RESPONSE TO BEIS CONSULTATION ON INSOLVENCY AND CORPORATE GOVERNANCE

JUNE 2018

ABOUT THE INVESTMENT ASSOCIATION

The Investment Association is the trade body that represents UK investment managers, whose 240 members collectively manage over £6.9 trillion on behalf of clients.

Our purpose is to ensure investment managers are in the best possible position to:

- Build people's resilience to financial adversity
- Help people achieve their financial aspirations
- Enable people to maintain a decent standard of living as they grow older
- Contribute to economic growth through the efficient allocation of capital

The money our members manage is in a wide variety of investment vehicles including authorised investment funds, pension funds and stocks & shares ISAs.

The UK is the second largest investment management centre in the world and manages 36% of European assets. IA members hold in aggregate, 34% of UK publicly listed companies.

More information can be viewed on our website.

EXECUTIVE SUMMARY

The Investment Association (IA) is pleased to provide input to BEIS' consultation on Insolvency and Corporate Governance. Asset managers consider it essential that company Boards operate in the long-term interests of the company. Well run companies that take a long-term approach are more likely to deliver long-term returns for their clients (asset owners). As stewards of their clients' assets, our members conduct considerable stewardship activities with the companies in which they invest from research and analysis, voting at AGMs, questioning companies on their strategy, to working with other investors to discuss concerns.

In most cases, the investment chain works well and the interests of asset owners, asset managers and companies are aligned. It is in investors' interests for the companies in which they invest to uphold the highest levels of corporate governance, including the decision making of their Directors, as this will act to promote the success of the company and generate long-term value for shareholders as well as other key stakeholders such as employees.

Where a company is facing challenges, which may have the potential to result in insolvency, stewardship can help a company to improve its prospects if the underlying business is viable and if the company is receptive to constructive engagement with shareholders. Good stewardship alone cannot prevent company insolvencies where the underlying business is unviable. In light of recent major company failures, such as Carillion, it is right for the Government to consider the role that good investor stewardship can play in improving Director accountability and raising concerns about companies. Unfortunately, strong stewardship cannot be a replacement for strong Board governance and reporting. Evidence has emerged in the case of Carillion that there were clear challenges in both these areas.

Improving Director Accountability

Investors think it is important that Directors of companies are held accountable and appropriately sanctioned for failing to fulfil their duties, whether this negligence results in insolvency or not. It is equally important that sanctions do not increase personal liability in a way that would dis-incentivise good Directors from joining Boards of companies in need of turnaround or otherwise provide perverse incentives whereby it is safer for a Director to put a company into administration instead of considering the sale of subsidiaries or other transactions.

We do, however, consider that new measures are needed to ensure that Directors take proper account of their duties, *in all circumstances*, and not only with respect to the sale of an insolvent subsidiary, as there is currently no single regulator responsible for holding Directors to account for fulfilling their duties.

Government should reassess the current framework for the sanctioning of Directors and appoint a single body to be responsible for Director sanctions when individuals have been negligent in fulfilling their duties.

The development of such a body is the best starting point to improving Director accountability, and will send a strong signal to Boards that Directors who negligently ignore their duties are under scrutiny. It will also complement the recently announced reporting requirements on s.172.

Stronger stewardship

There are a number of ways in which the stewardship environment in the UK can evolve and continue to be at the forefront of international best practice. We think this can be done by:

- **Improving public reporting by asset managers on how they have carried out their stewardship activities and fulfilled their stewardship policies; and**

- **Developing more demanding and discerning asset owners in order to develop market practice and increase competition in the industry on stewardship.**

- One possible approach to improving Director accountability via investors stewardship activity, **is to create the opportunity for shareholders to privately raise concerns to a regulatory authority** regarding a company's corporate governance, risk management or other material issues such as fulfilment of the Directors duties where shareholders have escalated and exhausted the limits of their engagement activity with that company. This authority could then take a decision on whether to investigate a company or individual Directors based on the information received through this reporting mechanism and other intelligence. It would be likely that the authority would focus on those companies where similar concerns are received from a number of shareholders. This could be the same regulatory authority that is responsible for Director sanctions proposed above.

In terms of the specific proposals to improve stewardship put forward in this consultation:

- We support the suggestion to amend the Stewardship Code to focus on long-termism – as the existing Code does not currently make a sufficiently explicit connection between shareholder engagement and promoting medium to long term value and capital efficiency.

- There are mixed views amongst our membership as to how useful a stewardship oversight group could be. Some question what additional role such a body could play when there are already a number of mechanisms to review significant company failings. Others, more enthusiastic about the role of such a body, feel that any organisation set up to review these events would need to be given sufficient access and powers to be effective.

- We do not think it is necessary for there to be a requirement in the Stewardship Code for asset managers to monitor Directors' adherence to s.172 at this stage, as we expect asset managers to fully incorporate new publically available information from the new reporting requirement for companies into their analysis and engagement. We have also noted how the refocussing on Director Duties through the s.172 reporting requirement should encourage Directors to have better regard to these duties when commissioning professional advice and therefore exercise greater autonomy over the use of this advice in their decision making process.

