



Association of British Insurers

Improving Corporate Governance and  
**SHAREHOLDER  
ENGAGEMENT**

## **Acknowledgments**

We are very grateful for the support and advice of Board Intelligence and Skadden, Arps, Slate, Meagher & Flom LLP in the preparation of this report.

# Foreword



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Director of Investment Affairs

**Corporate governance remains a key area of focus for ABI members as institutional investors. Good governance enhances a company's sustainable performance and so helps underpin long-term economic growth.**

This report follows our two reports on Board Effectiveness in September 2011 and December 2012 and our report on Comply or Explain, also in December 2012. In it, we consider critically the different roles and responsibilities of all the principal elements within governance – or stewardship – with particular focus on non-executives' ability to provide constructive challenge, the variety of approaches institutional investors take in holding companies to account and ensuring that they are run in the long-term interests of shareholders and the relationship between, and different responsibilities of, asset managers and asset owners.

The report is again the result of robust and careful analysis, taking into account the views of a large number of investors, as well as of a range of other market participants. We hope that you find the information and recommendations helpful. As ever, a continued and close dialogue between companies and their shareholders is crucial.

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# 1. Summary and Key Recommendations

## A. PURPOSE OF CORPORATE GOVERNANCE AND REPORTING

Good corporate governance enhances and underpins a company's long-term sustainable performance: it is critical to long-term value creation and economic growth.

ABI members remain strongly supportive of the UK's principles-based approach to corporate governance and the 'comply or explain' framework.

ABI members also strongly support the principle that the reciprocal of the accountability of the board to shareholders is the responsibility of shareholders to be proactive in the discharge of their stewardship responsibilities.

Governance should be a means to an end and not an end in itself. The objective should be to underpin and facilitate a more successful and sustainable enterprise over the long-term.

Corporate governance reporting by companies should focus more on the application of the Principles of the UK Corporate Governance Code (the "Code"), rather than just compliance with provisions. In this sense, we support the notion of 'Apply and Explain'.

The new Preface to the Code urges Chairmen to report personally in their annual statements how the principles relating to the role and effectiveness of the board (in Sections A and B of the Code) have been applied. All companies should adopt a Chairman's introductory statement to the corporate governance section of the annual report.

When explaining deviations from the Code, disclosures should aim to adhere to the following criteria:

- Company-specific in context and historical background
- Convincing and understandable rationale
- Mitigating action to address any additional risk

- Time-bound and subject to on-going review
- Specify deviations from the main principles as well as from the specific provisions
- Explain how the alternative course being adopted is consistent with the Code Principles and contributes to the objective of good governance.

## B. PARTICIPANTS IN CORPORATE GOVERNANCE

*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. Therefore, broadly, the concept of separate "shareholder-representative directors" is logically flawed.

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.

In managing assets, asset managers have a duty to protect their clients' interests. They have a duty to be responsible shareholders of the companies they invest in. More generally, ABI members see effective shareholder engagement as an integral part of the investment process.

Having bought into the long-term strategy and business model of a company, shareholders will, for the most part, expect to be supportive of the board and management. In turn, boards can expect such support if they deliver on their strategy.

The term '*shareholder*' may refer in the institutional context to either:

- *asset owners*, such as pension funds and insurance funds, who have a duty to act in the best interests of the scheme beneficiaries when formulating investment objectives and overseeing appointed investment managers; or
- *asset managers* who are appointed by the asset owners for their professional expertise in meeting the investment objectives of the asset owners.

The problem of information asymmetry within this structure is well-rehearsed and to some extent unavoidable. It is crucial, however, that non-executive directors and asset managers have access to an appropriate level of information and access to appropriate individuals to be able to discharge their responsibilities effectively.

## C. NON-EXECUTIVE DIRECTORS

Non-executive directors are clearly crucial to good governance. We have focused on possible measures to improve the framework within which they operate and so enhance their ability to achieve the appropriate balance between support and challenge.

### Time commitment

Companies are encouraged to review the time-commitment requirements of different non-executive roles and how different non-executive roles may best be structured. This would include flexibility over different levels of time-commitment for different non-executive roles, particularly in larger companies. ABI members recognise that remuneration of non-executives may need to be adjusted to be commensurate with an increased time-commitment and responsibility.

If a non-executive has an increased time commitment at a particular company, this may affect the number of other roles that he or she can realistically take on.

### Board appointments

Companies are encouraged to consult their largest shareholders on major board appointments and improve Nomination Committee reporting in the annual report and accounts.

### Information flow

Boards are encouraged to be more demanding of the formal flow of information they receive. This might include the following:

- The board should provide management with a clear statement of their priorities to serve as a brief for their information needs – updated at least annually and as often as circumstances require it.
- The board pack should help monitor the health of their organisation's culture.
- Boards should not be accepting of a board pack that is too long to be read

### Transactions

Executive directors should inform the appropriate non-executive director of the proposed transaction as early as possible. In any case, this should occur when an approach is received from a possible bidder or management first actively considers a transaction in respect of which a shareholder approval is to be sought.

The non-executive directors should be provided with a narrative description of the discussions between the company and the transaction counterparty and such narrative should be disclosed in the circular to shareholders in summary form.

Non-executive directors should meet as a group without executive directors to consider the transaction and confirm to the Chairman, prior to the publication of any circular or recommendation to shareholders, that they are satisfied they have received sufficient time and information.

Non-executive directors should be given direct access to financial and legal advisers to the company on a transaction in order to ensure that information can be rapidly obtained and understood.

Where a company is subject to a management buy-out or similar transaction or engaging in a transaction with a controller or group of controllers, or where a conflict may otherwise arise, a special committee comprising only unconflicted directors should always be formed to consider the transaction. The committee should always take independent financial and legal advice. It is not acceptable for a 'Chinese wall' to be established within the existing advisers to the company.

Independent committees formed to consider a transaction should ensure their mandate is clear and is disclosed in any circular to shareholders or annual report. Normally the mandate should extend to considering the terms of the transaction and whether the transaction itself (as opposed to the other courses of action) is in the best interests of the company and shareholders as a whole.

The non-executive directors should consider whether it is appropriate to seek separate, independent advice on the merits of the proposed transaction. The adviser should be paid on a fixed fee (as opposed to 'success' or 'incentive') basis.

## D. SHAREHOLDER ENGAGEMENT

ABI members have a long record of taking their shareholder engagement responsibilities seriously. In 1991, we wrote: *“Institutional investors should encourage regular, systematic contact at senior executive level for the purposes of an exchange of views and information on strategy, performance, board membership and quality of management.”*

ABI members continue to see corporate governance analysis and engagement as an important duty to be exercised on behalf of their clients.

The positive experience and contribution to performance, over a number of years, of incorporating engagement and corporate governance analysis into the investment process has created a virtuous circle and increased recognition of its contribution by individual fund managers.

The culture of responsible ownership has become increasingly integrated into the investment process.

Corporate governance engagement and analysis activities are viewed as a method of seeking outperformance and, therefore, increasingly a commercial imperative.

Companies equally value engagement with shareholders, although they emphasise the importance of confidentiality being maintained to ensure an appropriate relationship of trust.

### Resources and integration

ABI members devote considerable resource and expertise to engagement in a variety of structures.

All aim to integrate corporate governance resources fully into the investment process. This is likely to translate into a more coordinated and sophisticated level of dialogue with companies and more informed proxy voting.

Substantial resources are at present engaged to respond to companies' remuneration consultations. Members understand the importance of this issue, but want to broaden the nature of their dialogue with companies.

### Approaches to engagement

ABI members have a range of different approaches to governance and stewardship-related engagement.

All members emphasise that every engagement approach depends on the specific circumstances of the company in question and that their approach can vary extensively from case to case.

All members have appropriate procedures in place to enable them to receive price sensitive information and become insiders with appropriate safeguards.

### Collective engagement

Most members do not contemplate collective engagement unless they have first raised the issue individually with the company and concluded that insufficient or no progress is being made.

However, often there are no clear and agreed objectives within collective engagement, particularly when a larger number of shareholders are involved. Equally, if efforts are made to reach a single view, the concern arises that members' individual views may be diluted or lost. Members are particularly concerned if they feel pushed towards solutions that they individually consider counter-productive.

The ABI Executive plays an important role in facilitating meetings between companies and investors. ABI collective meetings are initiated by members and supplementary to their individual engagements with companies.

The ABI will consult members on how to develop a proactive methodology for identifying companies for engagement, which would be complementary to existing investor engagement.

### Voting

Voting is considered a critical aspect of responsible ownership. It is also an important means to exercise influence.

- As Stewardship Code signatories, all members disclose their voting policies, their formal voting process and actual voting decisions.
- All members have a policy of using proxy adviser research primarily to identify potential issues and to inform their own in-house analysis, but final voting decisions do not rely on their recommendations. This is true for both the UK and overseas markets.

### Information flows

Companies should develop a transparent annual investor relations programme that includes the intended schedule and type of one-to-one and group meetings to discuss corporate governance and stewardship-related issues.

In developing an annual investor relations programme, companies should consider the attendance of non-executive directors at a selection of investor relations' presentations and proactively incorporate corporate governance institutional investor representatives in such communication. They should also consider whether a sufficiently wide range of corporate governance topics are incorporated in the annual schedule of meetings.

ABI members support the adoption of annual 'Stewardship Roadshows' but believe they would benefit from a wider coverage of investment issues, such as strategy, performance and capital management.

Members recognise the need, as part of their reciprocal stewardship obligation, to ensure the availability of appropriate governance expertise and to prepare fully for meetings and roadshows.

### Proposed improvements

The ABI Executive will adjust its existing collective engagement process in two ways:

#### a) Expand collective engagement

The current process of initiating collective engagement will be maintained but, when such meetings are convened, all significant shareholders will be invited to participate in the meeting whether or not they are ABI members.

The scope of engagement is intended to cover the top 10 shareholders (whatever their level of holding) and any shareholders with a holding of 1% or more.

#### b) Investor Exchange

An “Investor Exchange” mechanism will be established, which will enable any significant shareholder proactively to raise a concern on a particular UK-listed Company with other shareholders through the ABI.

The mechanism will be designed to enable participants to determine the level of confidentiality when raising an issue. For instance, an investor may not wish to be initially identified as raising the issue, or may wish to only share more detailed concerns at a later stage.

