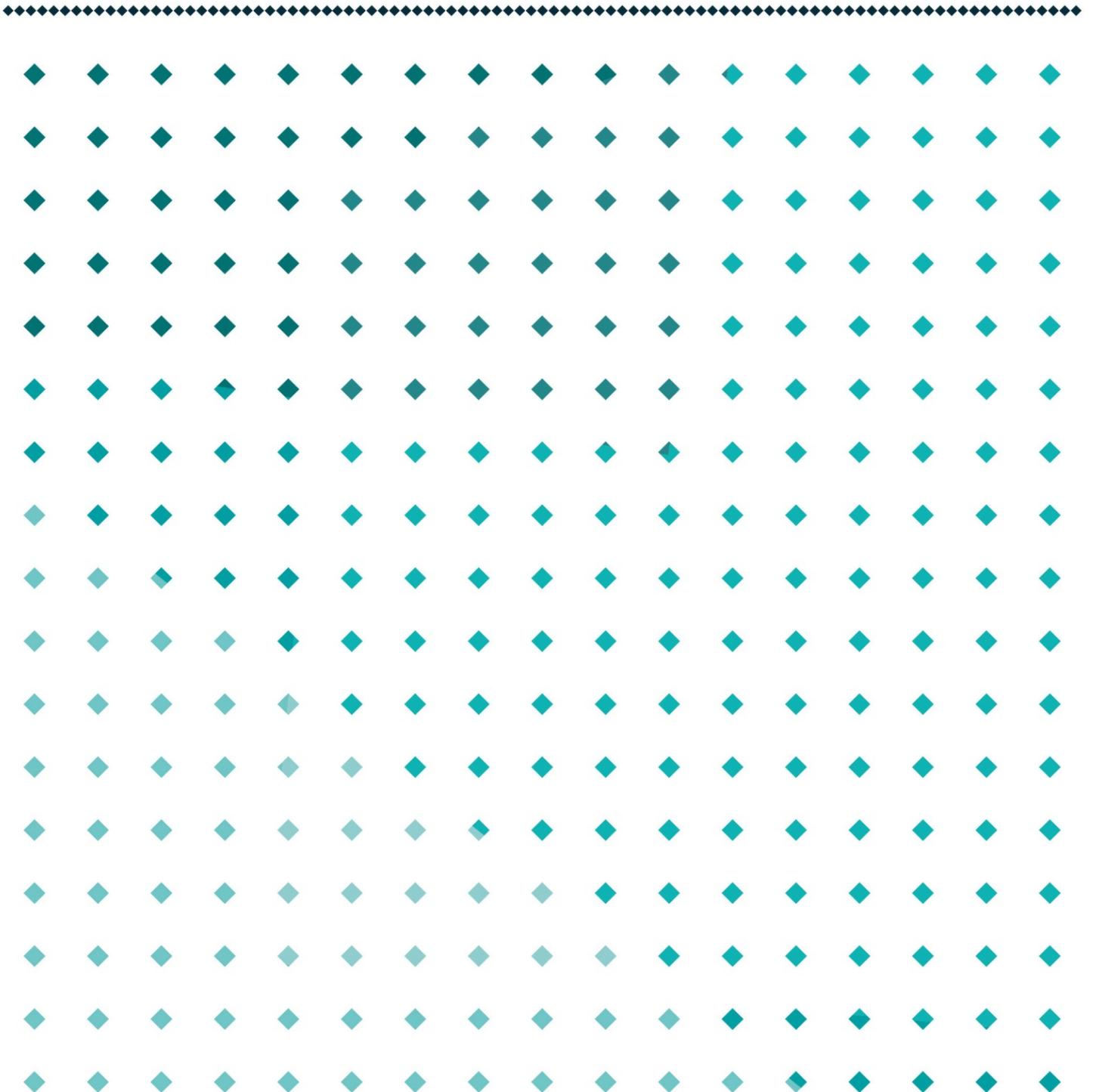


# **CORPORATE GOVERNANCE POLICY AND VOTING GUIDELINES 2019**



## **INTRODUCTION**

**The Pensions and Lifetime Savings Association brings together the pensions industry and other parties to raise standards, share best practice, and support our members. We represent over 1,300 pension schemes with just over £1 trillion in assets under management and over 400 supporting businesses, including asset managers, investment consultants and other service providers. Our mission is to help everyone achieve a better income in retirement.**

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## OVERVIEW

Members of the Pensions and Lifetime Savings Association have a clear interest in promoting the success of the companies in which they invest. As a consequence of this, the Association has long considered that one of its prime functions is to support members in engaging with investee companies. Our efforts are directed towards maximising the long-term returns of pension schemes' assets, irrespective of the potential for short-term discomfort. Only then can the value of savers' capital be protected and enhanced over the long-term.

