THE INVESTMENT ASSOCIATION

GOOD STEWARDSHIP GUIDE 2020

March 2020

ABOUT THE IA

The Investment Association (IA) champions UK investment management, a world-leading industry which helps millions of households save for the future while supporting businesses and economic growth in the UK and abroad.

Our 250 members range from smaller, specialist UK firms to European and global investment managers with a UK base. Collectively, they manage £7.7trillion for savers and institutions, such as pension schemes and insurance companies, in the UK and beyond. 40% of this is for overseas customers.

The UK asset management industry is the largest in Europe and the second largest globally.

INTRODUCTION

The way companies go about their business has an impact on much more than their bottom line. Management decisions have an impact close to home – creating jobs, providing opportunities to suppliers and contributing to the economic wellbeing of their local communities.

The bigger the company, the bigger the potential impact. The UK's biggest listed companies, and those on the FTSE 100 in particular, collectively create millions of jobs, pay billions in tax and have a presence in hundreds of communities across the UK.

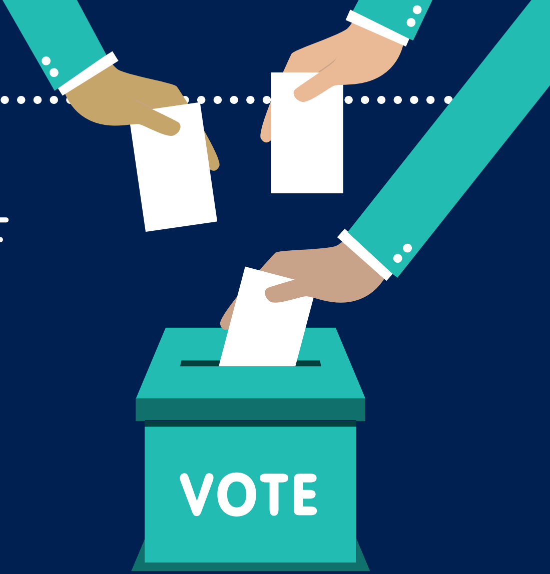
Businesses serve a useful purpose. Not only do they exist to provide goods and services that people want and need but by creating those jobs and paying taxes, companies provide for employees' financial wellbeing, contribute to the identity of communities, and help to fund our public services.

But a company's impact can go way beyond those who interact directly with it. The impact of climate change, for example, goes beyond borders and has the potential to change the fabric of our planet and everyone's way of life.

So the decisions companies take have consequences which are both local and global, environmental and social, as well as financial. Ultimately though this matters to the bottom line too. A company which neglects to understand its impact on people and the planet and doesn't think about the long-term changes to the communities it serves is unlikely to be making sound judgements on the risks and opportunities it will face as a business.

This is why shareholders engage with companies to understand their strategy and how they are adapting their business model to ensure they continue to thrive. The issues that face individual companies are multiple, complex, and sometimes unique to that business. This guide provides an overview of some of the key themes which are common to all UK listed companies and on which shareholders will be shining a spotlight in 2020.

VOTING AT AGMS AND THE ROLE OF SHAREHOLDERS



Listed companies are required to hold an Annual General Meeting (AGM) each year. It is one of the key ways that shareholders – who own shares in the company – hold the board to account for the decisions they make.

Any shareholder owning at least one share in a company can attend and vote at the company's AGM.

Decisions on how to vote are typically informed by views from across the investment business from fund managers and in-house governance experts who talk to the management teams of the companies they invest in all year round. The in-house view is also informed by external research services which provide detailed analysis of listed companies.

The IA's research service, the **Institutional Voting Information Service** (IVIS), provides independent information on listed companies in the FTSE All-Share and FTSE Fledgling Index, to help shareholders reach a decision on how to vote at AGMs. The IVIS team analyse all public documents provided ahead of a company's AGM and produces a detailed report containing key information on voting matters, the company's compliance with the UK Corporate Governance Code, and on environmental, social and governance issues.

The issues voted on at an AGM will include executive pay, appointment and re-election of the company's board of directors, dividend payments, the appointment and remuneration of the company's auditors and the approval of the annual report and accounts.

SHAREHOLDER DISSENT IN 2019

Investment managers kept up the pressure on companies in 2019, with key themes including executive pay and director re-election continuing to top the list of concerns.

Analysis compiled by the Investment Association shows that in 2019, 158 FTSE All-Share companies were added to the IA's Public Register, which tracks significant shareholder dissent at Annual General Meetings or General Meetings.

This was a slight increase on 2018 in which 150 companies were added to the register. Furthermore, 39 companies appeared on the register for the exact same resolution in both 2018 and 2019.

