UK Shareholder Activism - ESG revisited

In January 2020, we predicted that environmental, social and governance (**ESG**) issues would bring greater pressure to bear on companies to explain their purpose and culture ([UK Shareholder Activism - a new ESG environment?]) Although the pandemic had an impact on shareholder activism in 2020 (there were fewer activist campaigns as activists allowed companies to adapt to the situation), several of the predictions from last year have proved accurate. And, for 2021, ESG looks set to remain at the top of the agenda for corporates and others.

"COVID-19 had a profound effect on the way activism was conducted in 2020.........The pandemic slowed the volume of activism worldwide, with 810 companies targeted by activist investors, down around 10% from 2019. The number of companies targeted in so called "impactful" campaigns, i.e. by dedicated and occasional activists, were down 13% to their lowest level since 2014." [1]

As the world adjusts to the impacts of the pandemic, activists are likely to step up their activities, including urging companies to pursue new strategies or to speed up existing strategies.

The focus on the ESG agenda continues to provide shareholders with another metric on which to judge boards and voice their concerns, including through voting against resolutions at general meetings.

This article looks at the regulatory landscape in 2021 and its implications.

CURRENT FOCUS OF ACTIVISM

Whilst we expect shareholder activism to continue to focus on executive remuneration, including directors' pension contributions, and directors' re-elections in 2021, we also expect to see more 'environmental activism', a trend which started in the second half of 2020.

"*ESG funds have grown rapidly. Increased regulation and stakeholders' concerns provide activists, in the widest sense, with additional ways to engage with companies. Activists will use them.*" (Edward Baker, Simmons & Simmons)

EXECUTIVE REMUNERATION

Executive remuneration is widely predicted to be a major focus for shareholders and other stakeholders in 2021.The pandemic is seen as having widened wealth inequality, resulting in shareholders and the wider investment community putting greater pressure on boards to explain the rationale behind the remuneration of key personnel. In the 2020 AGM season, the Investment Association (**IA**) found that executive remuneration resolutions were the only type of resolution which did not see a decrease in shareholder rebellions that year.[2]

In the recent votes on Cineworld Group's long-term incentive plan and remuneration policy approximately 30% of the votes cast were against the resolutions. And more recently, over 40% of the votes cast on Imperial Brands' remuneration report at its 2021 AGM were against the resolution. Such votes are unlikely to be the only examples of shareholders' concerns over executive remuneration.[3]

The IA's letter to remuneration committee chairs notes that shareholders recognise that remuneration committees are trying to balance the need to continue to incentivise executive performance (at a time where management teams are being asked to demonstrate significant leadership and resilience) whilst at the same time ensuring that the executive experience is commensurate with that of shareholders, employees and other stakeholders.[4] However, they are not expecting executives to be isolated from the impact of COVID-19 in a way that is inconsistent with the approach taken for the general workforce and should also bear in mind the pandemic's impact on society.

Changes to the IA's Principles of Remuneration include:

- greater clarity on shareholder expectations on the range of non-financial performance metrics (strategic, personal and ESG) in variable remuneration;
- recognition of shareholders wanting to understand the enforcement mechanisms which the remuneration committee has in place to ensure that post-employment shareholding policies are enforced once a director has left the company; and
- members expectations that a proportion of the entire bonus will to be deferred when the bonus opportunity is greater than 100% of salary.

In November 2020, the IA also published updated guidance setting out its members' expectations on how remuneration committees should be reflecting the impact of COVID-19 on executive pay.[5]

MISALIGNMENT OF PENSION CONTRIBUTIONS

Institutional investors will also continue to focus on the misalignment of pension contribution rates for executive directors with those of a company's workforce.

The UK Corporate Governance Code (Governance Code) states that the pension contributions for executive directors, or payments in lieu, should be aligned with those available to the workforce, alignment meaning 'at the same rate'.[6] Companies are also expected to disclose, in their remuneration reports, the pension contribution rate that they consider is given to the majority of the workforce.