The relevant concern would then be distributed to other forum participants with a holding in the company of at least 1% or within the top 10 shareholders.

If there is common interest, the ABI will facilitate meetings for them to share concerns and it will be up to the discretion of the participants whether it is appropriate to include additional shareholders.

There will be no expectation of public statement, media activity or any particular escalation strategy, but appropriate action will be decided by interested investors.

The communication of concerns, and the organisation of any collective meetings, will be dealt with by the ABI Executive.

#### Investor Working Group on Collective Engagement

ABI members are currently participating in a review with members of the IMA and NAPF of possible means of enhancing collective engagement.

## E. SHAREHOLDER RIGHTS AND STRUCTURAL MEASURES TO ENCOURAGE LONG-TERM INVESTMENT

Differentiated voting or dividend rights are likely to result in a number of unintended consequences and are likely to affect the interests of minority shareholders adversely, rather than stimulate longer-term ownership.

AGMs remain an integral component of the UK corporate governance system and a key mechanism enabling shareholders to exercise their ownership obligations. There is no support for ‘virtual-only’ AGMs, but shareholders encourage companies to consider how the meeting can be reinvigorated.

The existing ownership thresholds for requisitioning General Meetings and proposing shareholder resolutions remain appropriate. Consideration might also be given to simplifying the process to lower costs.

## F. ASSET OWNERS AND ASSET MANAGERS

An increasing number of asset owners are conscious of the need to develop and implement stewardship policies when allocating investment mandates.

Clear specification of stewardship requirements of asset owners, particularly at the beginning of the client relationship, will improve understanding and enable corporate governance objectives to be reflected better in the investment agreement and agreed operational process.

ABI members would support the concept of developing a “Stewardship Mandate”, to be included as part of the investment agreement, to clarify and govern the client’s stewardship requirements. This could include the agreed range of stewardship activities to be undertaken by the asset manager on behalf of the client: for example, an annual review of the stewardship activities on behalf of the client, or, simply, confirmation that the investment manager is a signatory to the Stewardship Code.



## 2. Introduction

**Good corporate governance enhances and underpins a company's long-term sustainable performance: it is critical to long-term value creation and economic growth.**

Following Professor Kay's review of UK equity markets and the newly revised FRC's Stewardship Code, there has been increasing debate over the different responsibilities in corporate governance and, in particular, on the role of institutional investors in overseeing the companies they invest in. These are all different elements of 'stewardship'.

In this document, to help address these wide-ranging issues, we therefore:

- review the existing roles and responsibilities in corporate governance and shareholder engagement and make recommendations on how these may be enhanced; and
- demonstrate how existing mechanisms of corporate governance operate to support positive performance outcomes.

Specifically, we:

- review the underlying purpose of corporate governance;
- clarify the roles of different participants in governance;
- review the role of non-executive directors and consider board structures;
- review current approaches to shareholder engagement and consider possible improvements;
- review existing shareholder rights and measures to encourage long-term investment; and
- review the role of asset managers relative to asset owners, asset managers' underlying clients.

# 3. Corporate Governance Overview

## A. PURPOSE OF CORPORATE GOVERNANCE

ABI members remain strongly supportive of the UK's principles-based approach to corporate governance and the 'comply or explain' framework, which contributes to better governance outcomes.

ABI members also strongly support the principle that the reciprocal of the accountability of the board to shareholders is the responsibility of shareholders to be proactive in the discharge of their stewardship responsibilities. This helps underpin the overall governance structure.

### (i) Comply or Explain

The UK's principles-based approach to corporate governance has achieved many improvements in standards over the last 20 years, underpinned by the 'comply or explain' system of accountability.

It is no coincidence that these improvements have been achieved under a principles-based approach. Under the relationship between shareholders as owners, and managers as agents, of the company, accountability is exerted by the providers of capital, rather than regulators. As companies compete for the supply of capital, they are more likely to aspire to improvements in corporate governance. This elicits competition for the mantle of 'best in class', rather than a 'rush to the bottom', as is more likely under regulated minimum standards.

This flexibility enables companies to adapt their governance practices to the specific nature and challenges inherent in their business model and the challenges they face. Companies and investors can then take account of important variables, such as size, ownership structure and sectoral differences: built-to-measure rather than one-size-fits-all.

Explaining this properly is an essential part of demonstrating to investors why a company's governance approach supports its business model and is aligned with shareholder interests. ABI members strongly support the role of the UK Corporate Governance Code ("the Code") explanations and attach as much importance to good quality explanations as they do to basic compliance with Code provisions. However, it is important for companies to focus on the fundamental principles of governance and ensure alignment with the ultimate interests of shareholders. Equally, investors should consider Code explanations in a "non-mechanistic" manner, as guided by the Code.

### (ii) Good governance underpins a successful and sustainable enterprise

Governance should be a means to an end and not an end in itself. The objective should be to underpin and facilitate a more successful and sustainable enterprise over the long term.

Absent-minded compliance without consideration of the underlying principles is unlikely to achieve this. Lord Hampel recognised this in his report in 1998, when he emphasised that a compliance-driven approach was the easy option, compared with a more thoughtful and diligent consideration of how to apply the principles. He correctly predicted that companies with 100% compliance, on paper, might fail in the future. This message was not heeded.

Companies often follow the Code with insufficient regard to how the main principles should be applied given the nature of their business model, culture, key priorities and, ultimately, what enables the board to make effective and well-tested decisions in the long term interests of shareholders. In the same vein, shareholders may have historically focused excessively on the letter, rather than the substance, of the Code.

### (iii) Applying principles

This cultural approach to governance, from both shareholders and companies, has lent itself to a focus on the specific provisions of the Code at the expense of the main Principles. There is rarely a debate about how well a company states its application of the Principles. Too often it is assumed that compliance with the specific provisions means that the principles have been applied in the right way. This is often not the case.

The ABI's 2012 report<sup>1</sup> "Comply or Explain: Investor Expectations and Current Practice" found that only 33% of companies explaining a deviation from the Code linked it to the company-specific context and historical background. Furthermore, only 25% explained how the alternative approach they were adopting was consistent with the main principles and contributed to good governance.

Whether complying with or explaining a departure from the Code, disclosures should address the fundamental principles of governance and demonstrate alignment with the interests of shareholders and duties owed to the company.

<sup>1</sup> <http://www.ivis.co.uk/PDF/comply%20or%20explain%20-%20investor%20expectations%20-%20dec%202012.pdf>

<sup>2</sup> Ibid

## B. PARTICIPANTS IN CORPORATE GOVERNANCE

### (i) Directors are agents

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. The factors to be taken into account in discharging this responsibility are summarised in section 176, Companies Act 2006.

The directors, acting as the agents of the enterprise, and therefore of shareholders, protect the interests of the shareholders, as the owners of the company. It follows that shareholders should in the normal course be supportive of boards.

If shareholders believe that the board is not protecting or enhancing their interests sufficiently, they have an inalienable right under the Companies Act to remove the directors by ordinary resolution and elect a new board.

In Section 6 we review a number of shareholder rights and mechanisms to support the ability of investors to apply an appropriate level of accountability to directors.

### (ii) Executive directors

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.

### (iii) Non-executive directors

Non-executive directors are the representatives of shareholders on the board. All directors owe the same duties to the company, including the duty to exercise independent judgement. Therefore, broadly, the concept of separate "shareholder-representative directors" is logically flawed.

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. In providing challenge to the executives, non-executives should aim to remain constructive: needless confrontation is likely to lead to disharmony and a dysfunctional decision-making process. Equally, however, maintenance of a clearly independent position is critical to good governance.

Shareholders therefore have a key interest in ensuring that:

- the right balance of skills and experience is present on the board
- the right framework is in place to enable non-executives to fulfil their duties successfully, including an appropriate and timely information flow
- non-executive directors are able to assert their position

- of independence, where necessary and appropriate
- the lines of communication and consultation between shareholders and non-executive directors are open and fluent.

In Section 4 we review the role of non-executive directors in more detail and make recommendations on how their role may be enhanced.

### (iv) Investment managers

In managing assets, asset managers have a duty to protect their clients' interests. In turn, therefore, they have a duty to be responsible shareholders of the companies they invest in.

More generally, ABI members see effective shareholder engagement as an integral part of the investment process and therefore as a means to generate outperformance over the long-term.

Having bought into the long-term strategy and business model of a company, shareholders will, for the most part, expect to be supportive of the board and management. In turn, boards can expect such support if they deliver on their strategy.

Shareholders should be kept informed and consulted on material changes, including to the strategy, operation, financing, risk profile and governance of the business. Depending on the circumstances, this means providing shareholders with the opportunity for active oversight and consultation with both executive and non-executive directors. Again, an appropriate information flow is critical.

If shareholders become concerned by the decisions taken by a board, there are various options they may wish to pursue, some or all of which may be appropriate, depending on the circumstances:

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**Voice** in the normal course, shareholders may wish to attempt to exert influence over the board and encourage them to reconsider the course being adopted. Given the likely sensitivity of the topics and the need to build mutual trust, it is generally appropriate for this dialogue to be private

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**Escalate** by the same token, depending on the nature of the problem, it may be appropriate to escalate engagement activities, for example by co-ordinating with a wider group of shareholders

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**Vote** depending on the result of these activities, shareholders may wish to express disagreement with the board by voting against resolutions at a general meeting. They may also wish to propose their own resolutions

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**Exit** having reviewed changes to a strategy or governance model that they consider detrimental to shareholders' interests, they may choose to sell shares.

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There is no set formula for engagement. Given the diversity of approaches in evaluating and understanding companies, different shareholders will have different engagement approaches and likely adopt different voice and exit strategies, depending on the circumstances.

Whilst there may be a multiplicity of engagement strategies, public forms of engagement carried out via the media generally represent examples of a breakdown in trust and so constitute a last resort. In this context, there may of course be circumstances when public engagement or criticism is appropriate.

In Section 5 we review current investor approaches to corporate governance analysis and engagement and make recommendations on how to enhance current collective engagement mechanisms.

#### (v) Ownership

The term ‘*Shareholder*’ may refer in the institutional context to either:

- *asset owners*, such as pension funds and insurance funds, who have a duty to act in the best interests of the scheme beneficiaries when formulating investment objectives and overseeing appointed investment managers; or
- *asset managers* who are appointed by the asset owners for their professional expertise in meeting the investment objectives of the asset owners.