Our Corporate Governance Policy and Voting Guidelines seek to reflect current market best practice and highlight emerging areas of particular interest, as determined through consultation with our members. The aim of this document is to assist members in:

- Promoting the long-term success of the companies in which they invest
- Ensuring that the board and management of these companies are held accountable to shareholders
- Understanding the latest developments in UK corporate governance policy and practice

## CORPORATE GOVERNANCE

Corporate governance is about ensuring that appropriate structures and individuals are in place in order to enable effective, entrepreneurial and prudent management, in turns delivering sustainable business success. It is not a matter of box ticking or mechanistic compliance; in fact, a compliance mind-set can undermine good corporate governance.

Corporate governance is in essence about what the board of a company does and how it sets the values of the company. An effective board is therefore crucial and should be composed of a diverse grouping of directors each of whom commits – and is able – to contribute to the governance and long-term success of the company.

Truly effective corporate governance is reliant upon a company's willingness to engage with the spirit of the Code rather than simply about compliance with its Principles. In parallel, it is equally important that all institutional investors play their part and take their responsibilities seriously. The need for pension schemes in particular to do so has come under increasing scrutiny from policymakers and regulators in 2018 and this is likely to continue throughout 2019. It is important for schemes to work with their advisers and managers to monitor, engage with and ultimately hold accountable those individuals whom they have elected to the board.

### A HOLISTIC APPROACH TO CORPORATE GOVERNANCE

Assessments of corporate governance should be formed through the lens of directors' duties, as set out in the Companies Act 2006. To restate: these include, in particular, the duty to promote the success of the company, while having regard to, amongst other things

- ▶ The likely consequences of any decision in the long-term

- ▶ The interests of its employees<sup>1</sup>
- ▶ Its need to foster the business relationships with customers and suppliers
- ▶ The impact of its operations on the communities and environment
- ▶ Its desire to maintain a reputation for high standards of business conduct

As such as proactive and effective board should provide the framework for discussing, managing and driving the long-term sustainability of the company.

### **LONG-TERM BUSINESS SUCCESS**

Boards should endeavour to actively consider how the company's strategy, governance, arrangements, performance and prospects, in the context of its external environment, lead to the creation of value in the short, medium and ultimately long term.

Building a maintainable business model which works for the long-term should be central to the business strategy. We expect boards to explain to shareholders how they approach overseeing and managing the risks to their model, approach and strategy. In turn, shareholders may well form judgments on the management of these issues which will inform their understanding of the effectiveness of the board oversight and so guide their approach to resolutions at the AGM.

### **THE PENSIONS AND LIFETIME SAVINGS ASSOCIATION'S CORPORATE GOVERNANCE POLICY AND VOTING GUIDELINES**

The Pensions and Lifetime Savings Association's Corporate Governance Policy & Voting Guidelines endeavour to build on the above context while remaining firmly rooted in the provisions of the Code and the underlying principles of all good corporate governance, namely: accountability, alignment, transparency and integrity.

In July 2018, the Financial Reporting Council published a significantly changed version of its UK Corporate Governance Code. This included the introduction of five new principles:

- ▶ Board Leadership and Company Purpose
- ▶ Division of Responsibilities
- ▶ Composition, Succession and Evaluation
- ▶ Audit, Risk and Internal Control
- ▶ Remuneration

The new Code also introduces a greater role for inclusion of the workforce<sup>2</sup> voice in corporate governance, highlighting a number of engagement mechanisms for doing so:

- ▶ A director appointed from the workforce

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<sup>1</sup> The new (2018) Code aims to give greater support to companies in ensuring they take account of workforce issues and interests in their decision-making and strategy

<sup>2</sup> The PLSA has welcomed this development, building upon the findings from our previous work on workforce disclosure.

