquisition, ownership obligations and rights, and sale of shares. Clear and comprehensive information on directors, corporate governance arrangements and the company's management of corporate responsibility issues should be provided.

Shareholders should be given sufficient and timely information about all proposals to allow them to make an informed judgment and exercise their voting rights. Each proposal should be presented separately to shareholders – multiple proposals should not be combined in the same resolution. In the absence of sufficient information provided by a company on a proposed resolution ILC will vote against.

The Team believes voting is an important aspect of responsible ownership and valuable tool for engaging with companies to encourage better standards of corporate governance and management of Sustainability Risks.

### **Boards of directors**

ILC recognizes the plurality of corporate governance models across different markets and does not advocate any one form of board structure. However, for any corporate board there are certain key functions that apply:

- reviewing and guiding corporate strategy, major plans of action, risk policy, annual budgets and 6 business plans; setting performance objectives; monitoring implementation and corporate performance; and overseeing major capital expenditures, acquisitions and divestitures.
- monitoring the effectiveness of the company's governance practices and making changes as needed.
- selecting, compensating, monitoring and, where necessary, replacing key executives and overseeing succession planning.
- aligning key executive and board remuneration with the longer-term interests of the company and its shareholders.
- ensuring a formal and transparent board nomination and election process.
- monitoring and managing potential conflicts of interest of management, board members and shareholders, including misuse of corporate assets and abuse in related party transactions.
- ensuring the integrity of the corporation's accounting and financial reporting systems, including the independent audit, and that appropriate systems and controls are in place, in particular, systems for risk management, financial and operational control, and compliance with the law and relevant standards; and
- overseeing the process of disclosure and communications.

The board of directors, or supervisory board, as an entity, and each of its members, as an individual, is a fiduciary for all shareholders, and should be accountable to the shareholder body as a whole. ILC recognizes that its funds will sometimes be minority shareholders in businesses where there may be a major shareholder. In such instances, ILC analyzes the corporate objectives of the major shareholder as well as ensuring sufficient board representation by individuals not associated with the major shareholder. Each board member should stand for election on a regular basis. Boards should include enough independent non-executive members with appropriate skills, experience, and knowledge. Responsibilities should include monitoring and contributing effectively to the strategy and performance of management, staffing key committees of the board, and influencing the conduct of the board.

Audit, remuneration and nomination/succession committees should be established. These should be composed wholly or predominantly of independent non-executives. Companies should disclose the terms of reference of

these committees and give an account to shareholders in the annual report of how their responsibilities have been discharged. The chair and members of these committees should be appointed by the board according to a transparent procedure.

When determining how to vote on the election of a non-executive director, the Team will consider their independence and the proportion of independent directors on the Board as a whole.

ILC will vote against or withhold votes from the incumbent chair of the nominating committee if there is not at least one woman on the board. If the chair of the nominating committee is not identified or is not up for election, the Team will vote against or withhold from incumbent members of the nominating committee. If the company does not have a formal nominating committee, the Team will vote against or withhold votes from the incumbent board chair.

### **Accountability**

ILC believes that a company's directors should be accountable primarily to its shareholders as they are the owners of the company and the providers of its risk capital who reasonably expect the board to pursue business strategies to optimize long-term shareholder value. However, the Team recognizes that it is very much in the shareholders' own interests that directors should also consider the significance of other stakeholders to the company's long-term prosperity. The Team accepts that directors will be unable to pursue the objective of increasing long-term shareholder value without developing and sustaining these stakeholder relationships. For the same reason, directors must also manage the risks associated with social and environmental issues where appropriate as these may have a material impact on the company's long-term performance.

**Non-Executive Directors (NEDs)** are a vital safeguard of the interests of shareholders. NEDs should work cooperatively with their executive colleagues and demonstrate objective and independent judgement.

At least half the board, excluding the chair, should comprise non-executive independent directors except in the case of smaller companies, which ILC considers on a case-by-case basis. As a rule of thumb, boards should have at least three independent NEDs. NEDs considered by the board to be independent should be clearly identified in the annual report.