- We have expressed concern that if "strategy and stewardship meetings" are mandated by government as a compliance exercise there is a danger that they simply manifest as 'governance road shows' rather than as an opportunity for meaningful engagement.

Improved company disclosures

Carillion's collapse highlighted potential inconsistencies between the company's reporting of their financial position and the reality of their situation. Capital allocation decisions in particular play a vital role in determining a company's long term success and are viewed by our members as some of the most important responsibilities of company management. Companies need to provide more meaningful information on their group structures and capital management strategies:

- **Government should mandate companies to include organograms of group structures in their annual reports,** with information regarding key dependencies between subsidiaries, to make this information more accessible to investors and other stakeholders.

- **Government should consider giving regulatory backing to IA initiatives to improve company disclosure of their capital allocation strategies** (including the viability and appropriateness of the dividend payment) and how this relates to their strategic plans.

- **We have also suggested that Government should mandate a once yearly shareholder vote on dividend policies,** to ensure that companies can be held to account for their dividend payment decisions.

Corporate governance standards are currently under a great deal of scrutiny and there are several ongoing initiatives and investigations to ensure that standards remain high. Several of the initiatives put forward in the Corporate Governance Reform Green Paper are in the process of being implemented via the updated Corporate Governance Code review and the publication of new Statutory Instruments. These initiatives will take some time to produce results and effect change.

RESPONSES TO QUESTIONS

SECTION 1 – SALES OF BUSINESSES IN DISTRESS

1. **Do you think there is a need to introduce new measures to deal with the situation outlined?**

New measures are needed to ensure that Directors take proper account of their duties, *in all circumstances*, and not only with respect to the sale of an insolvent subsidiary. We do not agree with the 'new measures' proposed in this consultation, as they would result in a number of challenges to credible business rescue efforts. An alternative measure to deal with the situation outlined involves the development of a single effective, consolidated Director Sanction regime.

The proposal in this consultation is to make company Directors liable for losses following the sale of a group subsidiary where:

- The group subsidiary was insolvent at the time of the sale, or insolvent but for guarantees provided by other companies or Directors within the group;
- The subsidiary enters into administration or liquidation within two years of the completion of the sale (and there need not be any causal link between the sale of the company and the subsequent failure);
- The interests of its creditors have been adversely affected between the date of the sale and the liquidation; and
- The Director could not have reasonably believed that the sale would lead to a better outcome for those creditors than placing it into administration of liquidation.

The impact of insolvencies can sometimes be reduced if the Directors take early action, creating an orderly wind down which can protect value for creditors. This requires Directors to be honest about how close to an insolvency the company is, and whether rescue opportunities are viable. We note that the Government consulted on the Insolvency Framework in 2016, which considered a wide range of measures to support the orderly wind-down of companies facing insolvency. We still await the policy outcomes of this consultation.

We are concerned about the wider ramifications of this proposal on Director behaviour. When taking on a Directorship, individuals will consider the potential risks of taking on that responsibility to their personal reputation, as well as the various mechanisms by which they will be publicly held to account in that post, for example via the Senior Managers and Certification Regime for Directors in financial services firms or via shareholder accountability with their individual re-election at the company's AGM. Extending the potential for personal liability in this way could dis-incentivise individuals from taking up Directorships, particularly at those companies facing financial difficulties or in turnaround situations, constricting the pool of talent that can help develop economic value in these companies. Another concern is that these proposals could also have the effect of Directors taking the less risky option of putting companies into insolvency in order to mitigate potential personal liability when the company is in financial distress rather than pursuing rescue opportunities. The Government may envisage that these proposals would only impact a very small number of subsidiaries, however, the extension of personal liability for Directors more generally could impact on all companies.

We are also concerned that extending Director liability up to two years after a subsidiary has been sold is more onerous for Directors than the current 'Going Concern' requirement in s.714 of the Companies Act which only requires to confirm the business will be viable and meet its obligations as they fall due over the next 12 months. There are similar provisions in the Accounting Standards and UK Corporate Governance Code. We are unclear why a different regime is required or appropriate in these circumstances.

Proposals to improve Director accountability should focus first on creating a strong, credible sanctioning regime under one regulatory body, as set out below. Our member's primary concern is that Boards operate in the long-term interests of the company which is likely to have a positive impact on the economy and generate long term returns for shareholders. To do this, businesses need to be run by an effective Board that complies fully with their duties under s.172 of the Companies Act 2006. We believe that current Director Duties as set out in law are the right ones and set the right framework for Directors to fulfil these responsibilities.

However, there is currently no clear and consistent regime for disqualification of Directors and sanctions for ignoring the duties set out under s.172. There is a mismatch of sanctioning regimes that are held between the regulators, government departments, courts and other bodies; this has meant that where there have been clear breaches in the past, there has not seemed to be processes used for investigation or sanction. Negligence that takes place outside of an insolvency context, for example, is rarely addressed.

While the vast majority of companies maintain high standards of conduct, recent cases, including those that motivated the content of this consultation, have highlighted that some Directors could be negligent of their duties without recourse. In the case of Carillion, the BEIS Select Committee report concludes that its Board of Directors were culpable for the company's failure and there were clearly not sufficient deterrents in place to prevent Carillion's Directors from being negligent of their duties.