Executive pay continued to feature among the top investor concerns with 62 companies appearing on the register in 2019 for pay-related resolutions. In particular, 31 FTSE 250 companies appeared on the register over pay – an increase of nearly a third (29%). Opposition to individual director re-election also remained a key theme, with the number of resolutions against individual directors remaining constant at 103 in 2019 (105 in 2018).

THE IA PUBLIC REGISTER

In 2017, the Investment Association was asked by the UK Government to establish the world's first Public Register of listed companies which have experienced significant shareholder rebellions (any vote of 20% or more against the management's recommendation is considered significant).

Appearing on the Public Register should act as a warning to companies that their shareholders are concerned about aspects of the company's governance. Once companies appear on the Public Register we expect them to make a public statement on the action they have taken since the vote to address shareholders' concerns.

As the Public Register enters its fourth year, companies are doing more to acknowledge shareholder dissent, with over 80% of firms now making a public statement acknowledging the concerns and outlining how they plan to engage with shareholders – an increase from 55% in the register's first year.

STEWARDSHIP: HOW INVESTMENT MANAGERS HOLD BUSINESS TO ACCOUNT

Investment managers want companies to generate sustainable value over the long term for their clients. The activities undertaken by investment managers to promote the long-term success of companies are collectively known as 'stewardship'.

Stewardship involves looking at a range of issues which impact on the long-term performance of the company. These include strategy and financial performance, corporate governance (including executive pay, diversity of the board and management, succession planning, culture and stakeholder engagement), productivity and capital management, audit and accounting, and environmental and social issues, including climate change.

Stewardship works best when it is focusing on the right issue for the right companies at the right time. Investment managers have a number of tools at their disposal to hold companies to account. One of the most powerful and visible is voting at a company's AGM. But many other equally useful engagements happen all year round.

There are a number of ways in which investors engage with companies:

Setting expectations

Investment managers set out their expectations of companies in their stewardship, responsible investment and voting policies.

Research and Monitoring

Investment managers conduct research and monitor their investments against their expectations. They assess the ongoing risks and opportunities to long-term value and ensure the asset is meeting their clients' investment needs.

Engage

Investment managers engage with the companies they invest in to ensure that their expectations are being met. In dialogue with companies, investment managers raise issues which they think pose a material risk to the company. They want to understand how companies are managing those risks and responding to their concerns or views.

Collaboration and escalation

If investment managers don't think that companies are listening to their views, they consider other options available to them. This might involve working with other shareholders either formally (through organisations such as the Investor Forum) or informally, making public statements or requisitioning resolutions.

Vote

If companies listen to their shareholders then AGMs can take place without significant dissent. Otherwise, investment managers will express a view on the board by voting at AGMs or proposing their own resolutions to be voted on. A company that experiences a significant vote against will be named on the IA's Public Register.

Having taken consideration of these steps and the best interests of their clients, managers of some types of funds may feel that they have no option but to sell their shares. Exit is usually seen as the last resort, when all other approaches and engagement has resulted in no change. This option would not be open to 'index tracking' funds which clients choose because they replicate the performance of a whole index, such as the FTSE 100.

CLIMATE CHANGE

Climate change poses a significant risk to our way of life and will affect individuals, companies and financial markets. The risks associated with the impact of climate change could result in a significant loss of value in listed companies and this will ultimately impact on ordinary savers, whose pensions and savings are invested in these companies.

Climate related risks to companies range from the impact of extreme weather events on business operations and supply chains, to health implications, changes in consumer demand and employee behaviour.

As long-term investors in listed companies, investment managers' ability to create sustainable value on behalf of savers will be driven by how well listed companies identify, manage and mitigate the impact of climate change.

'TCFD' explained

The Taskforce for Climate Related Financial Disclosures (TCFD) is a globally recognised framework for reporting the financial impacts of climate change. It was developed by the Financial Stability Board, an international body established by the G20 in 2009, to monitor the global financial system.

TRENDING IN 2020

1 Climate risk reporting

Investors expect all listed companies to explain in their annual report what impact climate change will have on their business and how the company is managing risks and pursuing opportunities. We support the recommendation in the UK Government's Green Finance Strategy that all listed companies should disclose in line with the Taskforce for Climate Related Financial Disclosures (TCFD) recommendations by 2022.

2 Climate risk governance

Companies should have a governance process in place to manage and oversee their response to climate change, with clearly defined responsibilities for oversight and management. While this is a matter for the whole board, the company may also wish to identify additional roles and responsibilities for the audit, nominations and remuneration committees. It is vital that non-executive directors and other company representatives are equipped with the knowledge to properly engage with investors and other stakeholders on climate related issues.