The nature of this relationship is determined by the investment agreement or “mandate”. This should govern the nature of the asset manager’s performance objectives and performance appraisal, set out relevant risk parameters and define the expected stewardship activities the asset manager is expected to carry out.

Asset managers then make the specific portfolio level decisions on buying and selling securities. Within their mandate, asset managers will generally have responsibility for engagement with individual companies.

In section 7 we clarify the relationship between asset owners and asset managers in relation to their respective stewardship responsibilities.

#### (vi) Information asymmetry

The problem of information asymmetry within this structure is well-rehearsed:

- Executive directors will have greater access to information on, and a more detailed understanding of, the business than non-executive directors.
- Non-executive directors will have greater access to information on, and a more detailed understanding of, the business than asset managers.

- Asset managers will generally have primary responsibility for monitoring the performance of the companies they invest in and will make decisions on individual companies under their mandate. They will not generally refer individual decisions to asset owners.

These different levels of knowledge and access to information are unavoidable.

It is crucial, however, that non-executive directors and asset managers have access to an appropriate level of information and access to appropriate individuals to be able to discharge their responsibilities effectively.

## C. RECOMMENDATIONS

1. **Corporate governance reporting by companies must focus more on the application of the Code Principles rather than just compliance with provisions. In this sense, we support the notion of ‘Apply and Explain’.**
2. **The new Preface to the Code urges Chairmen to report personally in their annual statements how the principles relating to the role and effectiveness of the board (in Sections A and B of the Code) have been applied. The ABI’s review of Code explanations<sup>2</sup> in 2012 found that companies with a Chairman’s introductory statement to the corporate governance section scored on average 56% higher in terms of quality of explanation. We recommend that all companies adopt a Chairman’s introductory statement to the corporate governance section of the annual report and for the FRC to consider incorporating this into the Code as a provision.**
3. **When explaining deviations from the Code, disclosures should aim to adhere to the following criteria:**
  - **Company-specific in context and historical background**
  - **Convincing and understandable rationale**
  - **Mitigating action to address any additional risk**
  - **Time-bound and subject to on-going review**
  - **Specify deviations from the main principles as well as from the specific provisions**
  - **Explain how the alternative course being adopted is consistent with the Code principles and contributes to the objective of good governance.**

# 4. Non-Executive Directors

ABI members encourage companies to think about how different non-executive roles may best be structured.

## A. INTRODUCTION

Board effectiveness is the heart of good governance. The ABI published its second report on board effectiveness in December 2012<sup>3</sup>. As well as updating progress of how leading companies currently implement diversity, succession planning strategies and board evaluations, we reported on the key attributes of successful Chairmen.

Non-executive directors are clearly crucial to good governance. We have therefore focused on possible measures to improve the framework within which they operate and so enhance their ability to achieve the appropriate balance between support and challenge. In this context, we have concentrated on three areas:

- Expected time commitment
- Ensuring sufficient and timely information flow
- Structural measures to ensure that non-executives can maintain and assert independence.

We also consider whether shareholders should play an increased role in the nomination of new directors and whether there are potential advantages of a two-tier board structure (i.e. separate Supervisory Board and Management Board) or the enhancement of the role and authority of the non-executives as our near-equivalent to a supervisory function.

## B. TIME COMMITMENT

Non-executive directors need to be able to obtain a good understanding of the company's business and operations and the strategic challenges and opportunities it faces. Particularly for larger, international companies, perhaps with a range of different businesses, this has become increasingly complex and demanding.

At the same time, the amount of time non-executives spend on the principal Committees has been increasing. Directors often comment that this can be at the expense of understanding and overseeing more critical areas, such as

long-term strategy, operational performance and the financing model.

Shareholders encourage companies to think carefully about the time-commitment of non-executives, both in aggregate and in efficient development of suitable awareness and division of labour through the split of responsibilities between different non-executives. ABI members encourage companies to think about how different non-executive roles may best be structured. This would include flexibility over different levels of time-commitment for different non-executive roles, particularly in larger companies. ABI members recognise that remuneration of non-executives may need to be adjusted to be commensurate with an increased time-commitment and responsibility.

Approaches will vary depending on the nature and complexity of a company, but, for example, consideration could be given to increasing the level of time commitment for specific roles, such as Senior Independent Directors and Committee Chairmen, or creating new types of non-executive roles, such as non-executives who are experts in important technical or operational areas.

If a particular non-executive has an increased time commitment at a particular company, this may affect the number of other roles that he or she can realistically take on.

In the context of a material transaction, non-executive directors may be expected to have their time commitments expanded significantly in order to assess the merits of the transaction in a short period of time, led by non-executives who have expanded roles and expertise.

Concerns are sometimes raised that, if non-executives increase their time commitment and become more closely involved in the business, this may compromise their independence. ABI members believe:

- The role of executive and non-executive can remain clearly distinguished. Many, particularly larger, companies, already have non-executive Chairmen who may spend the majority of their time with one company.

<sup>3</sup> Report on Board Effectiveness: Updating progress, promoting best practice - <http://www.ivis.co.uk/pdf/abi%20report%20on%20Board%20effectiveness%202012%20-%20final.pdf>

## 'Information risk' is arguably one of the biggest risks faced by the board.

- Depending on the circumstances of the company, it may be appropriate to have a board structure which combines some non-executives who continue to devote the more traditional 20-40 days per year, with others who have a greater expected time commitment
- Remuneration structures and incentives distinguish and reflect the time commitment of the non-executive and an outcome-driven interest of the executive. Financial independence from the impact of a particular outcome is a material distinction between the position of a non-executive and the executive directors.

### C. BOARD AND COMMITTEE COMPOSITION AND MANDATES

The Corporate Governance Code requires that, except for small companies, at least half the board, excluding the Chairman, should be made up of independent, non-executive directors and that committee membership should not result in undue reliance being placed on particular individuals.

Where a transaction is contemplated, if there is a management buy-out or similar transaction with a controller or group of controllers, or where a conflict may otherwise arise, it is standard practice for the company to form a committee of directors who are not conflicted to consider the transaction and communicate their views to shareholders where their approval is required.

Where transactions do not require the establishment of a special committee, non-executive directors may not be sufficient in number or expertise to challenge the executive directors effectively without additional structural safeguards being put in place.

### D. INFORMATION FLOWS

#### (i) Introduction

Non-executive directors should have sufficient time and information so they are able to challenge the executive directors effectively in a constructive manner. This principle should be seen as part of the Chairman's responsibility to ensure that non-executive directors receive accurate, timely and clear information pursuant to the Code.

What is sufficient information is to be determined by the non-executive directors in dialogue with the Chairman.

Superficial business descriptions may fail to deliver adequately the required content for directors to challenge the executive directors constructively<sup>4</sup>. Recent common law developments require the board to control the process of information dissemination and non-executive directors not to allow themselves to be submerged in a sea of paper or accept poor materials.

#### (ii) General information flows

Information matters.

- No matter how skilled, experienced and collectively diverse the non-executives may be, in the absence of the right information, they are blindfolded.
- 'Information risk' is arguably one of the biggest risks faced by the board. Businesses are rarely plunged into crisis because of a lack of problem-solving prowess on the board – but more often because the board did not know they had a problem<sup>5</sup>.

The current state of information in the boardroom demands attention.

- The principal source of information for most non-executives (beyond board meetings) is the board pack and there are concerns that the state of many company board packs does little to mitigate information risk.
- A survey published in 2012 by Korn/Ferry and KPMG revealed that one in five non-executives felt out of depth in the boardroom because of poor briefing materials<sup>6</sup>.

Board packs are commonly too long to be read and too narrowly focused. The challenge is to broaden the scope of board information, whilst reducing the volume:

- A FTSE 100 board pack is, on average, 288 pages long which would take over 9 hours to read<sup>7</sup>.
- Board packs are often heavily weighted towards backward-looking financials and operational detail, providing little if any stimulus for a more strategic or forward looking discussion in the boardroom.

To develop the right scope of information, the board must first clarify their priorities and the value they want to add by having a clear brief for the board pack:

- Information is the stimulus for the conversation that follows. Directors need to be clear about their board's priorities, before attempting to fix the information flow.
- Armed with a clear brief, management can then develop the information that is needed to stimulate the right conversation in the boardroom.

<sup>4</sup> Salz Report para 9.40.

<sup>5</sup> Roads to Ruin: <https://www.cassknowledge.com/research/article/roads-ruin-study-major-risk-events>

<sup>6</sup> Korn/Ferry KPMG Research, 2012: <http://www.hrreview.co.uk/hr-news/hr-strategy-practice/bad-habits-in-the-boardroom/35307>

<sup>7</sup> Board Intelligence research in conjunction with the Judge Business School, 2012

Non-executive directors may not be advised of the transaction early enough in the process for them to have sufficient time and information to give proper consideration to the merits of the transaction: it is important they are able to do so<sup>9</sup>.

**The Six Conversations Model<sup>8</sup>**

	<b>Strategy</b> Becoming the business you want to be	<b>Performance</b> Achieving results in this financial year	<b>Conduct</b> Doing business in the 'right' way
<b>Stewardship</b> Shaping/supporting	<b>Conversation 1</b> • Priority • Priority	<b>Conversation 2</b> • Priority • Priority	<b>Conversation 3</b> • Priority • Priority
<b>Supervision</b> Monitoring/checking	<b>Conversation 4</b> • Priority • Priority	<b>Conversation 5</b> • Priority • Priority	<b>Conversation 6</b> • Priority • Priority

- One example of a structured approach to these issues is a thematic model, illustrated above, to help clarify a board’s priorities with reference to the full scope of their role. A model of this nature can help a board to apply the principles of UK Corporate Governance Code to what their business needs from their board, at a given point in time.

The board pack must be readable. It must be concise and easy to follow.

- The information in the board pack should be ‘demand led’ (addressing a pertinent question of relevance to the board) rather than ‘supply led’ (representing information that happens to be available).

Relevant and readable information will unlock the potential of a strong board, enabling a focused and productive conversation about the things that matter.

