

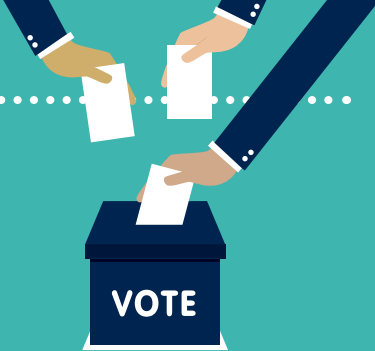
THE
INVESTMENT
ASSOCIATION

GOOD STEWARDSHIP GUIDE 2019

March 2019



INTRODUCTION



The London Stock Exchange features some of the world's oldest, best known, and most respected companies. FTSE 100 companies alone employ nearly five million people in the UK and overseas and in 2018 they generated £84.1 billion in taxes¹, making up one eighth of total government tax receipts.

The health of the UK's listed businesses is of great importance to the economic wellbeing of the wider country – providing jobs, using the services of small businesses, and paying taxes to help fund hospitals, schools and our defence and security.

It is when these companies run in to trouble that it becomes most clear how important they are. The near-collapse of AIM listed Patisserie Valerie in late 2018 put nearly 3,000 jobs at risk. At the time of its collapse in early 2018, the construction company Carillion had 43,000 employees, a pension obligation to 27,000 people and nearly 30,000 companies in its supply chain.

In 2017, the UK-based investment management industry had £920 billion invested in UK stocks and shares, representing roughly one third of the value of UK listed companies, and with this comes power and responsibility. This money, invested on behalf of large institutions and individual savers, ultimately belongs to the members of pension schemes and others who are trying to grow the value of their money for the future.

Asset managers know the responsibility they hold as both the stewards of people's money and towards the companies in which that money is invested. They live up to this responsibility all year round by engaging with companies and holding them to account but it is the annual AGM season when these stewardship activities really comes into the spotlight.

Through AGM votes, shareholders have an annual opportunity to publicly express and use their voting power to demonstrate their satisfaction, or dissatisfaction, with the way the company is managed and the people who run it. In this report we set out some of the important factors that shareholders consider when they are assessing the future prospects of a company. In each section we highlight the trending topics that we expect to be a key focus of shareholder scrutiny and voting activity throughout 2019 and at this year's AGMs. Shareholders will be asking questions of company boards about these issues throughout the year but the AGM season is their opportunity to publicly express their concerns through votes if they don't think they are being listened to.

¹ PwC, 2018 Total Tax Contribution survey for the 100 Group, 2018

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 businesses, including from fund managers and in-house governance experts. The in-house view is also informed by external research services which provide detailed analysis of listed companies.

The IA's own 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 IA's 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 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 reports and accounts.



STEWARDSHIP: HOW ASSET MANAGERS HOLD BUSINESS TO ACCOUNT

Asset managers want companies to generate sustainable value over the long term for their clients. The activities undertaken by asset 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.

Stewardship works best when it is focusing on the right issue for the right companies at the right time. Asset 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:

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- Voice**  In dialogue with companies, asset managers raise issues which they think pose a material risk to the company and want to understand how companies are managing that risk all year round. They set out their expectations of companies and speak to people at the companies they invest in to ensure that their expectations are being met.
 - Escalate**  If asset managers don't think that companies are listening to their views, they take their engagement up a level. This might involve getting together with other shareholders or making public statements.
 - Vote**  If companies listen to their shareholders then AGMs can take place without significant dissent. Otherwise, asset 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**.
 - Exit**  Having taken consideration of the previous steps and the best interests of their clients, asset managers 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.
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SHAREHOLDER REBELLIONS: THE PUBLIC REGISTER


In 2017, the Investment Association established a Public Register of UK listed companies which have experienced significant shareholder rebellions (any vote of 20% or more against the management's recommendation is considered significant). The Public Register shines a light on companies which are acting out of line with the expectations of their major shareholders on issues like pay and the appointment of board directors.

Analysis of AGM votes in 2018 has shown that shareholder rebellions are on the rise. Out of more than 640 companies on the London Stock Exchange's main markets 1 in 4 (151) experienced significant dissent, up from 110 companies in 2017.

Opposition to individual director re-election was a key theme, with the total number of resolutions increasing from 66 in 2017 to 105 in 2018. There was also a sharp rise in objections to FTSE 100 pay. 18 resolutions attracted over 20% shareholder dissent among FTSE 100 companies in 2018, up from 10 in 2017.

The Public Register aims to help focus public and media attention on how companies respond to the concerns of their shareholders. 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.

Appearing on the Public Register should act as a warning to companies that their shareholders are concerned about aspects of the company's governance. Many companies are taking the necessary action and engaging with their shareholders. Those who do not will experience further scrutiny from investors in the future.