3 Climate change adaptation

All UK listed companies should adapt or strengthen their business model and strategy to ensure long-term viability in response to climate change. For certain industries, such as energy, this strategy may include pursuing opportunities to contribute to climate change mitigation and adaptation. Investors expect companies to disclose how climate change will impact on their strategy and capital allocation decisions in the future. This may include spending on infrastructure to manage physical risks, acquisitions to transition the business model, and investment in research and development.

DIVERSITY IN LEADERSHIP

Diversity in leadership and across the organisation is essential to building a company which can continue to adapt and deliver value for investors. Different people, with different experiences, bring different outlooks and approaches to the way a business is run.

In 2019, as in previous years, investment managers offered wholehearted support to the UK Government-sponsored Hampton-Alexander Review, which works to increase the representation of women on boards and senior executive positions in companies. In March 2019, the Investment Association and the Hampton-Alexander Review wrote to to 69 of the FTSE 350 companies, outlining concerns about the lack of gender diversity on their board. The letter, which was sent to companies who have no women or just one woman on their board, asked companies to outline what action they are taking to make progress and ensure they are meeting the Hampton-Alexander targets. Last year, 45 more FTSE 250 companies achieved the Hampton-Alexander target of at least 33% of their board being female, taking the total to 111[1].

This is an important year for Hampton-Alexander with more than half of FTSE 250 companies needing to take further action if they are to meet the target by the end of 2020. Hampton-Alexander has been a trailblazer and its approach has rightly been replicated to encourage greater ethnic diversity on UK boards through the Parker Review. Investors expect to see significant progress on ethnicity and gender diversity this year too.

[1] *Hampton-Alexander Review, Improving gender balance in FTSE Leadership, November 2019*

TRENDING IN 2020

1 Women on boards

The Government's Hampton-Alexander Review has set a target of women making up at least one third of every FTSE 350 board by the end of 2020. Investors endorse this expectation as they consider gender diversity to be critical to companies' success. This year is the last in which companies can meet this target ahead of deadline and investors will be putting pressure on companies which are making slow progress against these targets by scrutinising the re-election of directors responsible for promoting board diversity.

TRENDING IN 2020

2 Diversity in senior executive succession planning

While progress on board diversity has been encouraging, there remains significant room for improvement in developing diverse leadership teams. Companies need to go further than looking at gender diversity on their board positions and look carefully at the pipeline of talent in the company's wider workforce. The Hampton-Alexander review also sets a target for women to make up at least 33% of a company's senior leadership team. Investors will be looking carefully at companies' approach to succession planning and how this serves to promote diversity.

3 Ethnic diversity on boards

The Parker Review – an independent review established in 2017 and dedicated to improving the ethnic and cultural diversity of UK boards – has noted that the progress made on gender diversity has not been matched on ethnic and cultural diversity.

The review has set a target for every FTSE 100 board to have at least one director from an ethnic minority background by 2021 (with every FTSE 250 board to do the same by 2024). Other recommendations included developing a pipeline of candidates and mentoring schemes, and enhanced transparency and disclosure of the ethnicity of board members. Investors expect to see companies make progress towards these targets.

EMPLOYEES, CUSTOMERS AND THE COMMUNITY

The prosperity of companies is built by the people who work in them, the communities they operate in, and the customers they serve.

Directors have a duty to promote the success of the company for its owners – the shareholders – and are required by law to have regard for the likely long-term consequences of decisions, and the interests of employees, suppliers, customers and the community.

Companies that are good at managing relationships with these stakeholders and think of the long-term will build a stronger strategy and make better business decisions which will deliver long-term returns for the company and shareholders.

1 Stakeholder engagement

In 2020, companies will have to report for the first time on how their directors take stakeholder interests into account. The relationship between a company and its key stakeholders (such as its employees, customers, suppliers, the environment and communities in which it) is an important determinant of long-term success. In 2018 new laws created requirements for companies to report on how they are fulfilling their duty to have regard for this wider group of stakeholders.

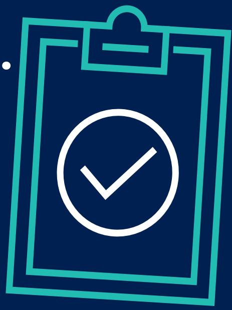
2 Employee voice

The Corporate Governance Code requires boards to disclose how they engage with the workforce to understand the views and concerns of employees – the 'employee voice'. Boards must either appoint a director from the workforce, create a workforce advisory panel, designate a non-executive director to engage with employees, or make appropriate alternative arrangements. Investors expect companies to explain which option they have chosen and why it is the right choice for the company and the people who work in it.