- With the right scope of information, presented in a concise and readable fashion, directors are better placed to ask the pertinent questions and add valuable insights around the things that really matter.
- The right information enables a board to take the right decisions, at the right time, about the right things.

**E. CORPORATE TRANSACTIONS AND INDEPENDENCE**

In the context of a transaction, it is of particular importance that non-executives are able to exercise their function of independent challenge effectively.

The Corporate Governance Code provides that the board should determine whether the director is independent in

character and judgment and whether there are relationships or circumstances which are likely to affect, or could appear to affect, the director’s judgement. Independence is more than the nature of the non-executive’s connections with the company – it extends to avoiding circumstances (which may involve a deficiency in internal structures and procedures) which may undermine, or appear to undermine, the ability of non-executive directors to act independently.

Where a company is considering a transaction which does not require an independent committee of directors to be formed, circumstances may nonetheless exist which create, or could appear to create, a conflict for certain of the directors (perhaps driven by their current and future management roles).

Non-executive directors may not be advised of the transaction early enough in the process for them to have sufficient time and information to give proper consideration to the merits of the transaction: it is important they are able to do so<sup>9</sup>.

In addition, executive directors typically are strongly supportive of the transaction and the information provided to, and communications with, non-executive directors may be characterised by advocacy rather than explanation of options in a balanced and even-handed manner. Non-executive directors may therefore find it difficult to challenge the views of the executive directors constructively.

As set out in the Salz Review, it is the Chairman’s obligation to ensure all directors have the opportunity to make their contribution to discussion and that individual directors invest time in developing their familiarity with the group businesses and with the subject matter of the meeting and related materials.

<sup>8</sup> <http://www.boardintelligence.co.uk/home>

<sup>9</sup> This is the logical extension of General Principle 2 of the Takeover Code, which provides that shareholders should have sufficient time and information to reach a properly informed decision on a transaction.

Because of concerns over secrecy, often major shareholders are not made aware of the possible transaction until very shortly prior to announcement. Non-executive directors should have sufficient time and information, as well as the opportunity, to consider a transaction and provide their views to shareholders when they are first made insiders. This is the best way to balance the need for the provision of sufficient information to shareholders with the desire to maintain secrecy before announcements and avoid false markets.

Companies do not always take care to ensure that non-executive directors are provided with all protections permitted under English company law. Non-executive directors may not be entitled to have defence costs incurred by their companies on their behalf for any relevant period prior to monies due under directors' and officers' insurance policies being paid. The absence of such protections can only weaken non-executive directors' ability to constructively challenge executive directors and reduce the number of persons willing to take on such a position.

In the context of a transaction, the mandate of the non-executive directors (or, where the transaction involves a potential conflict, the independent committee) is considered by the board at the outset. The mandate may extend not only to considering the terms of the proposed transaction but also whether the transaction itself (as opposed to other courses of action) is in the best interests of the company and shareholders as a whole.

The non-executive directors (or, where appropriate, the independent committee) should consider whether it is appropriate to seek separate, independent advice on the merits of the proposed transaction. The adviser should be paid on a fixed fee (as opposed to a 'success' or 'incentive') basis. Such advice is likely to be of particular importance and value in large, complicated or potentially hostile transactions.

Non-executive directors may be unaccustomed to operating as a group as opposed to individually. The Salz Report recommended that companies consider setting time aside at the end of the full board meetings for non-executives to discuss, without executives present, how a particular meeting has gone. Other jurisdictions recognise this imperative. The rules of the New York Stock Exchange and NASDAQ, for example, each provide that independent / non-management directors must have regularly scheduled meetings at which executive directors are not present<sup>10</sup>. This is instructive, given that typically the ratio of independent to non-independent directors is generally higher in US corporations. The need for collective action by the non-executive directors may be more acute where a large amount of information needs to be assimilated and difficult decisions taken in short timescales.

## F. APPOINTMENT OF DIRECTORS/ SHAREHOLDER NOMINATION RIGHTS

Following the Banking Crisis, there has been increased focus on director accountability and nomination processes. In 2011, a Department for Business Innovation and Skills' (BIS) discussion paper<sup>11</sup> raised the possibility of increased shareholder involvement in Director Nomination Processes. In particular, they considered the Swedish model, which provides large shareholders with direct representation on the Nomination Committee. Following this, the Kay Review recommended that companies consult long-term investors over major board appointments.

The Shareholder Nomination Committee model developed in Sweden as listed companies were often controlled by block shareholders, primarily large family investors or banking-industrial groups, who also determined the composition of the board. The Shareholder Nomination Committee was therefore created to give external minority shareholders a way to ensure they had greater input into board composition.

The UK market, in contrast, is one that is generally characterised by a dispersed share register with, in most cases, no one group of shareholders able to control the company. Under the UK Corporate Governance Code, the Nomination Committee, comprised of a majority of independent non-executive directors and usually chaired by the company Chairman, is responsible for proposing candidates to the board for endorsement. Candidates are then submitted to shareholders for their approval at the next AGM.

In addition, the small number of listed companies in the Swedish market means that it is relatively easy for investors to put candidates forward to serve as members of the Shareholder Nomination Committee. The large number of listed companies in the UK would make it far harder to staff such committees. Further, some evidence from Sweden suggests that such committees often become mere formalities, with real decisions taken outside the formal process.

Most ABI members are already involved to varying degrees in appointment processes in companies in which they have significant holdings. This is primarily for Chairmen or Chief Executive appointments and typically where they are a top five shareholder.

In most cases, this focuses on the qualities and expertise required by the company in view of its specific circumstances and strategy. Sometimes the largest shareholders are consulted on specific candidates, which in most cases requires them to become insiders.

<sup>10</sup> NASDAQ Equity Rule 5605(b)(2): "Independent Directors must have regularly scheduled meetings at which only Independent Directors are present ("executive sessions"). NYSE Listed Company Manual Rule 303A.03: "To empower non-management directors to serve as a more effective check on management, the non-management directors of each listed company must meet at regularly scheduled executive sessions without management."

<sup>11</sup> Department for Business Innovation and Skills. Executive Remuneration: discussion paper. 2011. <http://www.bis.gov.uk/assets/BISCore/business-law/docs/E/11-1287-executive-remuneration-discussion-paper.pdf>



While members want to be consulted, they consider that the Nomination Committee should retain control and responsibility for the nomination process. The role of the Nomination Committee is an integral part of the function of directors in fulfilling their duties.

Members consider the Swedish model to be driven by the nature of their domestic market and do not believe it would translate successfully to the UK market. In addition, in the UK it would require a disproportionate time commitment from a small number of large institutional investors.

Some members feel that there could be some benefit in becoming more directly involved in nominations in exceptional circumstances; for example, where there is a controlling shareholder.

Overall, members believe that, when consulted, their current level of involvement in director nomination processes is appropriate. However, consultation by more companies is encouraged. Members also noted that the quality of reporting on the activities of the Nomination Committee has often been poor and fails to give shareholders a good understanding of the reasons for appointments during the year.

## G. UNITARY VS. TWO-TIER BOARD

Following the Banking Crisis, there has been debate over the merits of different board structures.

Members have found no evidence that other board structures, such as two-tier boards (i.e. separate Supervisory Boards and Management Boards), work better than the unitary structure in practice. European countries with a Supervisory Board structure, including Germany, Holland and Belgium also had to support financial institutions during the banking crisis.

More broadly, members' experience engaging with companies with a two-tier board structure has not been positive. Members have often found the Chairmen of Supervisory Boards unwilling to engage in meaningful dialogue with shareholders. Other experiences have suggested that Supervisory Board members are often too remote from management and comparatively less knowledgeable about the business and its key risks and opportunities.

Members also believe there is considerable merit in the executives being directly available for questions and discussion while having collective responsibility as fellow board members: non-executive directors on a unitary board are closer to the day-to-day decision-making process of the business. This is also more likely to underpin the governance decision-making process better, in particular, on the principal board committees.

For these reasons, whilst remaining mindful of the need to avoid overly large boards, many members are supportive of the recent trend of companies increasing the number of executive directors appointed to the unitary board beyond the Chief Executive and Finance Director. These appointments have typically been directors that are responsible for individual business divisions or geographic regions.

Equally, however, it may well be appropriate for non-executives, both regularly and in specific circumstances, to have discussions without the executive present. ABI members encourage this practice.

Overall, there is little to indicate that a two-tier model of governance would result in an improved level of challenge or oversight from non-executive directors. Instead, focus on enhancing the scope for non-executive assessment of executive actions and decision making is to be encouraged.

## H. RECOMMENDATIONS

4. Companies are encouraged to review the time-commitment requirements of different non-executive roles and consider whether changes may result in better stewardship outcomes.
5. Companies are encouraged to consult their largest shareholders on major board appointments and improve Nomination Committee reporting in the annual report and accounts.
6. Boards are encouraged to be more demanding of the formal flow of information they receive. This might include the following:
  - a. The board should provide management with a clear statement of their priorities to serve as a brief for their information needs – updated at least annually and as often as circumstances require it.
  - b. The board pack should help monitor the health of their organisation's culture.
  - c. Boards should not be accepting of a board pack that is too long to be read.
7. In the context of a transaction, executive directors should inform the appropriate non-executive director of the proposed transaction as early as possible. In any case, this should occur when an approach is received from a possible bidder or management first actively considers a transaction in respect of which a shareholder approval is to be sought.
8. The non-executive directors should be provided with a narrative description of discussions between the company and the transaction counterparty and such narrative should be disclosed in summary form in the circular to shareholders.

9. Non-executive directors should meet as a group without executive directors to consider the transaction and confirm to the Chairman, prior to the publication of any circular or recommendation to shareholders, that they are satisfied they have received sufficient time and information.
10. Non-executive directors should be given direct access to financial and legal advisers to the company on a transaction in order to ensure that information can be rapidly obtained and understood.
11. Where a company is subject to a management buy-out or similar transaction or engaging in a transaction with a controller or group of controllers, or where a conflict may otherwise arise, a special committee comprising only unconflicted directors should always be formed to consider the transaction. The committee should always take independent financial and legal advice. It is not acceptable for a 'Chinese wall' to be established within the existing advisers to the company.
12. Independent committees formed to consider a transaction should ensure their mandate is clear and is disclosed in any circular to shareholders or annual report, as is currently required for e.g. remuneration committee terms of reference (Corporate Governance Code D.2.1 / DTR 7.2.7.R). Normally, the mandate should extend to considering the terms of the transaction and whether the transaction itself (as opposed to the other courses of action) is in the best interests of the company and shareholders as a whole.
13. The non-executive directors should consider whether it is appropriate to seek separate, independent advice on the merits of the proposed transaction. The adviser should be paid on a fixed fee (as opposed to 'success' or 'incentive') basis.