...on the London Stock
Exchange's main markets **1 in 4**
experienced significant
dissent in 2018

PEOPLE AND CULTURE



At the heart of nearly every business is its workforce. We all know how important it is to feel happy and valued when we go to work and shareholders know how important a well-motivated workforce is to the long-term success of a business.

Whether it is diversity of thought, experience and background in the boardroom or maintaining a healthy corporate culture throughout the business, shareholders are interested in the people who work for companies and how they are treated.



BP among 35 firms 'failing to meet board gender targets'

By Holly Williams

The oil company BP and several other firms were among the UK's biggest firms to have failed to meet the 25% target for female board members for the first time since the target was introduced in 2011.

The FTSE 100's gender diversity index fell to 21.8% in 2014, down from 22.5% in 2013, according to the FTSE 100 Gender Diversity Index. The index tracks the percentage of female board members on the boards of the 100 largest UK companies.

BP was among the 35 firms that failed to meet the target, with only 18% of its board members being women. Other firms that failed to meet the target include BT, British Airways, and British Petroleum.

The FTSE 100's gender diversity index has been falling since it was introduced in 2011. In 2011, the index was 25.1%, but it fell to 22.5% in 2013 and 21.8% in 2014.

The FTSE 100's gender diversity index is calculated as the percentage of female board members on the boards of the 100 largest UK companies. The index is published by the FTSE Group.

The FTSE 100's gender diversity index is a key indicator of a company's commitment to diversity and inclusion. It is also a key indicator of a company's performance on environmental, social and governance (ESG) issues.

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14 companies in the FTSE 100 have failed to meet the 25% target for female board members for the first time since the target was introduced in 2011.

TRENDING
IN 2019

1 Board diversity

The Government's Hampton-Alexander review has set a target of women making up at least one third of every FTSE 350 board by 2020. Investors endorse this expectation as they consider gender (and other forms of) diversity to be critical to companies' success. Investors will be putting pressure on companies who are making slow progress against these targets by scrutinising the re-election of directors responsible for promoting board diversity.

2 Employee voice

The new Corporate Governance Code introduced in 2018 requires boards to 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 appropriate alternative arrangements. Investors will expect companies to explain which option they have chosen and why it is the right choice for the company and the people it employs.

3 Healthy corporate culture

A healthy corporate culture is a valuable asset, a source of competitive advantage, and vital component in the creation and protection of long term value. Shareholders will assess a company's culture by considering metrics such as executive pay, the outcomes of employee and customer surveys, as well as their own experiences of interacting with the company, employees, management, and board.

4 People and productivity

How a company is managing and incentivises its workforce is a key driver of productivity. A well-engaged, stable, and trained workforce is likely to be more productive which in turn drives long term business success. This issue is deserving of more transparency from companies. Investors expect them to set out how they are working to improve the productivity of their workforce.

FAIR PAY



Fair pay is another important part of incentivising the workforce and protecting the reputation of a business with the wider public. First and foremost, remuneration policies should support performance, encourage the sustainable financial health of the business and promote sound risk management for the success of the company and to the benefit of all its stakeholders.

Undeserved and excessive remuneration sends a negative message to all stakeholders, including the company's workforce, and causes long-term damage to the company. Investors expect company boards to consider the pay and conditions in the wider workforce when setting executive pay.



1 Fair pensions

Pension contributions for executives should be aligned with pension contributions for the majority of the workforce, as a matter of fairness. If the majority of the workforce get an 8% pension contribution, it is unacceptable for board directors to 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 reduced over time.

2 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 state how the company intends to improve the situation. Gender Pay Gap Reporting is now in its second year and investors will be looking to see improvements on the previous year alongside clearer explanations of how they plan to close the gap.

3 Reporting pay ratios in 2019

New pay ratio reporting requirements came into force from 1 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. Given the methodology for calculating pay ratios is now set, we encourage companies to report their pay ratios this year.

ACCOUNTABILITY

Some remuneration committees have been too slow to respond to investor concerns and too quick to side with management.

Investors expect directors to have the foresight to make appropriate provisions to limit pay in the event that the company performs badly or fails. Executive and non-executive directors should have the ability to use discretion and should consider the reputational impact – with employees, suppliers, shareholders and the wider public – of taking high salaries and bonuses while a business has got into trouble.

Last year's AGM season saw a dramatic increase in the number of individual directors receiving a significant level of dissent from shareholders. This is for a number of reasons but includes accountability for the decisions made by individuals as members of the remuneration committee.





1 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. It is unacceptable that poor performance by senior executives can result in excessive payments to departing directors.

2 Retaining shares

In order to incentivise an interest in the long-term health of the company after executives have left, shareholders expect them to retain a proportion of their shareholding for at least two years.

3 Malus and Clawback

Remuneration policies should give remuneration committees the discretion to withhold a bonus ('malus') and recover sums already paid ('clawback') where warranted by the executive's performance or conduct. The circumstances in which performance adjustment and clawback can be implemented need to be agreed and documented before awards are made. In order to help the enforcement of clawback, it is important that the terms are clearly set out and accepted by the executive director.