In 2020, the IA's members expected remuneration committees to set out a credible action plan to reduce the pension contributions for all executive directors to the same level of contributions as those received by the majority of the workforce by the end of 2022.

In its review of the 2020 AGM season the IA noted that:

"14 FTSE 100 companies reduced pension contributions for existing directors during the year and a further 43 committed to reduce contributions in future years. Six FTSE 100 companies are increasing their workforce rate as part of their effort to align pension contributions.

Ten FTSE 100 companies were, however, issued a red-top by the IA's Institutional Voting Information Service (IVIS) service for having at least one existing director receiving a pension contribution of 25% or more with no commitment to align this with the rest of the workforce by the end of 2022."[7]

The pressure to align pension contributions is expected to increase in 2021 as the 2022 deadline approaches. For the 2021 AGM season, IVIS has said that it will 'red top' (the highest warning):

- any new remuneration policy that does not explicitly state that any new executive director appointed will have their pension contribution set in line with the majority of the workforce;
- the remuneration report if the pension contribution of any new executive director or director changing role is not aligned with the level of the majority of the workforce; and
- the remuneration report if the pension contribution received by the executive director is 15% or more (lowered from 25% last year) and the remuneration committee has not disclosed a credible action plan to align the director's pension contribution to the majority of the workforce rate by the end of 2022.[8]

In most circumstances, members do not consider fixing the monetary value of pension contributions over time to be a credible action plan to bring the pension contributions in line with the majority of the workforce.

ESG FUNDS ARE GROWING

The growth in the number and size of ESG-related funds and the increase in the number of campaigns focused on sustainability issues enables activists to improve perceived ESG weaknesses in businesses and provides them with another avenue of attack. More funds are also re-branding themselves as ESG funds and whilst this carries the risk of allegations of greenwashing, such allegations can be partially addressed through active campaigning on ESG issues. (See The rise and rise of ESG; a focus on disputes and managing risk for more information.)

EVER GREATER FOCUS ON ESG ISSUES IN THE US AND EU

Investor support for social and environmental issues in the US has steadily increased. And last year, despite the pandemic, climate change remained at the top of everyone's agenda.

In 2020, the UK, the EU, Japan, and South Korea made commitments to achieve net zero greenhouse gas emissions by 2050. And, with Joe Biden's election, the US has re-signed the Paris Agreement.

In September 2020, the Climate Action 100+, which then had more than 500 global investors with over US$47 trillion in assets, called for businesses to put in place net zero business strategies and to define targets to support their delivery.[9]

Institutional investors, such as BlackRock, are also now expecting companies to plan for how their business models will be compatible with a net zero economy; and how that plan will be incorporated into their long-term strategy and reviewed by their boards.[10]

At the same time, the EU has progressed its initiative for 'sustainable finance' (taking account of ESG considerations in investment decision-making, leading to increased investments in longer-term and sustainable activities). This includes:

- the **Sustainable Finance Disclosure Regulation**, which imposes transparency and disclosure requirements on financial market participants (i.e.: AIFMs; UCITS managers; and MiFID firms providing the service of portfolio management) in respect of the integration of sustainability risks in the investment decision-making process and advisory processes [11]
- the **Taxonomy Regulation**, which establishes a classification system (or taxonomy) to provide businesses with a common language to identify whether a given economic activity should be considered "environmentally sustainable". This, in turn, allows it to be determined how far an investment is environmentally sustainable, or 'green'.[12] The taxonomy is intended to be used by the EU, by EU member states, by corporate issuers, and by financial services firms, when assessing, and disclosing information on, environmental sustainability; and
- new **EU climate reporting guidelines**, which provide guidance for companies on how to report on the impacts of their business on the climate and on the impacts of climate change on their business.[13] They integrate the recommendations of the Financial Stability Board's Task Force on Climate-related Financial Disclosures (**TCFD recommendations**).