# 5. Shareholder Engagement

## A. INTRODUCTION

ABI members have a long record of taking their shareholder engagement responsibilities seriously. As early as 1991, the ABI published a discussion paper on the responsibilities of institutional shareholders<sup>12</sup>.

The document outlines nine principles of good practice for institutional investors, the first of which describes the responsibility to engage with companies: “Institutional investors should encourage regular, systematic contact at senior executive level for the purposes of an exchange of views and information on strategy, performance, board membership and quality of management.”

Over time, the ABI’s role in facilitating dialogue between investors and companies has led to a strong understanding of different approaches to engagement.

There is no set formula for successful engagement: different approaches are required for different companies and for different circumstances. Neither is there a single correct organisational approach. Investors’ engagement practices depend to a large extent on the nature of their investment process and business model. They will also depend on the specific requirements of their clients.

Like any other aspect of the investment process, asset managers will seek to provide market leading in-house research and analysis to gain a competitive advantage. There is a ‘market for ideas’ in governance, just as there is in any other aspect of investment analysis.

However, ABI members consider it increasingly important to communicate with stakeholders on the nature and scale of existing corporate governance analysis and engagement and consider whether it can be enhanced.

## B. UK EQUITY OWNERSHIP

ABI members remain substantial long-term UK equity investors. Individual members’ holdings in the UK range from £11bn – £64bn and the number of companies held from below 250 to in excess of 1000.

All members of the ABI Investment Committee are signatories to the FRC’s Stewardship Code and the UN-backed Principles for Responsible Investment.

## C. ROLE OF CORPORATE GOVERNANCE ANALYSIS AND ENGAGEMENT

Members see corporate governance analysis and engagement as an important duty to be exercised on behalf of their clients. This has been the case for a long period of time and has come to be a normal part of the investment process.

Some members acknowledge that their corporate governance practices may have begun as a compliance function separate from the investment process, but this has evolved over time into part of their investment process.

All members consider that the positive experience and contribution to performance, over a number of years, of incorporating engagement and corporate governance analysis into the investment process has created a virtuous circle and increased recognition of its contribution by individual fund managers.

The culture of responsible ownership has become increasingly integrated into the investment process.

Corporate governance engagement and analysis activities are viewed as a method of seeking outperformance and, therefore, increasingly a commercial imperative.

Companies equally value engagement with shareholders, although they emphasise:

- The paramount importance of confidentiality being maintained to ensure an appropriate relationship of trust
- The importance of engaged and expert corporate governance resource within institutions, and full preparation, to ensure effective dialogue.

## D. INTEGRATION OF GOVERNANCE AND INVESTMENT

### (i) Resources

As demand for more and increasingly sophisticated activities grows among clients, both in the UK and overseas, this puts pressure on existing levels of resources. It also makes it important to consider organisational approaches to exercising shareholder engagement responsibilities, including ensuring effective integration with investment teams.

<sup>12</sup> [http://www.avis.co.uk/PDF/3.3\\_The\\_Responsibilities\\_of\\_Institutional\\_Shareholders.pdf](http://www.avis.co.uk/PDF/3.3_The_Responsibilities_of_Institutional_Shareholders.pdf)

## 100% have a process in place to ensure that in-house investment analysts are integrated into dedicated corporate governance engagement and analysis.

Current approaches among ABI members include:

- No dedicated stewardship personnel, but with clear stewardship responsibilities allocated to portfolio managers and analysts
- Smaller teams that are integrated into the investment process
- Large dedicated stewardship teams, which may also provide responsible investment services to third party clients on a range of environmental, social and governance issues.

The average dedicated stewardship headcount among members is 6.5, but ranges from 0 to 16 full-time dedicated staff.

As members' stewardship activities become more integrated into the investment process, they are increasingly assigning stewardship responsibilities to non-dedicated staff, such as investment analysts, portfolio managers, compliance professionals, public affairs professionals and, in many cases, CEOs and CIOs.

- The average number of non-dedicated staff with stewardship responsibilities is 25, but ranges from 9 to 54
- 70% of members have a formal process to involve their Chief Investment Officers in escalated engagement activities
- 100% of members typically involve equity analysts and portfolio managers in engagement activities

On the question of whether institutions operate a formal materiality threshold for voting and engagement activities:

- 80% of members do not operate a specific "materiality rule" to guide their voting or engagement. However, a "common sense approach" to whether they can engage successfully at lower levels of ownership is generally applied.
- 20% applied a specific "materiality rule": for example, one member applied a less detailed analysis of voting decisions in respect of holdings of less than \$20 million or less than 1% of the company in question. Another member applied a 0.5% threshold for overseas companies.

Members allocate substantial resources to companies' remuneration consultations. While members understand the importance of engaging on this issue, they believe it important that it does not inhibit dialogue on a broader range of governance issues with companies.

### (ii) Integration

In the past there has been criticism from Chairmen that there is a lack of consistency in their dialogue with investors, including, for example, that:

- Governance teams can operate in a silo away from the investment process and, consequently, companies can receive different feedback from corporate governance specialists and portfolio managers
- Certain meetings do not have representation from both the governance specialists and portfolio managers
- Some governance teams are considered by Chairmen to fall short in their ability to form good judgement on companies' proposals and too often adopt a box-ticking approach, rather than forming judgements on new approaches and taking account of companies' specific business models.

There has also been wider criticism that long-term risks and opportunities relating to corporate governance, including environmental and social issues, are not integrated sufficiently into the methodology asset managers employ to analyse and value companies.

In response to these criticisms we asked members about their approach to integration across three areas:

- Investment Process
- ESG integration for equities
- ESG integration for other asset classes.

### Investment process

We asked members how corporate governance matters are integrated within the investment process on a day-to-day basis from an operational perspective. This includes how integration is managed in both directions i.e. whether the in-house investment analysis is incorporated into corporate governance engagement and vice versa:

- 100% have a process in place to ensure that in-house investment analysts are integrated into dedicated corporate governance engagement and analysis; for example, proxy voting analysis or understanding of companies' business strategies when responding to companies' consultations
- 80% of dedicated corporate governance teams have access to sell-side research and speak with analysts on specific sectors and companies

## 50% of members' proxy voting decision-making processes require formal approval from the Chief Investment Officer.

- 100% of corporate governance teams attend, or are able to attend, portfolio manager / analyst meetings with management to ensure they have a clear understanding of current trading events and strategic priorities
- 50% of corporate governance teams attend portfolio manager / investment analyst meetings that review or make investment-related decisions.

There has been criticism from companies that the corporate governance teams are junior members of staff who do not have sufficient senior level support among investment institutions:

- 80% of members' corporate governance teams have a direct reporting line to the CEO / CIO or at least Head of Equities
- 100% of corporate governance teams (or activities) work as part of the equity research or portfolio manager teams, and are a clear component within the overall day-to-day investment process.

### ESG integration for equities

This refers to approaches to investment analyses that incorporate risks and opportunities relating to environmental, social or governance matters into the method employed to value securities. On a portfolio level, it may refer to specific investment styles which seek to identify companies considered best-in-class across a number of corporate governance areas or those considered high-risk and so to be avoided.

ABI analysis shows that:

- 60% of members have adopted a formal mechanism as part of the investment process to integrate ESG risk or opportunities into their securities' valuation methodologies
- 50% of members apply similar ESG considerations in their portfolio construction
- 40% have begun developing performance-attribution analysis tools to track and understand the effect of ESG analysis and engagement
- 20% of members have begun incorporating top-down environmental and social themes as part of their process to consider asset allocation strategies.

### ESG integration for other asset classes

There is also demand for long-term ESG factors to be incorporated across different asset classes.

ABI analysis shows that:

- 70% integrate ESG research and engagement into the fixed income investment process
- 20% integrate ESG research and engagement into the private equity investment process
- 30% integrate ESG research and engagement into the property investment process
- 0% integrate ESG research and engagement into the alternatives investment process.

### (iii) Proxy voting

There has been criticism that proxy voting decisions are made without due regard for the commercial reality of the business and without sufficient understanding of individual companies' circumstances. Companies often believe that they have support from portfolio managers but find separate concerns within the governance team.

ABI analysis shows that:

- 90% of members' proxy voting decision-making processes include active participation from portfolio managers and investment analysts. For some, decisions are made in consultation with portfolio managers, whereas for others, portfolio managers are included as part of a formal decision via a Corporate Governance or Responsible Investment Committee.
- 50% of members' proxy voting decision-making processes require formal approval from the Chief Investment Officer for negative voting decisions or for large equity positions.
- 20% of members have assigned proxy voting responsibilities exclusively to portfolio managers.
- One member believes that, as a matter of policy, proxy voting should be operated separately from the portfolio managers, as it is considered important to retain the independence of the corporate governance team and minimise conflicts of interest. However, to retain company level understanding, analysts are assigned sectors among the corporate governance team. To strengthen their ability to operate independently, they also have direct access to the independent non-executive directors of their board for input on key voting decisions.

## E. ENGAGEMENT

All ABI members emphasise that the quality of dialogue is paramount and more important than, simply, the number of meetings held: stewardship should not be a “numbers-game”. In the same vein, in the absence of clear objectives linked to shareholder value, there is a risk that some meetings become a burden instead of a benefit.

We believe that the key to successful engagement is for boards and investors to behave in a way that is mutually supportive, promotes constructive dialogue and ensures that legitimate concerns are raised and addressed.

ABI research indicates that the members of the Investment Committee continue to dedicate substantial resources to company engagement meetings:

- Over the course of the last 12 months, members of the ABI Investment Committee each had on average 150 meetings with UK-listed companies that had a dedicated corporate governance agenda
- Corporate governance engagement is also increasingly incorporated as part of the regular investment-related meetings, both directly by portfolio managers or by dedicated corporate governance professionals in attendance. We found that on average over the last 12 months, each member had approximately 650 meetings with UK-listed companies where corporate governance was a subset (or potential subset) of the agenda.