- ▶ A formal workforce advisory panel
- ▶ A designated non-executive director

How well a company engages with, and considers the views of, its workforce should be a critical topic for shareholder engagement. The PLSA's ongoing research<sup>3</sup> into corporate reporting by the FTSE 100 on their employment models and practices is premised on the argument that a stable, motivated workforce who feel financially secure, professionally fulfilled and appropriately skilled to carry out their responsibilities will greatly increase the chances of long-term success for any company.

Our Guidelines aim to assist pension schemes, asset managers and their proxy voting agents in their interpretation of the provisions of the Code and in forming judgements on the resolutions presented to shareholders at a company's AGM as well as highlighting emerging issues that shareholders may wish to engage on in the run-up. That is, while these Guidelines focus particularly on what voting sanctions may be applied at a company meeting, a decision to vote against management should only be taken after proper consideration of the company's explanation for non-compliance, in the light of the particular circumstances and ideally after a meaningful engagement process – either individually or collaboratively – and which gives sufficient time for the company to respond.

### **THE ROLE OF SHAREHOLDERS**

The Association recognises that the success of the Code relies to a significant extent upon investors – including pension schemes, even if not directly engaging with companies themselves – recognising and assuming their own stewardship responsibilities. To that end we are supporters of the current Stewardship Code<sup>4</sup> and the mind-set that underlies it, in particular that companies with engaged shareholders will perform better over the long run and this should have a positive impact on pension scheme members' savings.

We recognise the important role that investors play in making ensure companies genuinely feel there to be scope for explanations as well as compliance with the strictures of the Code. Where the views of boards and their shareholders differ on matters of corporate governance, it is to be hoped that constructive discussion will follow, albeit that ultimately shareholders will exercise their rights as owners to do what they see as necessary to protect their interests.

We encourage companies to make efforts to identify their long-term investors i.e. those who are investing with long-term objectives rather than those involved in short-term trading – to enable regular and strategic dialogue with a critical mass of engaged investors. It is important that the dialogue between investors and companies takes place throughout the year, rather than being compressed into the period leading up to the shareholder meeting.

Equally, it is important that investors are open to engagement on the full range of substantive matters. Shareholders should also be clear about their investment objectives when discussing governance and strategy with a company, so the Chair and directors are able

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<sup>3</sup> See *Hidden Talent: What do Companies' Annual Reports tell us about their Workers* (2018) for further details. The research will be updated in 2019 (expected March).

<sup>4</sup> At time of writing, the Financial Reporting Council is updating the Stewardship Code to better reflect industry practice and the implementation of the EU Shareholder Rights Directive. A formal consultation on the Code will be published in Q1 2019.

better to understand what is expected of them. They should also make it clear to a company where decisions on both investment and voting rest.

The Association is always willing to facilitate active engagement between issuers and pension fund investors to discuss substantive matters of concern or company-specific issues. This includes through initiating a proactive set of engagement dialogues for our members with relevant companies on key strategic issues where we believe long-term value may be at stake.

#### **THE ROLE OF THE AGM**

The AGM is an important part of the dialogue between a company and its shareholders, regardless of size, as well as being the occasion at which the board is held accountable for its actions during the preceding year. Shareholders should therefore make every effort to register their votes after careful consideration of the resolutions on the agenda. Attendance and speaking at the AGM can also be an effective way of expressing views about the company, not least when concerted attempts at engagement have failed to achieve a satisfactory resolution. Should an investor decide to vote against or abstain on a particular resolution, they should seek to explain to the company the reasons for doing so as early as practicable.

Companies should publish the results of the general meeting as soon as practical after the meeting and should include in this disclosure a record of votes withheld. Where a significant number of votes on a particular resolution – based upon the judgement of the board and in the context of the type of resolution – have not been registered in support of management (meaning both votes against and active abstentions) the board should acknowledge this within its RIS statement and communicate as soon as reasonably possible following the AGM how it intends to engage with shareholders in order to understand the reasons for dissent.

Subsequently the company should explain within the following year's annual report and accounts the steps it has taken, or will be taking, to resolve the concerns.

## THE 2019 POLICY FRAMEWORK AND THEMES

The Association recognises that it is a fundamental precept that shareholders have responsibilities to work to ensure good governance at the companies in which they invest, one which goes beyond the latest shifts in policy and regulatory thinking. However, it is clear that developments in the policy environment can fundamentally alter the framework within which pension schemes and other investors exercise their stewardship responsibilities.