More recently the European Commission published a **consultation on possible sustainable corporate governance initiative** to foster long-term sustainable and responsible corporate behaviour.[14] And the European Parliament has asked the European Commission to introduce urgently new laws that will ensure companies are held accountable and liable when they harm - or contribute to harming - human rights, the environment and good governance.[15]

GREATER ESG FOCUS IN THE UK

Increased regulation/codes with ESG emphasis

The UK legal and regulatory framework relating to shareholder rights and engagement has gradually evolved. A raft of legislation and updated voluntary codes, which took effect in 2020, required ever greater focus on ESG matters, not only by companies themselves, but also by institutional investors and asset managers.

There is an ever-increasing pressure on companies to deliver sustainable, long-term success in a socially responsible manner; together with greater emphasis on engagement with their stakeholders and employees and alignment of their purpose, values and strategy with their culture. The pandemic has only increased this focus – particularly on the social and governance aspects.

This emphasis on corporate purpose and ESG issues aligns with the duties of directors of a UK company to promote the success of the company for the benefit of its members as a whole, having regard to the various matters listed in s.172(1) of the Companies Act 2006. These matters include:

- the likely consequences of any decision in the long term; employees' interests;
- the company's business relationships with its suppliers, customers and others;
- the impact of the company's operations on the community and the environment; and
- its business reputation.

Both the Governance Code and the s.172 statement further emphasise this duty.

S.172 statement

Directors of certain large companies must report annually on how they have complied with their duty to have regard to the matters in s.172(1) Companies Act 2006 and this statement must be included in the annual report.[16] (See Section 172 statement – further guidance on how to prepare it for more information.)

Governance Code

Premium listed companies are expected to:

- place greater emphasis on culture and purpose;
- consider their responsibilities to, and engage more with, shareholders and the wider stakeholder group; and
- explain how key stakeholder interests and the s.172(1) matters were considered in board discussions and the decision-making process.

Companies will be expected to do more this year, as overall the FRC is disappointed with companies' responses to the Governance Code last year, which was the first year in which all UK premium listed companies reported on their application of the Code.[17] The FRC states that *"effectively applying the Principles is much more important than a 'tick box' approach"* and its expectations for this year include that it is looking for a high standard of reporting which demonstrates that boards have considered matters beyond process and reassessed issues such as company purpose, culture, and strategy, in order to set them at the heart of governance. (See Box-tickers beware: FRC's 2020 review of UK Governance Code reporting for more information.)

Increase in climate-related financial disclosures

Companies will be expected to up their game on climate-related financial disclosures in 2021. They will be expected to plan for how their business model will be compatible with a net zero economy.

In January 2021 HSBC was the subject of a climate-related shareholder resolution proposing to authorise its directors to set, publish and report against a strategy and targets to reduce its exposure to fossil fuel assets.[18] And we think climate-related shareholder resolutions are likely to become much more common in the UK, the EU and elsewhere. (See More hot news: climate-related shareholder resolutions for more information.)

For 2021, the IA's IVIS has said that it will introduce an 'amber top approach' for all companies in a high-risk sector (e.g. energy) that do not address all four pillars of the TCFD recommendations (governance; risk management; strategy; and metrics & targets).

The IA has also published a paper which represents the stance of the investment management industry on climate change.[19] This includes seven commitments from the industry as well as proposals for certain government action.

Government Green finance strategy

The UK government's Green Finance Strategy set out the actions that it is proposing to take. These include its expectation that all listed companies and large asset owners will disclose in line with the TFCD recommendations by 2022.

But, in a recent interim report, the UK government states that its previous voluntary approach to climate-related financial disclosure may no longer be enough due to the urgency of climate change.[20] And it sets out the UK's approach to introducing, by 2025, mandatory climate-related financial disclosure requirements that are aligned to the TCFD recommendations, including the new mandatory requirements for listed companies below.