Shareholders can play a role in enforcement, either in terms of engaging privately with companies where Directors are not seen to be working in the interest of the company, which can lead to Directors being removed. This can also be done publicly through the right to re-elect Directors. The new S.172 reporting requirement should also improve compliance. Requiring Directors to explain how they have complied with their duties, will force Boards to carefully scrutinise their behaviour in this respect resulting in improved compliance.

However, it is not solely for shareholders to enforce the provisions of s.172; this engagement needs to be backed by a credible and consistent sanctioning regime so that those who are negligent of their duties are properly held to account, including where they have been negligent in respect of the sale of a company.

The Government should therefore reassess the current framework for the disqualification and sanctioning of Directors who have been negligent in carrying out their duties. The Government should appoint a single body to be responsible for Director sanctions.

This single body should have sufficient powers to investigate and apply sanctions, including Director disqualification, in the case of all misconduct, so that sanctioning is not limited to misconduct that has been brought to the body's attention as a result of insolvency.

The development of such a body is the best starting point to improving Director accountability, sending a strong signal to Boards that their compliance with their duties is under scrutiny.

2. **Should the new measures be limited to the sale of a subsidiary or should a new measure extend to any act procured by the parent (through its Directors), which operates to the prejudice of the creditors of the subsidiary once that subsidiary is insolvent? Might such measures create material conflicts for Directors? If so, how might they be resolved?**

We do not think these measures should be introduced – see Question 1.

3. **Should the target be the parent company Directors responsible for the sale? If not, who else should be targeted; or who in addition?**

We do not think these measures should be introduced – see Question 1.

4. **How can we ensure that there is no impact on sales which genuinely seek to rescue distressed businesses, or bring new investment into distressed businesses?**

We are concerned that this proposal will impact on sales which genuinely seek to rescue and bring new investment into distressed businesses as set out in our response to Questions 1 above. We believe a better starting point is to ensure that there is a robust Director sanctioning regime in place to deter against misconduct.

SECTION 2 – VALUE EXTRACTION SCHEMES

5. **Are new tools needed to enable insolvency office-holders to better tackle this behaviour? Or could existing antecedent recovery powers be expanded to ensure this behaviour is tackled?**

N/A – this questions is not of particular relevance to our membership.

6. **Do you agree the Government should introduce a value extraction scheme reversal power as outlined above? Do you agree that the insolvency test in the current powers is not appropriate in the circumstances outlined above?**

As investors in fixed income securities, our members have seen instances where value extraction schemes have eroded value for long-term debt holders. We therefore agree that the Government should consider whether better oversight of these schemes is needed. We are concerned however that the proposal in this consultation could dis-incentivise new investment into distressed businesses.

It is important that the legal framework for distressed investment does not discourage new investment in companies where the underlying business could be viable over the long term. Each business approaching insolvency or facing financial difficulty is unique; we are concerned that, if formulated too broadly, the attempt to limit "unfair value extraction" could act to dis-incentivise new investment into distressed businesses as this would not allow sufficient flexibility to devise financing options most appropriate to the business.

Before introducing legislation in this area, the Government should develop guidance that includes case studies to clearly define what it considers "unfair and excessive value extraction" and to look at what a "good" rescue transaction looks like. Government should also ensure that any further work to develop legislation in this area encompasses value extraction schemes both with respect to the sale of subsidiaries and where changes of ownership of subsidiaries are conducted outside of a formal sale.

7. **Could the proposal adversely affect the availability of finance for distressed companies? Could it have other adverse effects? If so, how might the proposal be modified to mitigate these effects? Are there any protections that should be given to investors?**

We are concerned that the proposals are currently too broadly formulated and might limit flexibility in providing the right financing options for companies. This could lead to fewer sales of businesses with Directors putting subsidiaries into administration rather than exploring turnaround opportunities. As a starting point, the government should produce further guidance in this area.

8. **How could the proposal be developed to ensure that only those schemes which unfairly extract value and harm the interests of other creditors can be challenged by the insolvency office holder? Should concepts such as "unfair" and "excessive" be defined or left to the courts to develop through case law?**

We think it would be more helpful for to Government to clearly define what "unfair and excessive" value extraction schemes are, as per our answers questions 6 and 7.

SECTION 3 – DISSOLVED COMPANIES

9. **Do you agree that there is a problem in this area and that action should be taken to prevent Directors from avoiding liabilities and scrutiny by dissolving their companies**?

N/A.

10. **Do you agree that Director conduct in a dissolved company should be brought within the scope of the Secretary of State's investigatory powers? Do you have any other comments on the proposal?**

Directors ought to be held accountable for misconduct whether the company under consideration is dissolved, insolvent, or actively trading. Any new powers introduced to consider Director sanctions however should be brought into consideration for the scope of powers of a new consolidated, Director sanctioning regime.