As highlighted in the Association’s Review of the 2018 AGM season<sup>5</sup>, both UK corporate behaviour and the effectiveness of shareholders in influencing this have been the focus of increased media and policymaker attention. The high-profile cases of Carillion and BHS have not just shone a light – from the pension scheme perspective – on challenges facing the Defined Benefit (DB) sector when a company fails but also on issues such as **executive remuneration**<sup>6</sup>, **audit quality**<sup>7</sup> and **corporate behaviour on dividend payments**<sup>8</sup>.

How well companies deal with the increasingly recognised issue of **climate change** and the risk it poses to the business models and approach of nearly every company in every sector is also likely to be an increasingly important topic for investors to consider during the 2019 AGM season<sup>9</sup>.

Finally, 2019 brings with it **new responsibilities for pension schemes**<sup>10</sup> when it comes to communicating how they have undertaken their stewardship responsibilities. The Department for Work and Pensions (DWP) recently amended the *Occupational Pension Scheme Investment Regulations (2005)* to clarify a number of issues, including expanding the definition of “stewardship” to include engagement. From 1 October 2019 the Regulations will require DB and Defined Contribution (DC) schemes (for their default strategy) to set out their policy in their Statement of Investment Principles (SIP) regarding how they undertake stewardship, including engagement and voting, as well as how they consider financially material environmental, social and governance (ESG) factors. A key development will also be the 2019 update to the **FRC’s Stewardship Code**. Although the formal consultation on the proposals is yet to be published, this is likely to include an enhanced focus on the responsibilities of asset owners as well as clearer recognition of the growing importance of ESG issues.

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<sup>5</sup> Please see *2018 AGM Review* (January 2019) for further details

<sup>6</sup> For instance, January 2019 has seen new pay ratio regulations come into force in the UK.

<sup>7</sup> This includes: the ongoing *Competition and Markets Authority’s study into the statutory audit market*; the newly established *Brydon Review into UK Audit Standards*; and the Business, Energy and Industrial Strategy Parliamentary Select Committee’s inquiry into the *Future of Audit*.

<sup>8</sup> The Pensions Regulatory is more closely scrutinising the relationship between a company’s dividend payments and its Deficit Repair Contributions. A good summary of the issues can be found in the Department for Business, Energy and Industrial Strategy’s consultation paper on *Insolvency and Corporate Governance*.

<sup>9</sup> An approach to climate risk for pension schemes can be found in the 2017 PLSA/ClientEarth guidance *More Light, Less Heat: A Framework for Pension Fund Action on Climate Change*

<sup>10</sup> See also the Shareholder Rights Directive and forthcoming Stewardship Code.

## **THE PLSA'S CORPORATE GOVERNANCE PRINCIPLES**

- **The Pensions and Lifetime Savings Association supports the UK Corporate Governance Code.** The Code is the benchmark upon which this Policy seeks to build in an effort to promote the sustainable success of companies
- **Adherence to the spirit of the Code is important.** Good corporate governance is all about achieving long-term sustainable business success, not mere compliance.
- **Governance should be considered holistically.** Boards should endeavour to set the cultural tone from the top and give full consideration to understanding and in turn mitigating long-term risks to its financial sustainability. This should include 'environmental' and 'social' risks.
- **Boiler-plating which provides little data or insight must be avoided.** Our members expect clear and specific explanations to be provided for non-compliance with Code provisions including relevant insights and a convincing rationale for choosing to override the provisions of the Code. Equally, shareholders must be prepared to listen to and give consideration to these explanations. Good corporate governance and its reporting is a matter of principle and nuance, not dogma or mechanistic evaluation.
- **Prompt and effective communication** on corporate governance issues, including with respect to changes in board structures and responsibilities, and remuneration policies, greatly assists in developing good relations between companies and their shareholders and avoids unnecessary surprises. Shareholders are becoming increasingly alert to corporate communication efforts which appear merely to 'go through the motions' instead of being a genuine attempt at engagement.
- **The Nomination Committee is vital and should anticipate change** by ensuring the proper planning of succession; ensuring boards are equipped with a diversity of perspectives, skills and experience and that each member is able to devote the necessary time to carry out their responsibilities. Boards should endeavour, where feasible, to consult their long-term investors over sensitive board appointments.
- **The Remuneration Committee should design rewards that drive long-term success.** Remuneration committees should take ownership of, and be accountable for, both the remuneration policy and its outcomes. Companies should consider how they might align pay more closely with the interests of their long-term owners in order to position themselves best for future success.
- **The Audit Committee has arguably the most complex brief** of any of the board committees. Objective and prudent accounts sit at the heart of an effective accountability regime. The Committee should be staffed solely by independent directors (both from the executive, but also taking into account independence from the external auditor) and enjoy sufficient relevant experience to carry out its responsibilities to a high standard.