## Independence

ILC endorses the UK Corporate Governance Code's (the "Code") definition of independence of directors. According to the Code, a director is assumed not to be independent if he or she:

- is currently or has been an employee of the company within the past five years.
- has, or has had within the last three years, a material business relationship with the company, either directly or as a partner, shareholder, director, or senior employee of a body that has such a relationship with the company.
- received or receives additional remuneration from the company other than director's fees or participates in the company's share option or performance related pay scheme or is a member of the company pension scheme.
- has family ties with other directors, senior staff, or advisers.
- holds cross-directorships or has significant links with other directors through involvement in other companies or bodies.
- represents a significant shareholder; or
- has served on the board for more than nine years from their first election.

Additionally, the following factors also affect independence:

- board member/employee of competitor.
- stakeholder representative other than shareholders.
- receives remuneration from third party.
- wasn't appointed via an appropriately constituted nomination committee.
- is on the board of or is employed by a notifiable holder in the company.

ILC takes a flexible view on the application of the so-called "nine-year rule" regarding the independence of NEDs and will carefully consider the continuing independence of any NED who has been on the board for more than nine years. Long tenure does not necessarily mean a loss of independence, but boards must make a persuasive case in the annual report for a NED's continuing independence in such cases. There are other factors to consider in determining independence in such cases; however, NEDs serving more than nine years on the board should be subject to annual re-election.

Companies, if they wish, may pay NEDs partly in shares, which should be retained whilst they are in office. NEDs should not participate in performance-related pay or incentive schemes.

**Senior Independent Non-Executive Director (SID):** The appointment of a SID is encouraged. The individual should be identified in the annual report to provide a communication channel between shareholders and NEDs in addition to existing channels. It is accepted that in many companies this channel need only be used occasionally. However, ILC considers that the appointment of such an individual is beneficial. A further role for the SID should be to perform the periodic performance appraisal of the Chair. Due to the nature of the role, it is important that the SID's independence be demonstrable, and ILC will look closely at how the board has determined his or her independence.

**Combined Chair/Chief Executive:** The combination of these roles is actively discouraged. Any departure (e.g. in a small company) should be fully justified and balanced by the presence of independent and effective NEDs so that no one individual has unfettered powers of decision. ILC would normally expect a fully independent deputy chair or senior independent director to be clearly identified when these roles are combined.

**Independence of Chair:** A Chair should be independent on appointment.

**Chief Executive Officer (CEO) becoming Chair:** The elevation of a company's CEO to Chair will generally be discouraged unless it is part of a transitional period at the company or if the company can present a compelling justification for the move. The company should be prepared to explain the measures in place to ensure that the incoming CEO would be able to operate without undue intervention from his predecessor.

**Board Appointments** should be both formal and transparent with detailed information on the candidates' background, competencies, and skill sets. Both appointments and succession plans should be based on merit and objective criteria and, within this context, should promote diversity of gender, social and ethnic backgrounds, cognitive and personal strengths.

There should be audit, nomination, and remuneration committees on boards of all but the very smallest companies, with a majority of independent NEDs, and exclusively independent in the case of the audit and remuneration committees. Members of all the committees must be identified in the annual report. The Chair of the company may be a member of the nomination committee, and there are very good arguments for his/her inclusion in its membership. ILC also accept that permitting the Chair to sit on the remuneration committee, as a full member would ensure that performance incentives and other elements of the remuneration policy are properly aligned with the company's strategic objectives. However, the Chair should not chair the remuneration committee.

**Audit Committees** should consist of at least three NEDs, all of whom must be independent, and who should be identified in the annual report and accounts. At least one member must have recent and relevant financial

experience, and this should be clearly set out in the annual report. The committee should have written terms of reference, which are published either in the annual report and accounts or on the company's public website.

**Nomination Committees** should consist of at least three NEDs, the majority to be independent. As with the Audit Committee, written terms of reference should be made available. The Chair of the company can be a member and the SID should be a member.