SECTION 4 – STRENGTHENING CORPORATE GOVERNANCE IN PRE-INSOLVENCY SITUATIONS

11. **Are stronger corporate governance and transparency measures required in relation to the oversight and control of complex group structures? If so what do you recommend?**

There should be improvements in number of areas relating to the disclosure of group structures so that investors can have the right information to hold companies to account for their governance structure, strategy and approach to risk management.

Each company is unique, and needs to retain flexibility over how it is structured to best serve its business needs. In general it is not in a company's interests to have overly complex, unwieldy corporate structures as this makes governance more challenging and reduces operating efficiencies. Indeed, our members will typically consider unwieldy structures to be an indicator of poor governance standards; in their engagement with companies, investors will often challenge Boards to explain how their group structure supports their business strategy.

A number of improvements will help investors to hold companies to account:

- There should be greater visibility of the current list of subsidiaries in a group structure.

- It should be easier for companies to rationalise complex group structures and dissolve dormant companies.

- The information presented to investors on group structures ought to be presented in an accessible and meaningful way e.g. through organigrams rather than long lists of subsidiaries. It is helpful where these organisational charts also explain key dependencies between subsidiaries, for example parent guarantees. It would be helpful for Government to mandate companies to make these disclosures through the current reporting requirements.

- Companies should provide better explanations of how the structure relates to the business model and strategy of the group in their engagement with shareholders.

- It is clearly an expectation of investors that companies have appropriate record keeping of their Directors. Investors would like to see evidence of clear central oversight and record keeping on the Directors of all of the subsidiaries in a group.

- Investors expect large and complex groups to have their own in-house internal audit function.

12. What more could be done through a revised Stewardship Code or other means to promote more engaged stewardship of UK companies by their investors, including the active monitoring of risk? Could existing investor initiatives to hold companies to account be strengthened (e.g. through developing the role of the Investor Forum)? Could better arrangements be made to ensure that lessons are learned from large company failings and controversies?

The UK is internationally recognised as a leader on stewardship; UK institutional investors have a long track record of working with the companies they invest in to ensure their long-term success. There is a need for continuous improvement for stewardship in the UK; we would like to see the role of stewardship grow further and improve its effectiveness. We set out below a number of ways in which the IA would like to see the market for stewardship improve. To provide context for these recommendations, we have also sought to clarify the extent and limit of stewardship activities and the role that investors can play in holding companies to account.

Asset Managers seek to generate long-term returns for their clients, asset owners - typically pension funds and insurance companies. Our members believe that well run companies that take a long-term approach will deliver better value for their clients. Stewardship describes all the activities that investors conduct which aim to promote the long-term success of companies so that the ultimate providers of capital will also prosper. Stewardship activity extends far beyond voting activity at a company's AGM and will involve research, individual engagement and collective engagement with other investors on a range of topics considered instrumental to the long term success of the company including company strategy and performance, governance, diversity and capital management.

When all of the different actors in the investment chain work together, the responsibilities and interests of asset owners, investors and businesses are all aligned:

- Directors are appointed to manage and control the company's business. The primary responsibility of the Board is, through its senior management, to promote the success of the company over the long-term. Executive Directors run the business on a day-to-day basis. They are also responsible for developing a strategy, managing the operation of the business, formulating clear objectives, monitoring performance and identifying the key risks facing the business. Non-executive Directors are the independent representatives of shareholders on the Board. All Directors owe the same duties to the company, including the duty to exercise independent judgement. Non-executives both support and challenge the decision making process on the Board and, ultimately, the formulation and execution of the company's strategy. The balance between support and challenge is crucial.

- Asset managers are motivated to engage with the companies they invest in, in accordance with the Stewardship Code, to assure that they are being well run and will be sustainable in the long term. This will involve conducting analysis and research on the company they are invested in, to come to their own assessment regarding the companies' ability to generate long term value, as well as setting out clear expectations to companies they are invested in on the standards they are expected to adhere to. An important division of responsibility is that shareholders cannot and should not be involved in the management of the companies they invest in.
- Asset owners are motivated to select asset managers on the basis of their ability to deliver sustainable long term returns and conduct their stewardship activities well in support of this aim; this relationship is governed by the investment mandate.

It is important to remember that asset managers' stewardship activity is carried out in the context of this relationship with their client. They will be monitoring risk and making risk based decisions on that basis, including when to escalate engagement activity for businesses that are exhibiting 'red flags' and when that engagement highlights that a particular company presents an intolerable risk and therefore a decision is made to divest holdings. Crucially, different asset managers will have different risk tolerances according to their clients' long term objectives.

In most cases, this investment chain works well. Asset managers devote significant resource to ongoing monitoring and engagement of companies. If shareholders become concerned by the decisions taken by a Board, there are various options they may wish to pursue to try and secure a better outcome for all actors, some or all of which may be appropriate, depending on the circumstances:

Voice - shareholders can attempt to exert influence over the Board by voicing their concerns privately.

Escalate – where merely voicing concern isn't effective, investors might escalate their approach for example by joining together with other investors. This can happen informally or more formally through representative bodies or the Investor Forum. The IA's Stewardship Survey[1] highlights how collective engagement is considered to be a very effective mechanism by investors.