- **The Pensions and Lifetime Savings Association supports the principle underlying pre-emption rights** except where a clear case is made for these not being applied in the context of the best interest of all of the owners of the company concerned. Similarly, in order to protect the rights of existing shareholders and reinforce the accountability of management to the company's owners, the Association generally opposes the creation of "poison pill" provisions.
- **Companies should take capital structure decisions which balance the financing needs of the firm with the interests of broader stakeholders.** This includes striking the right balance between dividend payments to shareholders and paying Deficit Repair Contributions (DRCs) to any Defined Benefit (DB) pension scheme, and undertaking share buybacks only when doing so is the best way of achieving long-term value.
- **Effective engagement with shareholders is crucial.** Companies should take care to ensure their messages are clearly understood by their investors and in turn that their concerns are communicated to, and considered by, the board. The roles of the Chair and the senior independent director in these regards are of the greatest importance.
- **The Pensions and Lifetime Savings Association strongly supports the Stewardship Code** which sets out important principles for the role of institutional investors in monitoring and improving standards of corporate governance in the UK. As with the UK Corporate Governance Code, it is incumbent upon signatories to the Stewardship Code to demonstrate their commitment to the spirit of the Code and communicate how they adhere to its principles in order to enhance and protect long-term value for their clients.
- **The Pensions and Lifetime Savings Association supports the OECD Corporate Governance Principles and ICGN Global Governance Principles.** These globally accepted standards of best practice provide a sound foundation for the development of market-specific codes of best practice for investors to adopt and support as part of their corporate governance programmes.
- **Smaller companies should seek to emulate best practice.** While the Code only applies on a mandatory basis to companies with a premium listing, its principles are just as relevant to smaller quoted companies as they are to larger ones. The Quoted Companies Alliance (QCA) Corporate Governance Code for Small and Mid-Size Quoted Companies is a useful reference point for companies in this respect. In judging practice, investors should be mindful of the individual circumstances of the business, reflecting upon its size and complexity. A key focus for smaller quoted companies should be to seek regular and constructive engagement with their shareholders.
- **Investment Companies have specific characteristics which commonly lend themselves to alternative governance approaches than those set out in the Code.** To that end, the Association of Investment Companies (AIC) Code of Corporate Governance forms a comprehensive guide to best practice. Of particular importance to shareholders is that the board is, and acts, fully independently of the firm providing fund management services. The board of these companies is crucial in ensuring that shareholders are provided with sufficient information for them to understand the risk/reward balance to which they are exposed by holding the shares.

- **Pension schemes should consider explicitly setting out their expectations for outsourced engagement and stewardship activities in their contracts or mandates.** Asset owners which outsource engagement to asset managers and others still have stewardship responsibilities and a duty to monitor and scrutinise the work undertaken on their behalf. The ICGN's Model Mandate provides a helpful starting point for schemes who want to ensure their Investment Management Agreement (IMA) and other contracts are set up to help them hold their service providers to account.

**UK VOTING GUIDELINES**

The general structure of these Guidelines is based around the new core Principles of the 2018 Code followed by a discussion of the key issues. More detailed voting guidance is subsequently set out in the second section of the Guidelines. **This year, for the first time, the Guidelines do not follow the format and order of a standard AGM agenda.** Instead the Guidelines are arranged to highlight those issues and resolutions which the Association believes will be of particular interest to investors in 2019<sup>11</sup>.

**The voting recommendations assume that shareholders have evaluated explanations for non-compliance, taken account of a company’s individual circumstances and engaged as appropriate. They should in no way be interpreted as being prescriptive.**

“Comply and explain” confers a dual responsibility: it is the company’s duty to avoid “boilerplate” explanations, providing instead a thoughtful and justifiable explanation for areas of non-compliance. Conversely, shareholders need to evaluate these explanations with intelligence, taking care not to adopt a mechanistic approach and should make companies aware of the reasoning behind their votes on contentious issues. An effective “comply or explain” regime must be based on regular and open dialogue between companies and shareholders, which should extend beyond the voting season.

