simmons + simmons

UK Shareholder Activism - a new ESG environment?

January 2020

Increasing focus on environmental, social and governance (ESG) issues is forcing companies and investors to ensure that their stance on these topics is both credible and understood. Increased regulation is pushing investors to "actively manage" their holdings in companies and again be seen to be doing so, requiring companies to engage with their stakeholders and directors to justify publicly the decisions they have taken by reference to their duties under the Companies Act 2006. As a result, all the ingredients seem present to encourage and promote a "healthy public debate" and for companies to be placed under greater pressure to explain their purpose and culture.

This article looks at the new regulatory landscape and its implications. The focus on the ESG agenda provides shareholders with another metric on which to judge boards and voice their concerns, including through voting against resolutions at general meetings.

Current focus of activism

Activism in the UK has often focussed on either strategic activism (such as calling for a sale or disposal of a business or asset or a change in strategy; consolidation or breaking up a company, often including a demand for a seat on the board) or executive remuneration issues.

Executive remuneration

Issues around executive remuneration have arisen due to the gap between executive and workforce pay. Activists have been assisted by the 'say-on-pay' legislation (introduced in October 2013) that requires shareholder approval of a company's remuneration policy at least every three years or earlier if any change is made to the policy.[1] Further encouragement was provided by a letter issued by Blackrock (in 2017)[2] to the chairs of FTSE 350 companies stating that executives' pay should be strongly linked to long-term performance and should only be increased at the same level as for the company's overall workforce.

Executive remuneration is expected to remain a key target for activists in 2020 as this pay gap persists and many FTSE companies must put a second remuneration policy to shareholders for approval (as they are required to do so at least every three years).

Updated Principles of Remuneration[3]:

- reflect the continuing interest in executive remuneration and the ever-increasing need for companies to focus on sustainable long-term success delivered in a socially acceptable manner
- consistently refer to remuneration which creates and rewards 'sustainable long term' success or value
- expect increases to executives' base pay to be aligned to (instead of appropriate against) increases awarded to the wider workforce. IA members consider this to be the rate of increase which is given to the majority of the company's workforce. Generally, this can either be the average increase for UK employees or for the employees in the location in which the executive is based.

Report published by the House of Commons Business, Energy and Industrial Strategy Committee[4] in 2019 states:

- companies must do more to link executives' pay to that of the rest of their workforce and refers to the "huge differentials" between the remuneration of chief executives and average pay being "baked into the pay system".

This differential is also likely to become more apparent as companies:

- publish more information about the ratio of the CEO's total remuneration to that of the company's UK workforce [5] and
- must start publishing the information on the ratio for each director.[6]

(1) S. 439A Companies Act 2006, inserted by the Enterprise and Regulatory Reform Act 2013.
(2) Letter from head of Blackrock's investment stewardship team in Europe, January 2017.
(3) IA Principles of Remuneration and a letter to the remuneration committee chairs of FTSE 350 companies, 13 November 2019
(4) Executive rewards: paying for success, 26 March 2019.
(5) UK incorporated quoted companies with more than 250 UK employees must publish the ratio of the CEO's total remuneration to the median (50th), 25th and 75th percentile of the full- time equivalent remuneration of the company's UK employees, together with certain supporting information for financial years beginning on or after 01 January 2019 under the Companies (Miscellaneous) Reporting Regulations 2018.
(6) The Companies (Directors' Remuneration Policy and Directors' Remuneration Report) Regulations 2019.

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. This is one of many topics highlighted in the 2018 UK Corporate Governance Code (Governance Code) (which applies to all premium listed companies in respect of financial periods beginning on or after 1 January 2019). This 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'.