Other ways that asset managers can escalate their concern involves making public statements and requisitioning resolutions at company AGMs.

Vote – Investors can express disagreement by voting against resolutions at a general meeting. Investors expend considerable resource to engage with companies to understand their rationale behind resolutions, and to conduct analysis to ensure they are making an informed decision about which way to vote. The Stewardship Survey[2] provides some practical examples of how voting has been used to escalate engagement with companies.

Where a company is facing challenges and is receptive to constructive engagement, these activities can go a long way in supporting a company to improve its prospects. For example, results from the Stewardship Survey highlight that engagement tends to lead to positive outcomes; 62% of respondents did not change their investment following their engagement

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[1] The Investment Association, Stewardship Survey, September 2017, https://www.theinvestmentassociation.org/investment-industry-information/research-and-publications/stewardship-survey.html
[2] IBID

with companies as communication with the companies had improved and their concerns were addressed as a result.

Asset managers are particularly concerned with how companies and their Directors behave when they are facing financial challenges. It is in asset managers' interests to ensure that they have an accurate understanding of the company's financial position and future viability; given this information, they will need to make a decision as to whether the investment is delivering value for their clients. While continuing to invest in a company faced with financial difficulties, asset managers will want to assure that Directors are realistic about the company's prospects and robust in their approach to putting the company back on a sustainable footing through their stewardship activities. Where the Board pursues strategies or governance proceedings that the asset managers considers detrimental to their clients' interests, they may choose to sell their shares.

We have found that in a number of high profile cases where businesses have collapsed or gone through significant financial strain, investors' concerns had been ignored by the Board. In light of this, it is appropriate for Government to question whether Director accountability mechanisms could be made stronger. It has been questioned whether shareholders can play a more proactive role in publicly or privately reporting their concerns over company behaviour, if they feel their engagement activity is not producing the desired results.

Principle 3 of the FRC's Stewardship Code states that "Institutional investors should endeavour to identify at an early stage issues that may result in a significant loss in investment value. If they have concerns, they should seek to ensure that the appropriate members of the investee company's Board or management are made aware."[3] It is important for investors to retain flexibility to take the right approach to raising these concerns with company management, rather than turning stewardship into a complianc**e** exercise. There is a limit to shareholders ability to public comment on a company, without inadvertently influencing company share price which could impact on their clients' interests. The FRC's Stewardship Code states that "Institutional investors should not be expected to make disclosures that might be counterproductive".

Shareholders do have powers to pursue legal action against Directors if they are not complying with their duties. This has seldom been pursued however, as it is generally not in asset managers' interest to engage in protracted legal battles with a company, especially if this will not deliver any value to clients.

One possible approach to improving Director accountability via investors stewardship activity, **is to create the opportunity for shareholders to privately raise concerns to a regulatory authority** regarding a company's corporate governance, risk management or other material issues such as fulfilment of the Directors duties where shareholders have escalated and exhausted the limits of their engagement activity with that company. This authority could then take a decision on whether to investigate a company or individual Directors based on the information received through this reporting mechanism and other intelligence. It would be likely that the authority would focus on those companies where similar concerns are received from a number of shareholders. This could be the same regulatory authority that is responsible for Director sanctions, proposed above.

Other intelligence the regulator could use to inform their investigations includes the company's share register and how it changes over time, particularly for those shareholders that have a significant disclosable position in a company, as this can also be a significant public indicator of the health or ill health of a company. In addition, the level of short selling is a good indicator of the perception of a company. We have often seen the share registers

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[3] The Financial Reporting Council, September 2012, The UK stewardship code, https://www.frc.org.uk/getattachment/d67933f9-ca38-4233-b603-3d24b2f62c5f/UK-Stewardship-Code-(September-2012).pdf

of companies that are of concern to investors' change significantly prior to a significant event, with the traditional long-only institutions often selling out. This is one public indicator of the views of the market on a company that this regulatory body could include in its intelligence.

Unfortunately, strong stewardship cannot be a replacement for strong company governance and assurance. In recent company failures such as Carillion, there were clear challenges in both these areas. The BEIS Select Committee's report into Carillion's collapse states that "effective stewardship by investors depends in large part on the availability of trustworthy financial reporting and on honest engagement with Board members in response to the raising of concerns. The Carillion Board failed on both these counts."

We would like to see the role of stewardship grow further and to further improve its effectiveness. To do this we want to go beyond the Stewardship Code and create "a better market for stewardship". None of the links in the investment chain is fundamentally broken, however, more can be done to strengthen them, in particular to ensure that Directors are held properly accountable for compliance with their duties (as set out in answer to question 1 in this consultation), how asset managers demonstrate that they have fulfilled their stewardship responsibilities and to create a better demand for stewardship from asset owners.

Further details about how we envision the market for stewardship to grow can be found in our response to the FRC's consultation on the Corporate Governance Code[4]. Key points that we highlighted in that response are that:

- **End clients and the public need to understand what stewardship is and what role it plays in order for there to be greater demand for it.**

  There is limited understanding in the general public and amongst end clients, savers, about what stewardship is, and how stewardship activities are conducted on their behalf. The IA's 2017 Stewardship Survey[5] found for example that 16% of pension fund respondents had no opinion on whether pension funds have stewardship responsibilities. We would like to see asset owners setting out their expectations to asset managers. We will see some progress in this area as a result of the extra reporting requirements for asset owners being implemented in the Shareholder Rights Directive next year.