Voting decisions should always be made in the context of a company’s overall governance arrangements and consider the progress made, given that governance is always dynamic.

Certain corporate governance issues would not generally have voting consequences; an accumulation of minor issues, however, may be indicative of poor corporate governance. A holistic approach should be adopted when assessing corporate governance arrangements.

**Shareholders are encouraged to make systematic use of all of the powers at their disposal** as necessary in order to coherently support the highest standards of corporate governance at the companies in which they invest. This should include escalation in instances where it is clear that a given company is repeatedly failing to respond meaningfully to investors’ concerns on a specific issue. Those voting powers which have been traditionally more rarely used include: the adoption of the annual report and accounts; the (re)appointment of the auditors; attendance and speaking at AGMs and tabling shareholder resolutions.

However, shareholders should always balance the “signalling” effect of a voting sanction against the potential for it to exacerbate the situation which they seek to remedy.

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<sup>11</sup> For a detailed review of the key themes from the 2018 AGM season, please see the PLSA’s *AGM Annual Review 2018* (January 2019).

## **SECTION 1: BOARD LEADERSHIP AND COMPANY PURPOSE**

### **Principles from the UK Corporate Governance Code**

- A. A successful company is led by an effective and entrepreneurial board, whose role is to promote the long-term sustainable success for the company, generating value for shareholders and contributing to wider society.**
- B. The board should establish the company's purpose, values and strategy, and satisfy itself that these and its culture are aligned. All directors must act with integrity, lead by example and promote the desired culture.**
- C. The board should ensure that the necessary resources are in place for the company to meet its objectives and measure performance against them. The board should also establish a framework of prudent and effective controls, which enable risk to be assessed and managed.**
- D. In order for the company to meet its responsibilities to shareholders and stakeholders, the board should ensure effective engagement with, and encourage participation from, these parties.**
- E. The board should ensure that workforce policies and practices are consistent with the company's values and support its long-term sustainable success. The workforce should be able to raise any matters of concern.**

### **GUIDANCE**

The board is tasked with promoting the long-term success of the company and is accountable to shareholders for protecting and generating sustainable value over the long term. The 2006 Companies Act requires Directors to have regard for other stakeholders, including workers, customers, suppliers and wide society and the environment, and boards should be aware of these requirements when carrying out their work.

The challenge for a board and its Chair is to demonstrate to shareholders the effective application of good corporate governance. Shareholders will naturally look at financial results as one measure, but will also look for wider evidence that the Chair and the board as a whole are adhering to the spirit of the Code's Principles.

A key change to the 2018 Code has been the explicit clarification surrounding a company's responsibilities to its shareholders and stakeholders – including its workforce. The 2018 Code also more clearly highlights the role of the board in determining and assessing a company's culture and values.

Shareholders may want to undertake closer analysis of the narrative used in company statements to assess its approach to the workforce and stakeholders: does the language used indicate that the company sees its workforce as a source or value or as a risk to be managed?

Is there evidence of a clear sense of corporate purpose, culture and values and how these align with the company's strategy?<sup>12</sup>

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<sup>12</sup> Please see the PLSA's *Worth of the Workforce: A Stewardship Toolkit for Investors* (2016) for further exploration of how investors should seek to engage on these issues.

## **SECTION 2: DIVISION OF RESPONSIBILITIES**

### **Principles from the UK Corporate Governance Code**

- F. The chair leads the board and is responsible for its overall effectiveness in directing the company. They should demonstrate objective judgement throughout their tenure and promote a culture of openness and debate. In addition, the chair facilitates constructive board relations and the effective contribution of all non-executive directors, and ensures that directors receive accurate, timely and clear information.**
- G. The board should include an appropriate combination of executive and non-executive (and in particular, independent non-executive) directors, such that no one individual or small group of individuals dominates the board's decision-making. There should be a clear division of responsibilities between the leadership of the board and the executive leadership of the company's business.**
- H. Non-executive directors should have sufficient time to meet their board responsibilities. They should provide constructive challenge, strategic guidance, offer specialist advice and hold management to account.**
- I. The board, supported by the company secretary, should ensure that it has the policies, processes, information, time and resources it needs in order to function effectively and efficiently.**

### **GUIDANCE**

The success of a board is down to its members' contributions and how the different roles and individuals work together collectively and effectively. Shareholders should seek to assess whether the quality and mix of individuals on the board gives them reassurance.