The Corporate Governance Code explained

The UK Corporate Governance Code is a set of best practice principles for corporate governance in listed companies. The Financial Conduct Authority's Listing Rules – the regulations for companies listed on UK stock exchanges – require premium listed companies to apply the principles of the Code.

TRANSPARENCY AND ACCOUNTABILITY



In recent years there have been some high-profile failures in private and listed companies which have had serious implications for these companies, the people they employ, their suppliers, their clients in the public and private sectors, and shareholders.

Businesses are rightly accountable to their owners. It is the responsibility of company boards and management to run the business but shareholders have a right to ask questions about the way the companies are run and whether management are considering the material risks to the long-term health of the company.

Investment managers own shares on behalf of clients and in the UK they own roughly one third of the value of shares in UK PLCs. This money is often managed on behalf of pension savers and insurance companies. Shareholders need high quality audits so they can have trust in the information companies provide, they expect transparency in the decisions that companies make, and they expect accountability mechanisms to exist so that executives will not profit from poor performance.

TRENDING IN 2020

1 Transparency on audit quality

Investors expect audit committees to explain in audit committee reports the steps they have taken to ensure a high quality audit. If there has been a tender for the audit of the company then the committee should be transparent as to why it recommended a particular auditor and why they considered that firm would provide a quality audit. Every year audit committees should assert whether they believe the auditor has provided a high quality audit, been challenging enough, looked at and questioned the granularity of key accounting issues and how the auditor challenged management's judgement and assertions, and exercised professional scepticism.

2 Pay for performance

Levels of pay that do not reflect corporate performance are a matter of deep concern to shareholders. Shareholders object to levels of pay that do not respect the core principles of paying no more than is necessary and expect a clear link to sustainable long-term value creation. In order to incentivise an interest in the long-term health of the company after executives have left, shareholders expect executives to retain a proportion of their shareholding for at least two years. Remuneration policies should give remuneration committees the discretion to withhold a bonus ('malus') and recover sums already paid ('clawback') where payments were not warranted by the company or executive's performance or conduct.

3 A policy for dividends

The IA wants companies to publish a 'distribution policy' setting out their approach to paying dividends to shareholders. This new policy should set out the company's approach to dividend payments alongside other ways of returning capital to shareholders, in order to promote a more transparent, long-term approach.

PAY

In recent years there has been a firm focus on the pay of senior executives, with public concern expressed that executive pay doesn't always match company performance.

As important as executive pay – and in many respects more important to most people – is the pay that the rest of the workforce receives. The past decade has been characterised by wage stagnation which has been linked to a decade of stagnant productivity in the economy.

Companies are already required to publish their gender pay gaps and 2020 will be the first year in which large companies are required by law to publish the pay ratio between the chief executive and the average worker. Pay is an important part of incentivising the workforce and investors expect company boards to consider the pay and conditions in the wider workforce.

1 Explaining pay for all employees

Investors expect company remuneration committees to look at their wider workforce remuneration policies when deciding how much to pay chief executives and other highly paid employees. When complying with reporting obligations in relation to workforce pay, such as the Gender Pay Gap Reporting or executive to employee pay ratios, shareholders expect the company to fully explain these figures and why they are appropriate or state how the company intends to improve the situation. Gender Pay Gap Reporting is now in its third year and investors will be looking to see improvements on the previous year alongside clearer explanations of how they plan to close the gap.

2 Pension contributions

Pension contributions for executives should be aligned with pension contributions for the majority of the workforce. Investors question why board directors should be awarded much higher contributions in addition to their pay, bonus and incentive packages. New remuneration policies should state that any new executive director will have their pension contribution set in line with the majority of the workforce and pension contributions to existing directors should be brought in line with the rest of the workforce by the end of 2022.

3 Reporting pay ratios

New pay ratio reporting requirements came into force in January 2019, with most companies being legally required to report against them in their 2020 Annual Reports. The IA has supported the introduction of pay ratios and requested companies disclose them for a number of years and investors will be looking at this year's pay ratios with interest.

MORE WHERE THIS CAME FROM...

This report draws heavily on the position statements and guidance produced by the Investment Association and IVIS. To find out more about the attitudes and expectations of Investment Association members on issues including executive remuneration, audit, and long-term reporting visit **ivis.co.uk/guidelines**

The IA's Public Register of FTSE All-Share companies who have received significant shareholder opposition can be found at **theinvestmentassociation.org/publicregister**

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