In 2020, the Investment Association's (IA's) members expect remuneration committees to set out a credible action plan to reduce the pension contributions to all executive directors to the same level of contributions as that received by the majority of the workforce by the end of 2022. From the start of the 2020 AGM season, the IA's IVIS will:

- 'amber top', (the second highest warning) any company when an existing director has a pension contribution of 25% of salary or more provided there is a credible plan
- 'red top' (the highest warning) any company with an existing director who has a pension contribution of 25% of salary or more, and there is no credible plan
- 'red top' any company who appoints a new executive director or a director changes role with a pension contribution out of line with the majority of the workforce or seeks approval for a new remuneration policy which does not explicitly state that any new director will have their pension contribution set in line with the pension contribution for the majority of the workforce.

Companies are also expected to disclose, in their remuneration report, the pension contribution rate that they consider is given to the majority of the workforce.

This has already started to have an impact as recently five large listed UK banks have announced that they will make significant reductions in executive pensions to bring them more in to line with the rates for the wider workforce.

Greater focus on ESG issues in the US and the EU

Investor support for social and environmental issues in the US increased from 23% in 2014 to 27% in 2017.[7] In 2018, institutional investors in the US focussed more on ESG-related issues, including board diversity, employee diversity, environment, sustainability and climate change. Institutional investors, such as BlackRock and State Street, also added board diversity to their voting policies.[8] In 2019, the focus was also on corporate culture and purpose and how they can affect long-term performance.

In 2020 one of the main areas of focus in the US is likely to be 'Sustainability' – this includes not only climate change risks but also how a company serves its full set of stakeholders, such as the diversity of its workforce, the sustainability of its supply chain, or how well it protects its customers' data.[9]

At the same time, the EU is progressing 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 proposals for institutional investors and asset managers to disclose how they have integrated ESG factors in their risk and investment decision-making processes.[10]

(7) The Activist Investing Annual Review 2019, published by Activist Insight.
(8) Blackrock's 2019 letter to CEOs and State Street's letter to board members, January 2019.
(9) Blackrock's 2020 letter to CEOs.
(10) EU Commission action plan on sustainable finance. See also "Sustainable Financing and ESG Investment" and "Top 10 things asset managers need to know about the ESG initiative".

Why is this shift likely to be mirrored in the UK?

Increased regulation/codes with ESG emphasis

The UK legal and regulatory framework relating to shareholder rights and engagement has gradually evolved and, because of a raft of new legislation and updated voluntary codes which will take effect in 2020, requires 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.

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) 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 new regulations further emphasise this duty:

Regulations

- require the directors of certain large companies[11] to report annually how they have complied with their duty to have regard to those matters in s.172(1) (the s172(1) Statement) and this statement will have to be included in the annual report.[12]

(See "O tangled web! UK Government publishes final corporate governance reporting rules" for a detailed review of these rules.)

Governance Code

Expects premium listed companies to:

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

(See "Treat me right! FRC published revised UK Corporate Governance Code" for more information.)

(11) 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.
(12) The Companies (Miscellaneous Reporting) Regulations 2018, which apply to financial years beginning on or after 01 January 2019.
(13) The Companies (Directors' Report) and Limited Liability Partnerships (Energy and Carbon Report) Regulations 2018, which apply to financial years beginning on or after 01 April 2019.

Additional climate-related financial disclosures

New energy and carbon reporting regulations,[13] require quoted companies, large private companies and limited liability partnerships to disclose emissions, energy consumption and energy efficiency in the directors' report or in a separate energy and carbon report.

The UK government and UK regulators are encouraging companies to disclose their climate change risks and opportunities in their annual reports:

- Government's actions include its expectation that all listed companies and large asset owners will disclose in line with the Financial Stability Board's Task Force on Climate-related Financial Disclosures (TFCD) recommendations by 2022.
- Government will publish an interim report by the end of 2020 which will include progress on the implementation of the TCFD recommendations.[14]

- FRC has emphasised the responsibility of UK company boards to consider their company's impact on the environment and the likely consequences of any business decisions in the long-term.[15]
- These companies should address and, where relevant, report on the effects of climate change.
- FRC will monitor how companies are fulfilling their responsibilities.