**Remuneration Committees** should consist of at least three members, all of whom must be independent NEDs. No director should be involved in setting his/her own pay. An independent Chair may be a member of the committee; however, ILC would not expect the Chair of the company to chair the remuneration committee.

**Re-election of directors:** All directors should be required to submit themselves for re-election at least every three years. There must be no insulation from this requirement. Full biographical details, including other directorships and/or chairships, should be disclosed. As stated above, ILC will not apply the "nine-year rule" inflexibly when considering whether to re-elect a NED. However, if there are an insufficient number of independent NEDs on the board, the company will be expected to justify fully the long-serving continuing independence of NEDs and disclose any succession plans for the board.

**Education and Evaluation of the Board:** The board, its committees and individual directors should be evaluated for their effectiveness on an annual basis and the process for evaluation should be disclosed in the annual report. Consideration should be given to periodic external evaluation where appropriate. Disclosure on the outcome of the board performance appraisal process is encouraged. There should be a full formal induction for new directors, and regular refresher and updating sessions should be available.

**Board Attendance:** The number of board, committee and other meetings attended by each director should also be disclosed routinely in the annual report and accounts as a matter of best practice. Instances of poor attendance should be explained. Disclosure should include the number of meetings, which everyone was entitled to attend.

### **Remuneration Philosophy & Design**

Below ILC sets out its general views on what constitutes an appropriate remuneration policy:

**Remuneration Design:** Executive remuneration arrangements are often quite complex and need scrutiny. In line with the Code on the design of performance-related remuneration, actual and potential awards should not be



excessive and should be directly related to the company's success and aligned to the returns achieved by the shareholders. ILC would expect to see directors maintaining a shareholding in the company. Exceptional rewards can only be justified by exceptional performance. It follows that performance targets should be rigorous. ILC would look favorably on the inclusion of non- financial performance criteria in both short and long-term variable pay, where such factors represent material risks and opportunities as identified by the directors in the business review. ILC support both short and long-term variable performance-based remuneration being paid in the form of equity. Remuneration systems should genuinely incentivize directors to deliver durable shareholder value and policies should be clearly aligned with business strategy, objectives, and key performance indicators (KPIs) which link to long-term value creation.

**Pay for Performance:** Remuneration should include performance-based rewards. Executives should not be compensated merely for market or sector increases in stock prices. Performance metrics should be relevant, linked to strategy and enhance long-term shareholder value. Recipients should have a line of sight between performance and reward. Performance should be assessed relative to relevant peers and over an appropriate timeframe. ILC does not encourage transaction, recruitment, or termination payments.

**Disclosure:** ILC expects companies to make full disclosure of the detail of directors' pay and benefits. Key areas where full disclosure is encouraged include:

- Rationale behind the selection of the chosen performance metrics. Including the precise targets – simply naming the financial ratio used is not adequate.
- Linkage between pay and delivery of strategic objectives.
- Breakdown of total remuneration received during the year.
- Remuneration potential for the following year, including details of bonus.
- Maximum awards available under any long-term incentive plan and option plans and the minimum threshold below which awards not available.
- Any required explanations and justifications for the decisions and actions taken by the remuneration committee.
- Full justification and explanation for any discretion, which the remuneration committee uses, or plans to use.

**Long Term Incentive Plans:** Such plans should always be put to shareholders for approval as well as any material changes to existing plans. Payment for failure must be avoided, and mitigation arrangements should be applied routinely and robustly on both the appointment of directors and the termination of their contracts. Performance targets should be demonstrably stretching and measured over an appropriate period. ILC encourages the use of

both financial and extra financial performance metrics within the remuneration structure. Share awards granted should be released for sale on a phased basis and be subject to a total vesting period of no less than three years.

**Remuneration Report:** The inclusion of a remuneration report detailing a company's remuneration policy and directors' pay in a company's annual report and accounts is a statutory requirement in some jurisdictions. Where companies do not provide shareholders with an advisory vote on the remuneration report, ILC will consider withholding support for the report and accounts. ILC sees an advisory vote on the remuneration report as an important right of shareholders.