### (i) Members’ approaches to engagement

ABI members have a range of different approaches to governance and stewardship-related engagement.

All members emphasise that every engagement approach depends on the specific circumstances of the company in question and that their approach could vary extensively from case to case. They also emphasise the importance of confidentiality being maintained to ensure an appropriate relationship of trust and, in turn, enhanced dialogue.

However, the broad categories of engagement meetings are:

**On-going** these meetings are part of building a long-term relationship with a company. Meetings are typically with Chairmen or CEOs and cover a wide range of topics such as corporate governance, strategy, financing and performance. The company generally arranges such meetings with its largest shareholders to give an overall update and to give shareholders the opportunity to raise any specific concerns. Members find these meetings helpful in improving understanding and trust. The meetings also enable large holders to explain their approach to corporate governance away from the busy AGM environment and to flag

potential issues at an early stage. Many members believe that regular meetings with companies tend to help them to have increased influence if problems occur. Some members may have up to four meetings per year with a Chairman, whereas other members prefer to only meet when they have a specific issue to raise with the company.

**Specific** this form of shareholder engagement is generally initiated by companies to consult shareholders on specific business proposals. The process is typically highly iterative and may require a series of meetings to navigate the feedback from shareholders. For example, this could include, inter alia, consultation on:

- major changes to the structure of remuneration
- the merits of different corporate transactions
- consultation on the nomination process for major board appointments or
- changes to long-term strategy.

Such dialogue is generally initiated by companies to seek shareholder input before making final decisions. In some cases, shareholders may request consultation on a specific issue.

**Reactive** these meetings relate to issues that emerge unexpectedly. The issues can vary extensively but often include concerns over remuneration, board changes, capital decision-making, poor performance or general emergencies. These meetings are concerned with ensuring the company responds in the right way to the problem, handles an emergency appropriately or simply that the right level of accountability is applied in the circumstances.

**Proactive** such meetings may be initiated by investors, sometimes in the absence of a specific or obvious problem to address, where, for example they consider there is some matter or risk that may result in underperformance or poor governance outcomes in the future. Investors that adopt this approach tend to focus on the momentum of change at a company. For instance, governance may be gradually deteriorating or other characteristics of a company’s decision-making may indicate poor governance processes, for example, matters relating to environmental or social issues. Such meetings attempt to address these issues at an early stage before they result in value loss. Proponents are generally long-term shareholders that have developed a strong understanding of the business and a comprehensive engagement strategy.

**Systematic** these meetings overlap with the “pro-active” approach, but refer to cases where members have developed formal mechanisms to identify companies where increased engagement is needed. These typically seek to identify companies where poor governance has coincided with underperformance. Members adopting this approach generally have in-depth interaction with fund managers at an early stage in identifying company issues and attempt to make a firm link between underperformance and the governance practices.

### **(ii) Escalating issues of concern not adequately addressed**

Approaches to escalating issues with companies will again depend significantly on the case and circumstances in question. Overall, however, institutions tend to have similar general approaches.

A typical approach might include:

- speaking with, or writing a letter to, the Chairman
- raising the issue with the ABI Investment Committee
- meeting the Senior Independent Director
- sharing concerns with other shareholders with a view to potential collective engagement
- voting against resolutions or requisitioning General Meetings.

Although processes among investors are similar, there are many differences on when to escalate, at what pace, and with whom.

### **(iii) Feedback to companies**

Nearly all members give direct feedback on engagement matters to companies during the meeting. Most members will also follow a meeting with a letter, outlining the issues discussed and any agreed company commitments. This is an important component of the engagement process.

On various sensitive issues, some institutions prefer to give feedback to companies following the meeting. This would typically be because of the number of fund managers who may be present in meetings and who may have different investment approaches and different priorities (e.g. income or growth). In such cases, institutions prefer to consider the weight of opinion among the team before presenting the “house view” to the company. This may be communicated via the house broker or directly to the company.

### **(iv) Willingness to be insiders**

All members have appropriate procedures in place to enable them to receive price sensitive information and become insiders with appropriate safeguards.

60% of members have developed Chinese wall procedures to enable their corporate finance or corporate governance team to be contemporaneously inside while the portfolio managers continue to be able to trade in the company’s securities.

This enables investors to give good, non-binding feedback to companies and reflect investment views without having to implement stock restrictions. For example, in relation to mergers and acquisitions, the governance team can go into a price sensitive meeting knowing the institution’s “house view” on valuation. In such approaches, the corporate governance team is the first point of contact and co-ordinates internally whether to go inside and, if so, with the compliance department.

The corporate governance team may go inside relatively early in the process, enabling the investor to engage in dialogue for a longer period. The investment team will be made inside only at a late stage.

Members are most commonly asked to go inside on matters relating to capital raising, merger and acquisitions, remuneration and executive director changes.

In deciding whether they are prepared to become insiders, members generally consider the size of their holding, whether they have an active or passive interest in the securities of the company, the duration they would be expected to be off market and, in some circumstances, whether the “house view” on the company in question has shifted materially in recent times.

Generally, members are willing to be insiders for a week and, in some circumstances, for as long as a month.

### **(v) ABI facilitating proactive engagement**

Members are increasingly developing more proactive and systematic approaches to identifying engagement targets. This has focused on specific thematic topics and identifying companies that are considered to be underperforming and/or which are considered to have poor management and/or governance.

We asked members whether they would see merit in the ABI developing a proactive mechanism for identifying engagement targets to be operated in tandem with existing engagement meetings. This could focus either on specific themes, for example succession planning, or developing a process of identifying companies with both poor governance and performance.

Some members felt that such an approach might suffer from problems similar to those associated with other forms of collective engagement. However, a large majority felt that, if designed appropriately, such a process would be of benefit to members and complement their own engagement approaches, rather than duplicate them.

Often issues that require collective engagement are complex and solutions not always obvious. A key role for the ABI Executive is to foster an understanding of common concerns among members but, in so doing, ensure that they are able retain individual specific views.

Supportive members felt that this would be possible given the ABI's flexible approach to engagement which, in particular, does not ascribe a specific escalation methodology. However, it would be important for companies' identity and subsequent dialogue to be confidential.

Such an approach would require further development and careful consideration of the appropriate approach to identifying relevant companies.

#### **(vi) Collective engagement**

Most members do not contemplate collective engagement unless they have first raised the issue individually with the company and concluded that insufficient or no progress is being made.

Often issues that require collective engagement are complex and solutions not always obvious. As a result, there are often a number of views on different possible approaches and solutions.

Different views on solutions often mean that there are different views on how best to escalate issues.

Often, therefore, there are no clear and agreed objectives within collective engagement, particularly when a larger number of shareholders are involved. Equally, if efforts are made to reach a single view, the concern arises that members' individual views may be diluted or lost. Members are particularly concerned if they feel pushed towards solutions that they individually consider counter-productive.

Collective activities are also prone to the risk of leaks. Not only does this break down trust with companies, it also frequently makes companies more trenchant and defensive. If engaging on strategically sensitive topics, such as M&A, leaks may also undermine the Board's ability to negotiate effectively on behalf of shareholders.

Many members believe that most successful collective engagements will tend to involve 3-5 shareholders and include at least one or two of the largest 10 shareholders.

Some members have built up a level of trust with other investors and are able to agree on collective approaches more easily. They are also comfortable that, in such an arrangement, there is less likelihood of a leak to the press or that the objectives of an engagement will change.

Some members feel they are generally best able to achieve their objectives without involving other shareholders. Others have found it effective not to formalise a collective group or arrange a collective meeting, but simply to coordinate similar individual communication to the company with a number of other shareholders.

#### **(vii) Collective engagement through the ABI**

The ABI Executive plays an important role in facilitating meetings between companies and investors.

ABI collective meetings are initiated by members and supplementary to their individual engagements with companies.

Meetings are generally engagements that have been escalated either by companies that are seeking to resolve issues with shareholders or by investors who feel that their concerns have not been addressed.

Often, specific company matters will be discussed formally at the Investment Committee of the ABI, meaning a wider number of institutional investors will be aware of concerns with different companies.

A key role for the ABI Executive is to foster an understanding of common concerns among members but, in so doing, ensure that they are able retain individual specific views. As members gradually coalesce around areas of concern, the ABI is able to represent concerns for a significant proportion of the share capital.

Such engagements normally require a series of meetings over an extended period of time and not just before company AGMs.

In the normal course of events, such meetings are constructive and collaborative, with the intention of increasing understanding on both sides. Typically, a director will describe the decision-making process on the board and give insight as to the rationale and intended alignment with shareholder interests. Investors give feedback to companies and suggest solutions or additional areas the board should consider.

Given the constructive nature of such meetings, the ABI has been able to develop a relationship of trust with a wide range of companies and companies increasingly contact the ABI Executive with a view to facilitating collective engagement with members.



Over the course of the 2012, the ABI facilitated collective engagement meetings with 18 different companies and held 38 separate meetings.

The Executive will normally arrange a pre-meeting to share concerns and decide on areas of focus for the meeting and any objectives, both short and long-term.

The meeting itself will be chaired by a senior figure among the ABI members and individual members will raise their own specific concerns.

A post-meeting discussion will then focus on members' interpretation of a company's statements or responses during a meeting. This will consider whether the company has fully addressed members' concerns and decide on any next steps.

In almost all cases, the Director of Investment Affairs will write a letter to the company following the meeting. This letter will typically outline commitments made by the company, highlight any areas of outstanding concern and convey whether a further meeting will be required. The letter draws on member feedback.

Members' engagement will normally continue on an individual basis with the company while collective engagement is undertaken. In some cases, it may be a means to apply pressure on the company to be more receptive to individual investor engagement.

By not applying a set formula or prescribed escalation process, the ABI's collective engagement leverages the influence of a number of members whilst enabling them to pursue their own individual objectives.

Over the course of the 2012, the ABI facilitated collective engagement meetings with 18 different companies and held 38 separate meetings.

These meetings covered a range of issues, including:

- Succession Planning
- Board Composition
- Remuneration
- Strategy
- Accounting and Audit
- Capital Management.

## F. VOTING

Voting is considered a critical aspect of responsible ownership. It is also an important means to exercise influence.