- **We need a more discerning asset owner community to boost demand for stewardship activity and support better competition in the industry.**

  Asset owners can help drive innovation in the stewardship market. The illustration of the investment chain above highlights the important role that asset owners play in setting the expectations for asset managers' stewardship activity through their investment mandates. Better inclusion of stewardship expectations in mandate design will better engage asset owners in the stewardship activities of their asset managers and ensure that the appropriate amount of resource can be dedicated to stewardship activity. In the IA's Productivity Action Plan[6], we set out our intention to develop best practice guidance for how stewardship and long-term incentives can be better incorporated into the

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[4] The Investment Association, Consultation Response, FRC's Proposed Revisions to the UK Corporate Governance Code, https://www.theinvestmentassociation.org//assets/files/20180228-%20IA%20Response%20to%20the%20FRC%20CG%20Code%20Consultation%20-Final%20-%20unsigned.pdf

[5] IBID

[6] The Investment Association, Productivity Action Plan, March 2016, https://www.theinvestmentassociation.org//assets/files/Productivity%20Action%20Plan%20_%20IA%20Stewardship%20Reporting%20Framework.pdf

Statement of Investment Principles and Mandate design. The IA will be looking at ways to better engrain stewardship expectations in the contractual relationship between asset owners and asset managers later this year.

- **Enhanced stewardship disclosure by asset managers will better facilitate engagement with asset owners.**

  The IA produced a Stewardship Reporting Framework[7] as a part of our Productivity Action Plan to provide a basis for public reporting of asset managers' stewardship activities and help asset managers to report in consistent way through a combination of summary statistics and case studies on both engagement and voting. The Stewardship Reporting Framework's recommendations have been taken up to a large extent by asset managers, with 20 of the top 30 asset managers now publicly reporting in line with a majority of the recommendations of the Stewardship Reporting Framework. We are continuing to engage with our membership to continually develop this framework so it reflects current best practice on public reporting.

  Below we consider the specific suggestions to improve stewardship set out in this consultation. Many of the proposals align with proposals that the IA has already made, such as incorporating long-termism into the Stewardship Code, and looking to improve stewardship reporting.

- **Amend the Stewardship Code to focus on long-termism.**

  We support this suggestion as the principles in the Stewardship Code do not currently make a sufficiently explicit connection between shareholder engagement and promoting medium to long term value and capital efficiency. In our response to the FRC's consultation on the Corporate Governance Code[8], we set out how a greater focus on long-termism can be better reflected in the Stewardship Code. We will be engaging further with the FRC on this issue when they consult a on a revised Stewardship Code later on this year**.**

- **Promote better reporting of stewardship outcomes**

  We support this suggestion as better reporting of stewardship outcomes is an essential ingredient in creating a better market for stewardship. As set out above, it will both improve general understanding of the extent of stewardship activities as well as acting as a starting point for asset owners to consider stewardship activity in their manager selection.

- **Set up "stewardship oversight group" to review significant corporate failings and scandals, and to make recommendations for the investment chain. Suggested members of this group are Investor Forum, company chairmen, company secretaries, asset owners and FRC.**

  There are mixed views amongst our membership as to how useful such an oversight group could be. Some question what additional role such a body could play when there are already a number of mechanisms to review significant failings. Take for instance the four separate investigations into the collapse of Carillion, conducted by the FRC, the Insolvency Service, the FCA and BEIS and Work and Pensions Select Committees - it is not clear how an additional body could add value amongst these investigations and what its role and remit would be. It would likely only be able to offer a view on improvements once the regulatory investigations are complete, which is likely to be a considerable time after the event. Others in our membership are more enthusiastic

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about the role of such a body and feel that any organisation set up to review these kinds of events needs to be given sufficient access to the relevant information and sufficient powers to implement its recommendations, and stress the importance of the independence of such a body. Such a body should go further than simply reviewing significant company failings and also be able to conduct thematic reviews and make recommendations for improving stewardship standards across the Board. It would have to be clear how such a body sits alongside and interacts with existing bodies such as the Investor Forum.

- **Set out new responsibility for investors to monitor Directors' adherence to S.172**

  A new requirement for companies to report against their duties under s.172 is set out in the recently published Statutory Instrument. Asset managers welcome these new requirements since, as mentioned in answer to question 1, investors are concerned about the extent to which Directors are fully complying with their s.172 Duties, in particular in relation to consideration of material stakeholders. We expect asset managers to fully incorporate this new publically available information into their analysis, and that it will form the basis of conversation in their engagement with the companies they invest in. As we set out in our response to the FRC's Corporate Governance Code Consultation, it is essential that the Stewardship Code maintains its **high-level principles approach**, and does not prescribe specific activities or topics that investors must comply with. Good stewardship relies on investors choosing the right approach and issues to engage on. These will change dependent on the individual circumstances of their investments. Stewardship cannot and should not be boiled down to a checklist. We therefore do not think it is necessary for there to be a specific requirement in the Stewardship Code on s.172 at this stage.