The UK government has now announced a new UK Centre for Greening Finance and Investment to be based in Leeds and London. These research hubs will *"provide world-class data and analytics to financial institutions and services such as banks, lenders, investors and insurers around the world to better support their investment and business decisions by considering the impact on the environment and climate change."* [21]

NEW CLIMATE-RELATED DISCLOSURES FOR LISTED COMPANIES

All commercial companies with a UK premium listing (including sovereign controlled ones) must include a statement in their annual financial report stating:

- whether they have made disclosures consistent with the TCFD recommendations in their annual financial report;
- where they have not made disclosures consistent with the TCFD recommendations, an explanation of why and a description of any steps they are taking/plan to take to make consistent disclosures in the future;
- where some or all of their disclosures are in a document other than the annual financial report, an explanation of why; and
- an explanation of where in the annual report (or other relevant document) the various disclosures can be found.

This applies to accounting periods beginning on or after 1 January 2021.[22]

But this is only the start as the FCA has also confirmed that, in the first half of 2021, it intends to consult on:

- proposals to extend these new rules to a wider scope of listed issuers and will consider strengthening the compliance basis; and
- potential TCFD-aligned disclosures by UK-authorised asset managers, life insurers and FCA-regulated pension providers.

The FCA has also introduced a new technical note which clarifies existing disclosure obligations for a wider scope of issuers. In the FCA's view, issuers may already be required to make disclosures on climate-related and wider environmental, social and governance matters, under particular provisions of the Listing Rules, Prospectus Rules, Disclosure Guidance and Transparency Rules, and the Market Abuse Regulation. This technical note already applies.

CONTINUED FOCUS ON BOARD DIVERSITY

Board diversity continues to have a central place on the agenda for the 2021 AGM season. FTSE 350 companies were expected to ensure that, by 2020, women constituted up a minimum of 33% of the board and executive committees (and reports to those committees).[23] Women now make up around 40%, in aggregate, of the non-executive directors on FTSE 350 boards (36.2% on FTSE 100 boards and 33.2% on FTSE 250 boards) and the number of women in the combined executive committee and direct reports of FTSE 100 is 30.6% and 28.5% in FTSE 250. But more still needs to be done as almost one-third of the FTSE 100 haven't met the 33% target and women still represent only 14% of the executive directors in the FTSE 100.[24]

The focus for 2021 will also include the ethnic diversity of UK boards as FTSE 100 boards are expected to have at least one director from an ethnic minority background by 2021.[25]

Although these are only recommendations, investor sentiment means that companies are in effect expected to attain these voluntary targets within the timescales.

In January 2021, the IA announced[26] that IVIS will:

- 'red top' any FTSE 350 company that has female representation of 30% or less on its Board, and/or that has female representation of 25% or less in its executive committees and its direct reports;
- 'amber top' any FTSE SmallCap company that has female representation of 30% or less on its Board, and/or that has female representation of 25% or less in its executive committees and its direct reports; and
- introduce an 'amber top' approach for any FTSE 350 company that does not disclose either the ethnic diversity of its Board or a credible action plan to achieve the Parker Review targets.

DO SHAREHOLDERS HAVE A DUTY TO BE MORE ACTIVIST?

In the same way that companies have greater shareholder and stakeholder engagement obligations, institutional investors and asset managers have also come under scrutiny and are expected to have greater engagement with the companies in which they invest. (See Asset Managemnt Taskforce recommendations below.) There is a move towards embedding stewardship into the whole investment process.

Pension funds and investment managers have recently launched a new steering group to examine how stewardship and a focus on long-term investment can be better integrated into the investment process to create sustainable value for savers and investors.[27]

Whilst the SFDR and Taxonomy Regulation will not apply to the UK, the UK has said that it will adopt UK versions of them, but possibly with some divergence post Brexit.

Engagement and voting policies

Institutional investors and asset managers must disclose annually their engagement and voting policies and voting records and explain how they have implemented those policies. This includes disclosure of how they monitor investee companies on their social and environmental impact. They must also disclose any use of proxy advisers. (See SRD2 - are you ready? for more information.)

Stewardship report

All asset managers and asset owners wanting to be signatories to the UK Stewardship Code 2020 (**2020 Code**), will be focusing on their stewardship activities as the deadline approaches for them to publish their first Stewardship Report.