Where a company provides inadequate disclosure on remuneration or adopts remuneration policies and practices that are not aligned with shareholder interests, ILC may consider withholding support for the remuneration report and/or the re-election of remuneration committee members. For small cap and AIM/Fledgling companies ILC will usually support the approval of the remuneration report, unless deemed otherwise.

**Clawback:** Remuneration Committees should retain discretion to reduce or reclaim payments if the performance achievements are subsequently found to have been significantly misstated. ILC considers that there should be specific provision for 'claw back' policies that enable a company to reclaim compensation (bonuses and other incentives) that are awarded based on earnings that were subsequently found to be erroneous, fraudulent or manipulated or through any other such accounting restatement.

**Hedging:** ILC considers that companies should strongly discourage hedging by scheme participants of exposure to longer-term incentives, and plan rules should prohibit alienation, however derived.

**Service Contracts:** ILC believes that executives of listed companies should be appropriately rewarded for the value they generate. However, ILC are also concerned to avoid situations where departing executives are rewarded for under-performance. Shareholders have an expectation that boards will consider the risks of negotiating inappropriate executive contracts that can lead to situations where failure is rewarded. Companies should clearly disclose key elements of directors' contracts on their website and summarize them in the remuneration report, which should fully disclose the constituent parts of any severance payments and justify the total level and elements paid.

Executives should be employed no longer than one year rolling contracts which should be an upper limit rather than a floor, and ILC would strongly encourage boards to consider contracts with shorter notice. Compensation for risks run by senior executives is already implicit in the absolute level of remuneration, which mitigates the need for substantial contractual protection. Boards should ensure that contracts do not include any additional financial protection in the event of poor performance leading to termination and ensure that severance payments

arising from poor corporate performance do not extend beyond basic salary. The Team does not support contracts that become longer on a change of control of the company unless it is an initial contract for a fixed period. Changing a contract to a shorter period should not give rise to compensation because the one-year contract term is best practice. ILC expects companies to look for mitigation of loss if a director leaves and severance payments should be on a phased basis. ILC looks for Remuneration Policies to set pension arrangements for new joiners aligned with those of the wider workforce, and companies should actively disclose whether this is the case or not. For incumbent directors, companies should seek to align the contribution rates with the workforce over time, recognizing that many investors will expect this to be accomplished in the near-term.

## **Voting at Company Meetings**

**(i) Report and Accounts resolutions:** A separate resolution proposing the adoption of the annual report and accounts should be tabled at all annual general meetings (AGMs). Where the Team has general and persistent concerns about a company's governance or the actions of the Board as a whole during the year, or where concerns cannot be linked to a particular resolution, the Team may withhold support for the annual report and accounts.

The decision to vote against the annual report and accounts at a company meeting will not be taken lightly and will be considered on a case-by-case basis.

**(ii) Bundled resolutions:** Bundling of matters for consideration that should be put to separate shareholder votes is strongly discouraged. The Team will not generally support if it cannot support one of the underlying elements.

**(iii) Proxy voting disclosure:** The total proxy votes should be disclosed for each resolution at the meeting and should be made available on the company's public website or through a regulatory announcement as soon as practicable after the AGM.

**Donations:** Political donations should not normally be made without the prior approval of shareholders, and where such consent is obtained, it should not be for an indefinite period. Where the prior approval is not possible, political donations should be the subject of a vote of endorsement at the following AGM. The Team discourages direct or indirect donations made to political parties and would vote against a specific resolution of this type. The Team would also consider voting against the report and accounts in the absence of a specific resolution to approve a donation.

**Audit and Auditor Fees:** The audit committee should publish an explanatory report of its own in the annual report and accounts that should state its policy on the appointment, remuneration and rotation of external auditors, as well as how the independence of external auditors is maintained and assured. The committee should also make clear the nature of its relationship with the company's internal audit function. It should also conduct an annual review of internal controls and state that it has done so in the annual report.