- **Encourage FTSE companies to host periodic "strategy and stewardship meetings"**

  Asset managers would like to see companies being more proactive about their engagement with shareholders outside of the AGM activity. We have expressed concern in the past that engagement can be overly focused on executive remuneration at the expense of a focus on wider fundamental factors. Asset managers would like to have more engagement on corporate performance, Board leadership, culture and strategy. Strategy and Stewardship forums could therefore be a useful platform for these kinds of discussions. These forums are only useful when they are run well and there are significant issues to discuss aligned to the strategy of the company; if mandated by government as a compliance exercise there is a danger that they simply manifest as 'governance road shows" rather than as an opportunity for meaningful engagement.

- **The role of the Investor Forum**

  The Investment Association helped to establish the Investor Forum, providing it financing, infrastructure support and resources until it was able to develop a proof of concept and its own membership proposition in 2016. The Forum now has 40 members and its most recent review continues to demonstrate the contribution it has made to collective engagement in the UK. It has also developed a legal framework to allow members to engage with confidence that they can do so within the bounds of the appropriate law and regulations. UK ownership of UK PLC has reduced in recent years. When John Kay proposed the Investor Forum in 2012, a key purpose was to encourage more international investors to participate in UK collective engagement. This is an area which still needs to be addressed, with more international investors being encouraged to participate in the Investor Forum and UK corporate governance more generally.

There are also a number of initiatives which are being developed and are in the early stages of their life following the Corporate Governance Green Paper. One such example is the IA's

Public Register, which the IA was asked to develop by the Government in August 2017. The Public Register lists all companies in the FTSE All-Share which have received significant shareholder opposition to any resolutions or have withdrawn a resolution prior to the shareholder vote. The aim of the Public Register is to highlight companies which receive a high vote against or withdrawn a resolution, and to understand the process used by those companies to identify and address the concerns of their shareholders. IA members want companies to acknowledge that they had received a significant vote against at the time of their AGM results and then to set out the process they have been through to identify the reasons for the vote and the actions taken in response to the vote in the months following the AGM.

This is an important mechanism to encourage companies to foster better engagement with their shareholders and we will be looking at how this tool can be developed further. In particular, we will be closely monitoring those companies that are repeat offenders on the Public Register – those companies that receive significant votes against the same resolutions in two years running and do not make sufficient efforts to engage with shareholders regarding their dissention. The Public Register is a good early indicator of concern of investors into the company's actions or behaviours.

13. Do you consider reforms are required to the legal, governance and technical framework within which companies determine dividend payments? If so what reforms should be considered? How should they be targeted so as not to discourage investment?

Dividend payments are an important source of income for asset managers' clients. For example, in 2017, dividend payments constituted 12.6% of pension fund income[9]. It is not therefore in asset owners interests for the payment levels to be unsustainable.

When considering company dividend payments, asset managers are concerned not only with the quantum of dividends received for their clients but also how those dividend payments feature in the company's overall capital management strategy. Capital allocation decisions play a vital role in determining a company's long term success and are viewed by our members as some of the most important responsibilities of company management - our stewardship survey[10] highlights that capital allocation is considered one of the top issues to engage with companies on.

There should be better visibility of companies' capital allocation strategies and how this relates to their business plan, including how this is used to determine their dividend payments. The IA has made a number of recommendations to improve companies' disclosure and approach to their dividend policy and would like the Government to consider whether these suggestions could be given regulatory backing to ensure that companies are acting in line with best practise:

- In the IA's Long Term Reporting Guidance[11], we set out how our members expect companies to explain the approach taken to managing its capital, provide assurance that it is allocating capital efficiently, and demonstrate that it is acting in a manner that is consistent with shareholder interest in sustainable, long term value creation. We set

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[9] Office for National Statistics, MQ5: Investment by insurance companies, pension funds and Trusts: October to December 2017, https://www.ons.gov.uk/economy/investmentspensionsandtrusts/bulletins/mq5investmentbyinsurancecompaniespensionfundsandtrusts/octobertodecember2017

[10] The Investment Association, Stewardship Survey, September 2017, https://www.theinvestmentassociation.org/investment-industry-information/research-and-publications/stewardship-survey.html

[11] The Investment Association, Long Term Reporting Guidance, May 2017, https://www.theinvestmentassociation.org//assets//files/Long_Term_Reporting_Guidance__v1__1.pdf

these requirements out as we felt that companies were not fully explaining how their capital allocations decisions were being taken.

- The IA wrote a letter[12] to company chairs in 2016, in response to concern about the number of instances where companies have made significant changes to their profit expectations and/or have reduced the dividend policy following the appointment of new management. This highlights insufficient oversight on the part of independent Directors and the audit committees of how company dividend policy relates to a robust capital management strategy. IVIS (the IA's corporate governance research service) highlights on an "Amber Top" the re-election of non-executive Directors, where a significant devaluation of assets, profit forecasts and dividend policy follows the appointment of new management. Members have informed us of a number of instances, where investors were concerned that the proposed level of dividend payments were not supported by the company's financial position or balance sheet. They then engaged with these companies to discuss the appropriateness and viability of the dividend. Our members have discouraged companies from increasing dividend payments where they have felt the increase was unjustified and will challenge Board proposals to make dividends payment unsupported by the company's cash flows.