This report must:

- include an explanation of what their organisation's purpose, investment beliefs, strategy and culture are and how their governance, resourcing and staff incentives help with them;
- recognising the importance of ESG factors, take ESG factors (including climate change) into account in all stewardship activities and ensure their investment decisions are aligned with the needs of their clients;
- explain how they exercised stewardship across all asset classes (not just listed equity). Other asset classes include fixed income, private equity and infrastructure and investments outside the UK; and
- disclose greater detail about their engagement (including stating whether they participate in collaborative engagement with other investors).

Asset Management Taskforce recommendations

The need for greater stewardship by institutional investors and asset managers is set out in the 20 recommendations published by the Asset Management Taskforce (**Taskforce**) in November 2020. These aim to increase stewardship activities and ensuring that they are focused on delivering long-term, sustainable benefits for investors, the economy, the environment and society.[28]

The Taskforce was established in October 2017 to encourage greater dialogue between the government, the industry and the FCA to ensure that the UK investment industry continues to deliver for consumers and the wider economy. It is chaired by the Economic Secretary to the Treasury and comprises CEOs from a diverse cross-section of the investment management industry, senior representatives of investor groups and the FCA.

(See Stepping up for sustainability and stewardship for more information.)

The Taskforce's recommendations include that

"Shareholders should use requisitioned resolutions more proactively as an escalation tool and develop model resolutions to escalate a range of critical concerns with investee companies, including on climate change. The industry should develop guidance to overcome existing barriers to requisitioning resolutions."

Could there be a clearer indication of the direction of travel?

OUR VIEW

Whilst the effects of the pandemic are still being felt, stock markets appear to be looking to the future with some optimism. The inequalities of wealth that have been exacerbated by the pandemic have led to increased demands for reviews of corporate purpose and for greater stewardship from the investor community. Where companies have weaknesses in addressing the concerns, activists are likely to seize on the discontent, using the current environment to bring their own agendas to the fore. As the world takes steps towards recovery, activists have more levers to pull.

See also our Sustainable Financing and ESG Investment feature

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1 The Activist Investing Annual Review 2020, published by Activist Insight.
2 IA press release, 17 October 2020
3 IA Public Share Register
4 IA Principles of Remuneration and Letter to Remuneration Committee Chairs, November 2020
5 Executive Remuneration During the COVID-19 Pandemic - Shareholder Expectations
6 Governance Code applies to all premium listed companies in respect of financial periods beginning on or after 1 January 2019
7 IA press release, 17 October 2020
8 IA Principles of Remuneration and Letter to Remuneration Committee Chairs, November 2020
9 Climate Action 100+ announcement, September 2020
10 Larry Fink's 2021 letter to CEOs
11 Regulation on sustainability-related disclosures in the financial services sector
12 Regulation on the establishment of a framework to facilitate sustainable investment
13 New climate reporting guidelines and a summary of the guidelines
14 Consultation
15 Press release
16 The Companies (Miscellaneous Reporting) Regulations 2018, which apply to financial years beginning on or after 01 January 2019. Large companies – being ones that do not qualify as medium-sized for a financial year. A medium-sized company is one which qualifies as medium-sized under s.465- 467 CA 2006. This includes one which meets two of: turnover not more than £36m; balance sheet not more than £18m; and less than 250 employees
17 FRC annual review of reporting against the Corporate Governance Code and Guidance: Improving the quality of 'comply or explain' reporting
18 ShareAction announcement, 10 January 2021
19 Position Paper: Climate Change
20 HM Treasury interim report of the UK's Joint Government-Regulator TCFD Taskforce, November 2020
21 Press release, 15 February 2021
22 FCA Policy Statement 20/17
23 Recommendations in the Hampton-Alexander Review third report, November 2018
24 Hampton Alexander Review Report, February 2021
25 Parker Review
26 IA Shareholder Priorities 2021 and IA Good Stewardship Guide 2021
27 IA press release, 13 January 2021
28 Investing with purpose: placing stewardship at the heart of sustainable growth