In their annual report and accounts, companies should clearly disclose a breakdown of audit and non-audit related fees paid to their external auditors during the year. Non-audit related fees should not be combined into one sum but should be broken down into separate activities and if necessary, explained in the audit committee's own report. The nature of any non-audit work undertaken by the external auditor should be made in the notes to the accounts with additional supporting explanations in the audit committee's own report and an indication as to whether non-audit work is put out to competitive tender. There is no set ratio of audit to non-audit fees that the Team finds acceptable, but in general very large non-audit fees without adequate explanation will be resisted. Conversely, very small non-audit fees which are greater than audit related fees may be looked upon more favorably than if the quantum was substantially higher.

**Contested Takeovers:** The Team reserves its position in the event of a hostile takeover. Support might not be extended to the existing management in circumstances of poor performance or if a very full price is offered.

**Dilution of Equity:** The Team believes a company should be permitted to be able to offer up to 10% of share capital for cash rather than on a rights basis. Existing shareholders should be offered the right of first refusal when a company issues shares exceeding 10% of the existing shares in issue or exceeding a 15% 12 threshold in any three-year rolling period.

The Team also strongly supports the basic principle that overall dilution under all share option schemes should not exceed 10% in any 10-year period with the further limitations of 5% in any rolling 10-year period on discretionary schemes. The Team considers pre-emption to be a basic shareholder right that should not be eroded and will only agree in very exceptional circumstances to waive pre-emption rights. A wide variety of financing options are now available to companies. Companies should explain why a non-preemptive issue of shares is the most appropriate means of raising capital, and why other financing methods have been rejected. They should also disclose the level of dilution of value and control for existing shareholders on, both a proposed and rolling three-year measure and make clear the process they would follow if approval for a non-preemptive issue were to be granted. For example, how dialogue with shareholders would be carried out in the period leading up to the announcement of an issue. Furthermore, the Team would expect companies seeking authority from shareholders to waive pre-emption rights to do so on an annual basis.

**Strategic Report/Business Review:** Companies should publish an enhanced business review to allow shareholders to make an informed assessment of the performance and prospects of the company. This extends to, but is by no means limited to environmental, employment, social and community issues.

The Team strongly encourages companies to publish a forward-looking review as a best practice requirement in the spirit of “comply or explain” and go well beyond bare compliance or boilerplate disclosure. The business review should describe the company’s strategy, and associated risks and opportunities, and explain the board’s role in assessing and overseeing strategy and the management of risks and opportunities. The Team wishes to see a balanced and comprehensive analysis of the company’s performance and prospects; an informative description of principal risks and uncertainties facing the business; and analysis using appropriate financial and nonfinancial key performance indicators.

**Environmental, Social and Governance (ESG):** The Team is conscious that owning a company’s shares on behalf of clients confers certain rights and responsibilities. At the same time, environmental, social and governance issues, and the management thereof, are integral to the sustainability of a business. For this reason, as part of the Team’s investment beliefs it incorporates ESG issues when analyzing and reviewing companies.

The Team has clear voting guidelines on governance issues as laid out in this policy. On environmental and social resolutions at company meetings these are addressed on a case by case basis to reflect the company’s own practices, as well as the specific requirements of the resolution. The Team takes account of ESG reporting in deciding on support for the report and accounts.

**Climate Change:** Regarding voting, the Team considers the merits of shareholder resolutions, including climate related proposals, on a case-by-case basis. In 2020, the Team has incorporated climate change into its voting policy, whereby its proxy advisor (ISS) will be assessing for the majority of its holdings the company’s overall disclosure (governance, strategy, risk management, metrics & targets) and performance factors (norms, GHG emissions, performance rating). Depending on the assessment of how a company is evaluating risks associated with climate change and action being taken, the Team will vote accordingly.

As stated earlier, the Team considers that the board is accountable primarily to its shareholders but recognize that the board should consider the significance of other stakeholders. The Team supports the ABI Guidelines on Responsible Investment Disclosure and would expect to see disclosure in a company’s annual report regarding how it takes account of the significance of these matters to the business of the company and the materiality of any environmental, social and governance risks that impact their operations. The publication of a corporate social responsibility report, whether incorporated in the annual accounts or as 13 a standalone document, is encouraged. However, key risks should be covered in the business review of the main annual report and accounts.