ABI members believe it is important to demonstrate to the market that institutional investors undertake rigorous voting analysis and decision-making. As Stewardship Code signatories, all members disclose their voting policies, their formal voting process and actual voting decisions.

There is increasing interest in how institutional investors exercise their voting responsibilities, both in the UK and in overseas markets. There is also increasing focus on how institutional investors use proxy adviser research in formulating voting decisions, both from companies and regulators. Some companies have suggested that investors simply follow proxy advisers without regard to their own ownership policies and principles.

ABI analysis shows that:

- All members vote all of their UK equity holdings.
- Members regularly engage with companies on specific issues ahead of making a final voting decision.
- All members have a policy of using proxy adviser research primarily to identify potential issues and to inform their own in-house analysis, but final voting decisions do not rely on their recommendations. This was true for both UK and overseas markets.
- Where some members have a very small holding they do sometimes vote in accordance with proxy adviser recommendations. However, in all such cases, they have specified their own voting policy to the proxy adviser, so that the voting decision will always be made in accordance with the asset manager's proxy voting policy.
- In overseas markets, 70% of members use proxy adviser research to inform final voting decisions and sometimes follow their recommendations. However, 80% of these have developed their own voting policies for each international market to reflect their own particular policies and principles.
- Over 90% of members vote all of their overseas holdings (where they can). In addition, a large number of members engage with overseas companies on their specific voting intentions: 90% in Western Europe, 80% in USA & Canada, 70% in Central and Eastern Europe, 60% in Asia Pacific and 50% in Emerging Markets.

## Members have had a positive experience with recent "Stewardship Roadshow" events.

### G. INFORMATION FLOWS

In the same manner in which we have outlined the importance of non-executive directors accessing the right information, this principle is of equal importance to shareholders when exercising their stewardship role overseeing the board. This, in turn, requires access to the right individuals at companies as part of the on-going process of dialogue.

Members have found companies' approaches to engaging with shareholders on corporate governance and other stewardship-related issues to vary significantly. They have also found that there can often be confusion between companies and shareholders as to the purpose of different meetings and, in some cases, a lack of a coherent and transparent approach to shareholder engagement. There also remains a sense that corporate governance meetings and events can operate in a silo from the overarching investor relations programme.

Members believe that these issues may adversely affect their ability to meet the aims of the Stewardship Code and encourage companies to develop a more coherent and integrated approach to their investor relations.

Within this context, there are specific areas that may improve communication:

- To ensure a regular and consistent process of engagement, companies should develop a transparent annual investor relations programme, which should include the intended schedule and type of one-to-one and group meetings to discuss corporate governance and stewardship-related issues. It should also include any shareholder consultation expected during the year and the process that will be undertaken.
- Given the board's responsibility for ensuring satisfactory dialogue with shareholders under the Code and their active involvement in such dialogue, the board should periodically review the investor relations programme, in consultation with the largest shareholders.
- In developing an annual investor relations programme, companies should consider the attendance of non-executive directors at a selection of shareholder presentations on the annual results and strategy.
- The board should also consider whether a sufficiently wide range of corporate governance topics is included as part of annual investor engagement. Members have

had a positive experience with recent "Stewardship Roadshow" events that involve presentations from each of the principal Board Committee Chairmen on a wide range of corporate governance issues, including those relating to sustainability. However, members believe that this format would benefit from focusing on strategy and performance to a greater extent.

- Finally, to aid integration, companies could be more proactive in involving the corporate governance representatives of major institutional investors in the traditional investor relations event calendar and communications.

### H. PROPOSED IMPROVEMENTS

Professor Kay indicated that there is a disincentive for investors to engage with companies due to fragmented share ownership and perceived regulatory barriers that inhibit collective engagement.

Our experience facilitating members' collective engagement suggests that institutional investors continue to have a strong incentive to, and do, engage. When required, they also continue to have collective influence.

ABI members believe current collective engagement through the ABI works well but that it may be enhanced by involving a wider pool of institutional investors.

However, to build on the success of existing practices, it is important that any changes:

- retain the private and confidential nature of meetings and avoid duplicating existing practices
- do not seek to force a single view on investors' concerns or escalation approaches and, in particular, do not presuppose a policy of making public statements
- do not lead to an "abdication" of the individual responsibilities of large shareholders.

In this light, the ABI Executive will adjust its existing collective engagement process in two ways:

#### (i) Expand collective engagement

The current process of initiating collective engagement will be maintained but, when such meetings are convened, all significant shareholders will be invited to participate in the meeting whether or not they are ABI members.

The scope of engagement is intended to cover the top 10 shareholders (whatever their level of holding) and any shareholders with a holding of 1% or more.

### **(ii) Investor Exchange**

An “Investor Exchange” mechanism will be established, which will enable any significant shareholder proactively to raise a concern on a particular UK-listed company with other shareholders through the ABI.

The mechanism will be designed to enable participants to determine the level of confidentiality when raising an issue. For instance, an investor may not wish to be initially identified as raising the issue, or may wish to only share more detailed concerns at a later stage.

The relevant concern would then be distributed to other forum participants with a holding in the company of at least 1% of the free float or within the top 10 shareholders.

If there is common interest, the ABI will normally facilitate meetings for them to share concerns and it will be up to the discretion of the participants whether it is appropriate to include additional shareholders.

There will be no expectation of public statement, media activity or any particular escalation strategy, but appropriate action will be decided by interested investors.

The communication of concerns, and the organisation of any collective meetings, will be dealt with by the ABI Executive.

### **Investor Working Group on Collective Engagement**

ABI members are currently participating in an Investor Working Group on Collective Engagement. The Group is supported by the ABI, the Investment Management Association and the National Association of Pension Funds.

The objective of the Working Group is to identify how investors might be able to work together in their engagement with companies to improve both sustainable, long-term company performance and the overall returns to end savers.

The Working Group expects to present its findings by the end of November 2013. These will include recommendations to investors concerning the best ways to structure collective engagement. They will also include recommendations to Government and regulators regarding changes that might be required to law, regulation or guidance to give any new initiatives the greatest chance of success.

## **I. CONCLUSIONS AND RECOMMENDATIONS**

### **(i) Information flows**

14. To ensure a regular and consistent process of engagement and to improve mutual understanding of the engagement process, companies should

develop a transparent annual investor relations programme that includes the intended schedule and type of one-to-one and group meetings to discuss corporate governance and stewardship-related issues.

15. In developing an annual investor relations programme, companies should consider the attendance of non-executive directors at a selection of investor relations’ presentations and proactively incorporate corporate governance institutional investor representatives in such communication. They should also consider whether a sufficiently wide range of corporate governance topics are incorporated into the annual schedule of meetings.
16. Members support the adoption of annual ‘Stewardship Roadshows’ but believe they would benefit from a wider coverage of investment issues, such as strategy, performance and capital management, so that both investment and governance specialists will benefit from being in attendance.
17. Members also recognise the need, as part of their reciprocal stewardship obligation, to ensure the availability of appropriate governance expertise and to prepare fully for meetings and roadshows.

### **(ii) Shareholder engagement**

18. ABI members direct considerable resource and expertise to engagement. As members report increased levels of integration into the investment process, this is likely to translate into a more coordinated and sophisticated level of dialogue with companies and more informed proxy voting.
19. Substantial resources are at present engaged to respond to companies’ remuneration consultations. Members understand the importance of this issue, but want to broaden the nature of their dialogue with companies.
20. While existing collective engagement is generally effective, ABI members are keen to enhance it where appropriate, without damaging current practices.

To this end:

- the ABI Executive will be shortly formalising its proposals to widen participation in existing collective engagements to non-members and launch the Investor Exchange
- the ABI will consult members on how to develop a proactive methodology for identifying companies for engagement, which would be complementary to existing investor engagement.

# 6. Shareholder Rights and Structural Measures to Encourage Long-Term Investment

Enhanced ownership rights were perceived to have generally been used to entrench family, founding or management shareholder control.

## A. INTRODUCTION

Particularly following the Kay Review, there has been considerable debate about:

- the relationship between companies and their investors
- how to encourage an increased proportion of longer-term UK equity investors, for whom engagement is worthwhile
- how to support long-term shareholders with the appropriate mix of ownership rights.

## B. ENHANCED VOTING OR DIVIDEND RIGHTS

Efforts to facilitate more active long-term investment have led to debate over the possible use of differentiated equity instruments that confer enhanced voting or dividend accruing rights for “long-term” holders.

Historically, members have retained a preference for “equality of ownership” and one share – one vote, but have reconsidered other approaches.

The concept of increasing voting rights upon reaching a specified duration of ownership has been tried in other countries, most notably in France. It is also being considered currently as part of the European Commission’s Green Paper on Long-term Investment.

However, there remains a unanimous consensus amongst ABI members on maintaining one share – one vote:

- Members’ experience of different models, such as that used in France, has been negative. Enhanced ownership

rights were perceived to have generally been used to entrench family, founding or management shareholder control. In this sense, it is viewed as a de facto anti-takeover device and, in the same vein, may be used by controlling shareholders - unable to subscribe to a rights issue and not wishing to be diluted - to restrict the use of equity as a capital financing currency.

- Members have also found that, when they have reached the required duration of ownership, they have often been unable to register the shares for enhanced voting rights. This was due to complexity in the ownership chain and difficulties in defining the “owner”.
- There is also concern over other unintended consequences. For example:
  - there could be a significant effect on stock borrowing (which involves a full transfer of legal ownership) which could adversely affect market liquidity
  - equally, it would be possible to evade the restrictions by a ‘long-term’ holder retaining legal ownership, but transferring economic ownership through a derivative, such as a Contract for Differences (“CFD”).
  - Differential dividend rights would suffer from similar administrative difficulties and could also distort market pricing and liquidity, as, for example, the ‘same’ share would be economically more valuable to a seller who qualified for the enhanced dividend than for a new buyer, who would not.

In any event, it is already legally possible for a company to issue different classes of share with different rights attached. That this is so rare<sup>13</sup> reinforces the conclusion that there is no enthusiasm for it on the part of either issuers or investors.

<sup>13</sup> Classes of preference share are commonplace but these are typically driven by financing considerations, rather than governance.