AUDIT AND REPORTING



Investors rely on the information in a company's annual report and accounts to provide them with the information they need to make investment decisions and fulfil their responsibilities as shareholders. The audit market exists to provide investors with this assurance and the AGM provides an opportunity for shareholders to approve accounts and reappoint the auditor.

It is vital that audits are high quality, trusted and there is a well-functioning market for audit services. Recently there have been some high-profile failures which have had serious implications for companies, the people they employ, their suppliers and shareholders.



1 Transparency on audit quality

Investors would like audit committees to give more insight into the steps they have taken to ensure a quality audit in their audit committee reports. If there has been a tender then the committee should be transparent as to why it recommended a particular auditor and considered that firm would provide a quality audit. Every year audit committees should assert whether they believe the auditor has provided a 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 Improving viability statements

Companies are required to provide information to stakeholders about the economic and financial viability of the company over the period of their assessment and to explain what the directors are doing to preserve it. Investors are concerned that viability statements have become too short-term in their focus, tending to cover a three or five year period. Investors expect viability statements to show a greater differentiation in the time periods and regard for long-term risks by including long-term scenario analysis.

3 Audit tender process

It is vital that the audit committee ensures any tender is planned carefully and well in advance. When a company plans to enter into a tender it should also contact major investors so they can engage with it on the process. Investors expect a wide range of audit firms to be invited to tender, and except for large multi-nationals, not just restricted to the main four firms. To ensure there is a range of candidates it is critical that companies ensure that likely candidates are not providing prohibited non-audit services which would preclude them from participating before they go out to tender.

PRODUCTIVITY AND LONG-TERM THINKING

Management that is concentrated on short-term performance is not conducive to building a sustainable business. Rather, it can come at the expense of investments in the long-term drivers of company productivity and sustainable value creation.

A company that focuses on the longer term underpins investor confidence, and facilitates enduring relationships between companies and shareholders.

Improving productivity can increase wages, improve living standards, and enhance company performance. Stronger and more productive businesses can help to deliver long-term investment returns.





1 End quarterly reporting

Quarterly reporting is a distraction that shifts company resources away from long-term strategic considerations. The practice risks promoting myopic behaviour by senior management who channel their focus on short-term fluctuations in performance, resulting in the risk of managing the market, rather than managing the business. We therefore call for companies to cease reporting quarterly and refocus reporting on a broader range of strategic issues.

2 The drivers of productivity

Companies are encouraged to regularly assess productivity levels, and explain its impact on operations. They should set out in their strategic report the main drivers of productivity within the business, how they are regularly assessed and the planned investments to improve productivity over the next year.

3 Board oversight of profit expectations and dividend policy

Investors expect companies to accurately assess the value of assets and future profit expectations. It is inappropriate and gives little confidence to investors, when these are suddenly written down when new management is brought in – this implies that underlying risks have been ignored. Investors will hold the independent directors to account when there is a significant revaluation of assets, profit forecasts and dividend policy following the appointment of new management.

ENVIRONMENTAL AND SOCIAL RISKS AND OPPORTUNITIES

Sound management of significant environmental and social risks and opportunities by a company's board can have an important, positive effect on the business's ability to generate sustainable value for its shareholders.

Shareholders encourage companies to demonstrate how they are managing material environmental and social risks. They also want to understand how companies are positioned to create sustainable value by responding to social and environmental opportunities. This could be in response, for example, to anticipated regulatory changes and shifting social attitudes in consumers.





1 Board responsibility for ESG

Accountability for environmental and social impact starts at the top. A company should state in its annual report whether its board takes account of the significance of environmental, social and governance (ESG) risks to the company and how it has identified and assessed the significant ESG risks to the company's short and long term value.

2 ESG in annual reports

The annual report should set out the environmental and social risks that the board has identified and provide an explanation of the company's policies and procedures for managing those risks. If the Annual Report and accounts states that the company has no such policies and procedures, the board should explain why.

3 ESG issues being considered by the remuneration committee

The company's remuneration committee should explain how it has linked the company's performance on ESG issues to the remuneration of executive directors. The remuneration committee must ensure that the incentive structure for senior management does not raise ESG risks by inadvertently motivating irresponsible behaviour.

MORE WHERE THIS CAME FROM...

This report draws heavily on the position statements and guidance produced by the Investment Association and IVIS. Readers wishing to build a greater understanding of the attitudes and expectations of Investment Association members on issues including executive remuneration, audit, and long-term reporting are advised to visit [ivis.co.uk/guidelines](https://www.iais.co.uk/guidelines)

You can find the IA's Public Register of FTSE All-Share who have received significant shareholder opposition at [theinvestmentassociation.org/publicregister](https://www.theinvestmentassociation.org/publicregister)

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.



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