- In the IA's Productivity Action Plan, we noted that companies often misunderstand investors' expectations with regards to capital allocation, and how this feeds into expectations regarding return on invested capital. This is causing some perverse behaviours by management underpinned by the mantra "if in doubt, return the cash" whereas shareholders are often very willing to support well-reasoned and articulated capital and operational expenditures which are consistent with a company's strategy. One example of this kind of perverse behaviour is where companies are motivated to strengthen their balance sheets in response to the potential impact of short selling.

FRC's Financial Reporting Lab produced a study on the disclosure of dividends in 2015 and made a series of recommendations for enhanced disclosures in 'disclosure of dividends – policy and practice.

They identified the following key features of good dividend disclosure:

- An understanding of the Board's considerations in setting the policy,

- The rationale for the approach selected, and

- Sufficient detail to understand how the policy will operate

- The key judgements and constraints considered by the Board in applying the dividend policy,

- The availability of dividend resources, including cash and distributable profits, to pay dividends (this was considered particularly useful in situations where either was a constraining factor), and

- Clear linkage from the disclosed policy to its application in the period.

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[12] The Investment Association, Board oversight of profit expectations and dividend policy, May 2016 https://ivis.co.uk/media/12237/Board-Oversight-Letter.pdf

The following year, the FRC Reporting Lab looked at how well these recommendations had been implemented across the market, finding that only 58% of the FTSE 100, and 30% of the FTSE 250 were making enhanced disclosures in line with these recommendations[13].

Government should consider giving regulatory backing to some of these proposals, as the above results indicate that companies are not on the whole observing best practice in this area.

In addition, it would be helpful to consider whether the current rules on distributable profits are stringent enough to account for dividend payments that immediately precede profit warnings. Investors are also concerned about companies that exclusively submit interim dividend payments, seemingly to avoid shareholder votes on final dividend payments. This policy takes dividend approval away from shareholder scrutiny. **Government should mandate a once yearly shareholder vote on dividend payments.**

14. There are perceptions that some Directors may not be fully aware of their duties with regard to commissioning and using professional advice. Do you agree, and if so, how could these be addressed?

It is important the Directors take appropriate advice to ensure that they are fully aware of the legal or financial implications of any decisions. Advisors do play an important role in advising Boards. However, it is important that they are only advising the Board and Directors. Directors are bound by their duties and have to take the decisions which are in the best interests of the company as a whole. It is important they do not rely solely on the advice provided by their advisors but also consider the advice they receive through the lens of their s.172 duties.

The refocussing on Director Duties through the s.172 reporting requirement should encourage Directors to have better regard to these duties when commissioning professional advice and therefore exercise greater autonomy over the outcomes of this advice when making decisions rather than just following the advice given.

15. Should Government consider new options to protect payments to SMEs in a supply chain in the event of the insolvency of a large customer? Please detail suggestions you would like to see considered.

N/A

16. Should Government consider removing or increasing the current £600,000 cap on the proportion of funds that can be ring-fenced and paid over to unsecured creditors (the "prescribed part") or enabling a higher cap in larger insolvencies? What would be the impact of increasing the prescribed part?

N/A

17. Is the current corporate governance framework in the UK, particularly in relation to companies approaching insolvency, providing the right combination of high standards and low burdens? Apart from the issues raised specifically in this consultation document, can you suggest any other areas where improvements might be considered?

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[13] FRC, Lab implementation study: Disclosure of dividends – policy and practice, October 2017, https://www.frc.org.uk/getattachment/3a7972af-35ae-4354-8136-0b395f5bbbba/Dividends-implementation-study-Lab.pdf

Corporate governance standards are currently under a great deal of scrutiny and there are several ongoing initiatives and investigations to ensure that standards remain high. Several of the initiatives put forward in the Corporate Governance Reform Green Paper are in the process of being implemented via the updated Corporate Governance Code review and the publication of new Statutory Instruments. These initiatives will take some time to produce results and effect change.

We encourage the Government to ensure it is taking a holistic view of the many reforms being implemented in the corporate governance and stewardship space, ensuring that these proposals have sufficient time to bed in and their effectiveness to be considered.

In addition to the proposals discussed in this consultation, we would like the Government to consider the role of Board effectiveness reviews in helping to spot 'warning signs' at failing companies.

Investors would like there to be more scrutiny of the Board effectiveness review process. Companies are required to have Board effectiveness reviews under the Corporate Governance code, however investors are concerned about the range of quality provided by these reviews and question whether they provide the right level of challenge to Board practices. Investors would like there to be a Code of Practice which is adopted by the Board review industry and for the company to disclose more information on how they select their service provider and any conflict of interest procedures that are in place to ensure that the Board reviews is effectively challenging.