## C. “TWO-TIER” INVESTOR RELATIONS

One idea discussed to improve the relationship between long-term investor and companies is the concept of differentiating the investor relations (IR) service, so that companies might provide a “premium” investor relations service for shareholders on an opt-in basis. This would provide enhanced engagement and access to information and senior management and a more detailed and comprehensive level of engagement for those investors who chose to subscribe. The service would be targeted at shareholders rather than other market practitioners, such as sell-side analysts.

Those investors who subscribed as “long-term engagement partners” might be publically identified. The company could disclose the topics and level of engagement for different investors, so enabling investors to demonstrate the level of engagement undertaken and benefit from success stories. It could also help overcome some of the “free-rider” issues that potentially undermine the ability of engaged investors to gain specific benefit from their own engagement work.

ABI members have divergent views. On balance, most feel that the current investor relations service is generally fit-for-purpose and reflects the principle that all shareholders should receive the same information about the company as nearly as possible at the same time and in the same manner<sup>14</sup>. If the idea was to be given greater consideration, it should not be separate from the existing IR service but seen as part of best practice. It would also depend on the nature of the company and its share register.

## D. ROLE OF THE AGM

The AGM is an integral component of the UK corporate governance system and a key mechanism enabling shareholders to exercise their ownership rights. They also provide the opportunity for shareholders, both small and large, to question the board directly.

However, institutional investors infrequently attend AGMs and they have become increasingly dominated by small retail investors. This has led to the perception, rightly or wrongly, that the AGM event is more synonymous with special interest lobby groups and is a costly exercise with questionable benefits.

‘Virtual’ AGMs have developed in other markets, for example in the US, some replacing in-person meetings entirely.

Members still believe that the AGM is an important last line of accountability for companies and directors and reinforces the relationship with shareholder. The annual requirement for directors publicly to face re-election and questions from shareholders is an important aspect of this.

While there is no support for virtual-only AGMs, as the lack of physical director attendance could dilute the level of public accountability, there is a sense that companies could do more to reinvigorate the format. Given the number of AGMs over a short period of time, it will continue to be difficult for institutional investors to attend. However, virtual formats complementary to the in-person meeting might enable increased participation from institutional investors.

The most effective way of improving the rate of participation of institutional investors at AGMs would be to spread the meetings over the year. This would, however, be unlikely to be practicable.

## E. GENERAL MEETING RESOLUTIONS

### (i) Resolution to approve discharge by board of its governance obligations

We considered the possibility of a new resolution that would specifically approve the completion of a board’s governance obligations for the year. This might be similar to the model used in the Dutch market but could encompass a wider range of issues.

In the Netherlands, when adopting the annual accounts, a general meeting usually discharges the directors of their legal obligations relating to their responsibilities for the preceding accounting year. This discharge requires a specific resolution and is not granted automatically by adoption of the annual accounts. It also only extends to activities and facts made known to the shareholders in the annual accounts or before they are adopted.

Some members felt that a similar approach could be a useful “lightning rod” for issues over which the board exercised judgement during the year. It could also reinforce the attention to the stewardship responsibilities of the board, as well as directors’ legal duties. Some members believed this would be a good means for shareholders to express wider-ranging concerns than are currently expressed via the resolution to approve the annual report and accounts.

Overall, however, members believe that such a resolution would be unlikely significantly to enhance shareholder rights given the ability to vote against the re-election of individual directors, as well as to vote on the approval of the annual report and accounts.

### (ii) Requisitioning General Meetings/ Proposing Resolutions

Members considered existing powers for shareholders to requisition General Meetings and propose shareholder resolutions. In the UK, two or more shareholders with 5% or more of the issued shares can requisition a General Meeting to vote on one or more resolutions proposed by

<sup>14</sup> See Takeover Code Rule 20.1

such shareholders. Shareholders can also propose their own resolution at an AGM if they represent either 5% of the issued share capital or if there are 100 separate shareholders holding shares of which there has been paid up an average sum per shareholder of £100.

Some shareholders believe that, for large companies, this level of required ownership can be onerous, particularly compared with the US market, which has an aggregate ownership threshold of 1% or \$2,000 for proposing a resolution. It also means that, in many cases, it would be difficult for a single institutional investor acting alone to requisition a meeting or propose a resolution.

In the US this is off-set to an extent by a lengthy lead time in proposing a resolution, the requirement that the shares have been held for at least 12 months, and the fact that shareholders may not be entitled to requisition a general meeting at which their resolution can be moved. The threshold to convene a meeting is entirely dependent on the relevant company's constitution in the US whereas, in the UK, statute allows shareholders holding 5% to do so.

Overall, members believe that the experience in other markets with lower ownership thresholds has resulted in too many frivolous resolutions from, in many cases, special interest groups pursuing a narrow agenda. This could be destabilising and costly and undermine the legitimate use of requisitioning powers by institutional investors. Members believe that the UK regime achieves a good balance.

There are, however, some concerns over the nature of the requisitioning process and level of costs in the UK. For instance, a shareholder must lodge a resolution with a company at least six weeks before the date of the meeting or, if later, at the time the company gives notice of the AGM. This deadline creates an anomaly where shareholder may often be unable to table a resolution on the content of the annual report and accounts, as the time-limit for their publication is only 21 days before the AGM.

Members questioned why it is necessary to have to requisition before seeing the new report and accounts – or pay substantial costs for printing and distributing the materials to support the resolution being proposed. This can result in substantial cost, particularly for large companies with highly dispersed share registers.

## F. CONCLUSIONS AND RECOMMENDATIONS

21. Differentiated voting or dividend rights are likely to result in a number of unintended consequences and are likely to affect the interests of minority shareholders adversely rather than stimulate longer-term ownership.
22. AGMs remain an integral component of the UK corporate governance system and a key mechanism enabling shareholders to exercise their ownership obligations. There is no support for 'virtual-only' AGMs but shareholders encourage companies to consider how the meeting can be reinvigorated.
23. The existing ownership thresholds for requisitioning General Meetings and proposing shareholder resolutions remain appropriate. Consideration might also be given to simplifying the process to lower costs.

# 7. Asset Owners and Asset Managers

## A. INTRODUCTION

An increasing number of asset owners are conscious of the need to develop and implement stewardship policies when allocating investment mandates. They are also paying increasing attention to the corporate governance capabilities of asset managers when awarding mandates. This is a positive development.

However, as asset owners develop more sophisticated stewardship requirements, it will be important to delineate the stewardship responsibilities of asset managers clearly.

## B. DEMAND INCREASING

A growing number of asset owners specify stewardship policies when allocating investment mandates. There has been a noticeable increase in the number of request for proposals ('RfPs') seeking information on how stewardship issues are managed, as well as increased focus on these matters in the tender process.

ABI members support this development: more discerning clients are more likely to reward leaders in the field and, in turn, identify the laggards in the market. This also helps overcome the free-rider problem.

As this demand increases, however, it is important to develop mutual understanding of how the expectations of asset owners can be met by asset managers in the most appropriate manner.

## C. CLARIFICATION OF ROLES UNDER THE STEWARDSHIP CODE

Clarification of the roles of asset owners under the newly revised Stewardship Code should help focus attention on aligning the desired level and sophistication of stewardship objectives between client and manager. Code disclosures

can help inform this alignment which, in turn, should help asset owners to select appropriate asset managers.

However, it is important to clarify where the different responsibilities fall between client and manager. The Stewardship Code is clear about the general orientation of such responsibilities:

- Asset owners have a responsibility to communicate their expectations clearly and incorporate this into both the investment manager selection process and the performance oversight of existing mandates
- Asset managers have responsibility for executing these expectations directly with companies.

## D. DANGER OF SPLINTERING ENGAGEMENT PROCESS

ABI members are conscious of the need to fulfil their mandate so as to meet the requirements of their asset owner clients, including in relation to engagement matters. However, there are concerns that some asset owners may seek to direct engagement activities at a company-specific level, which is likely to lead to confusion.

One example of this is the practice of directed voting by asset owner clients into pooled funds. If adopted widely:

- this would quickly become costly and time consuming, both in respect of the administration of such activities and the additional resource required to explain to companies why voting positions may change from that conveyed through the engagement process.
- There is a danger that this undermines the engagement process and, in turn, the ability of asset managers to exercise influence over companies.
- There is also a risk that because of the added resources required, over time, the business of running low-cost pooled accounts becomes economically unviable.
- Given that voting is an integral part of the investment

## Transparency is an important feature of effective stewardship.

process, members also believe that directed voting may have a detrimental effect on their ability to integrate stewardship appropriately. For example, there may be situations when the client's directed voting is viewed as commercially detrimental, particularly if used for approving corporate transactions. This could lead to a situation where a client's directed-voting decision could have the perverse effect of causing an asset manager to alter its view of a company to the extent they are compelled to sell down the holding.

Accordingly, further clarity is needed as to where company-specific engagement responsibilities lie, particularly for different investment products. For instance, it is easier for investment managers to meet their clients' expectations under segregated accounts.

### E. REPORTING

Transparency is an important feature of effective stewardship. ABI members believe that they have an important obligation to report to clients how they have delivered stewardship responsibilities on their behalf. However, the particular information reported and the format used should be a matter for agreement between the client and manager. Following the publication in 2011 of the Stewardship Supplement to Technical Release AAF 01/06, asset managers are encouraged to have the policies described in their stewardship statements independently verified. We would also encourage this practice.

The Financial Conduct Authority requires any firm authorised to manage funds to disclose "the nature of its commitment" to the Code or, "where it does not commit to the Code, its alternative investment strategy" (under Conduct of Business Rule 2.2.31). We encourage asset owners to apply the same discipline.

### F. RECOMMENDATIONS

24. **Clear specification of stewardship requirements of asset owners, particularly at the beginning of the client relationship, will improve understanding and enable corporate governance objectives to be reflected better in the investment agreement and agreed operational process.**
25. **To improve understanding at the outset, members would support the concept of developing a "Stewardship Mandate", to be included as part of the investment agreement, to clarify and govern the client's stewardship requirements. This could include the agreed range of stewardship activities to be undertaken by the asset manager on behalf of the client: for example, an annual review of the stewardship activities on behalf of the client, or, simply, confirmation that the investment manager is a signatory to the Stewardship Code. By extension, we encourage stewardship to be incorporated into the Statements of Investment Principles.**









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**For more information**

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