**Disclosure and transparency:** Companies should disclose accurate, adequate, and timely information, in particular meeting market guidelines where they exist, to allow investors to make informed decisions about the acquisition,

ownership obligations and rights, and sale of shares. Clear and comprehensive information on directors, corporate governance arrangements and the company's management of corporate responsibility issues should be provided.

Shareholders should be given sufficient and timely information about all proposals to allow them to make an informed judgment and exercise their voting rights. Each proposal should be presented separately to shareholders – multiple proposals should not be combined in the same resolution. In the absence of sufficient information provided by a company on a proposed resolution, the Team will vote against.

**Shareholder rights:** All shareholders should be treated equitably including minority shareholders. Companies' ordinary shares should provide one vote for each share, and companies should act to ensure the owners' rights to vote. Major strategic modifications to the core business(es) of a company should not be made without prior shareholder approval. Equally, major corporate changes, which in substance or effect, materially dilute the equity or erode the economic interests or share ownership rights of existing shareholders should not be made without prior shareholder approval of the proposed change. Such changes include modifications to articles or bylaws, the implementation of shareholder rights plans or so called 'poison pills', and the equity component of compensation schemes. The Team will not support proposals that have the potential to reduce shareholder rights such as significant open-ended authorities to issue shares without pre-emption rights or anti-takeover proposals unless companies provide a compelling rationale for why they are in shareholder interests.

**Audit and internal control:** Company boards should maintain robust structures and processes to ensure sound internal controls and to oversee all aspects of relationships with external auditors. The audit committee should ensure that the company gives a balanced and clear presentation of its financial position and prospects, and clearly explains its accounting principles and policies. Audit committee members should have appropriate levels of financial expertise, in accordance with prevailing legislation or best practice.

The audit committee should ensure that the independence of the external auditors is not compromised by conflicts of interest (arising, for example, from the award of non-audit consultancy assignments). Where the Team has serious concerns over auditor independence it will vote against the re-election of the auditor.

**Remuneration:** Remuneration of executive directors and key executives should be aligned with the interests of shareholders. Performance criteria attached to share-based remuneration should be demanding and should not reward performance that is not clearly superior to that of a group of comparable companies appropriately selected in sector, geographical and index terms. Requirements on directors and senior executives to acquire and retain shareholdings in the company that are meaningful in the context of their cash remuneration are also appropriate.

The design of senior executives' contracts should not commit companies to 'payment for failure'. Boards should pay attention to minimizing this risk when drawing up contracts and resist pressure to concede excessively

generous severance conditions. Companies should disclose in each annual report or proxy statement the board's policies on remuneration (and preferably the remuneration of individual board members and top executives), as well as the composition of that remuneration so that investors can judge whether corporate pay policies and practices are appropriately designed.

Broad-based employee share ownership plans or other profit-sharing programs are effective market mechanisms that promote employee participation. When reviewing whether to support proposed new share schemes the Team places particular importance on the following factors:

- the overall potential cost of the scheme, including the level of dilution.
- the issue price of share options relative to the market price.
- the use of performance conditions aligning the interests of participants with shareholders.
- the holding period, i.e., the length of time from the award date to the earliest date of exercise; and
- the level of disclosure.

---

RIVER AND MERCANTILE

---

## Important Information

River and Mercantile LLC is an investment advisor registered with the US Securities and Exchange Commission. It is a subsidiary of River and Mercantile Group PLC, a U.K. corporation.

The information and opinions contained in this document do not constitute investment advice and is provided for background purposes only. References to specific securities are provided solely as illustrative examples of River and Mercantile LLC's dba River and Mercantile Asset Management ILC Team's analytical methods and are not a recommendation to buy or sell such securities. This information is subject to updating and verification. Portions of this presentation are based on data provided by third parties whom River and Mercantile LLC deems to be reliable; however, River and Mercantile LLC cannot guarantee the accuracy and completeness of the information.