- FCA will consult, early in 2020, on proposed new disclosure rules for certain listed issuers.
- These will be aligned with the TFCD's recommendations, to be applied on a 'comply or explain' basis, as well as clarifying existing disclosure obligations relating to climate change risks.

Continued focus on board diversity

Board diversity continues to have a central place on the agenda as 2020 approaches, being the year in which women are expected to constitute up a minimum of 33% of the boards and executive committees (and reports to those committees) of FTSE 350 companies.[16] Although these are only recommendations, investor sentiment means that companies are in effect expected to attain these voluntary targets within the timescales.

In February 2019, the IA announced that its members will 'red top' (the highest warning) any FTSE 350 company with only one woman on its board; 'amber-top' (the second highest warning) companies not on course to meet 33% of women on their boards by 2020; and highlight any board where women represent 25% or less. This approach reflects the fact that investors want to see a company do more than take a tokenistic step of appointing a single woman to its board.

(14) BEIS' Green Finance Strategy, 02 July 2019
(15) FRC statement, 02 July 2019
(16) Recommendations in the Hampton-Alexander Review third report, November 2018.

Do shareholders have a duty to be more activist?

In the same way that companies have greater shareholder and engagement obligations, institutional investors and asset managers are also coming under scrutiny and are expected to have greater engagement with the companies they invest in. They will also have to comply with much wider transparency obligations regarding their holdings.

Certain amendments to the EU Shareholder Rights Directive (SRD II)[17] were implemented in the UK with effect from 10 June 2019 through new rules in the FCA Handbook.[18] These new rules require institutional investors and asset managers to disclose annually their engagement and voting policies and voting records and to 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.

The revised UK Stewardship Code 2020 (2020 Code), which is a voluntary industry code, has been updated both generally and to reflect the SRD II amendments. It "sets substantially higher expectations for investor stewardship policy and practice." The main changes include:

- defining stewardship as "the responsible allocation, management and oversight of capital to create long-term value for clients and beneficiaries leading to sustainable benefits for the economy, the environment and society";
- requiring signatories to explain what their organisation's purpose, investment beliefs, strategy and culture are and how their governance, resourcing and staff incentives help with them. This aligns the 2020 Code with the Governance Code;
- recognising the importance of ESG factors, signatories must 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;
- signatories are expected to 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
- signatories must disclose greater detail about their engagement (including stating whether they participate in collaborative engagement with other investors)[19].

(See "Stewardship & Sustainability: the revised UK Stewardship Code" for more information.)

(16) The EU Shareholder Rights Directive II (EU) 2017/828 amends the Shareholder Rights Directive 2007/36/EC.

(17) FCA PS19/13.

(18) Investors will, however, have to tread carefully, particularly if pursuing collective engagement, as activism can have market abuse consequences. Market abuse rules restrict the disclosure of inside information about a company and also restrict dealings when a person is in possession of inside information. Investors also need to be mindful that sharing strategic information could breach competition law following the recent FCA decision when it found that three asset management firms had breached competition law by sharing strategic information in connection with an IPO/placing (FCA decision, 21 February 2019.)

Our view

Greater pressure on institutional investors to deliver returns combined with these new requirements to demonstrate that they are engaging with their investee companies and other investors may result in them being more willing to support activist initiatives or to initiate an action themselves. The ESG push is also being driven by demands from investors, who are increasingly evaluating managers against ESG factors, including good governance, diversity and inclusion.[20]

Please contact Edward Baker, Jo Weston or your usual contact at Simmons & Simmons if you would like more information.

Edward Baker

Partner

T +44 20 7825 4062

edward.baker@simmons-simmons.com

Jo Weston

Partner

T +44 20 7825 4558

jo.weston@simmons-simmons.com

(20) Responsible Investment Primer, AIMA and Simmons & Simmons, May 2019

For additional information on our firm, please visit our website at simmons-simmons.com.