The roles of Chair and chief executive officer (CEO) are distinctly different and thus should be fulfilled by different individuals. A company's chief executive should not become chair of the company except in exceptional circumstances and we would expect significant engagement with shareholders, setting out the reasons for doing so and with clear timeframes indicated, in good time.

Shareholders also place particular importance on the appointment of a senior independent director (SID) as a key contact for shareholders when the normal channels of the Chair, CEO, or CFO have failed to address concerns or are not the appropriate avenues.

Shareholders should seek to have a clear sense of other demands on directors' time as well as any significant developments which may have occurred since a director's appointment and which could have an impact on their ability to commit appropriate time to the company.

Details of other current appointments – including any changes over the previous year – should be set out in the annual report.

Shareholders have a reasonable expectation that boards should be effective in delivering results, over time, which are consistent with the company's stated strategy. In so doing, shareholders should assess the extent to which performance results can be attributed to poor or imprudent management judgements, weaknesses in corporate governance or external factors over which the board has limited control. The annual reports should be used to set out the ways in which the board has sought to ensure its effectiveness.

The 2018 Code draws out more clearly its expectations regarding the independence and responsibilities of non-executive directors. Shareholders should ensure they have a clear understanding of any existing (or pre-existing) relationship between the independent non-executives and the company that could compromise directors' ability to hold management to account.

### **SECTION 3: COMPOSITION, SUCCESSION AND EVALUATION**

#### **Principles from the UK Corporate Governance Code**

- J. Appointments to the board should be subject to a formal, rigorous and transparent procedure, and an effective succession plan should be maintained for board and senior management. Both appointments and succession plans should be based on merit and objective criteria and, within this context, should promote diversity of gender, social and ethnic backgrounds, cognitive and personal strengths.**
- K. The board and its committee should have a combination of skills, experience and knowledge. Consideration should be given to the length of service of the board as a whole and membership regularly refreshed.**
- L. Annual evaluation of the board should consider its composition, diversity and how effectively members work together to achieve objectives. Individual evaluation should demonstrate whether each director continues to contribute effectively.**

#### **GUIDANCE**

Shareholders will be particularly concerned with the following: succession and refreshment plans; board evaluation; and re-election rationale (including biographical details).

The Pensions and Lifetime Savings Association strongly encourages companies to set out within the annual report the contributions in the year of individual directors and to provide a rationale for their election or re-election to the board. Such a statement should present shareholders with a full picture of the relevant skills, contribution and experience that a director is bringing to the board.

The value of the tenure guidelines of nine years is to drive refreshment of the board overall rather than marking a limit on the value offered by an individual. Most importantly, boards should set out their forward-looking succession and refreshment plans in detail when they propose the re-election of a long-serving non-executive director, especially when the director is chairing an important board committee.

Shareholders will look for evidence of implementation of a succession plan and its link to the company strategy. Advanced communication with shareholders when board changes are planned will help allay any concerns. A statement on succession should cover the board's policy on diversity, including gender and ethnicity<sup>13</sup>. The disclosure should set out clearly the board's approach to succession planning, any changes anticipated in the next year(s) and its diversity objectives and progress towards achieving them, bearing in mind the need to

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<sup>13</sup> We would expect diversity information to run through any key corporate disclosures on the board and workforce. This is particularly in the context of new (and forthcoming) disclosure requirements for the largest companies on gender pay and ethnicity pay and heightened investor focus on board diversity.

develop the right skills, experience and diversity of perspectives and personalities on the board – reference should be made to the efforts to develop talent internally in order to create a pipeline to the board.

External board effectiveness reviews are to be welcomed, but shareholders will expect that the organisation responsible for effecting the evaluation is in a position to take an independent and rigorous approach. Companies are encouraged to disclose details of the process – including the name of the firm or individual undertaking the board evaluation – and as far as possible the conclusions reached within the evaluation and subsequent actions taken.

## **SECTION 4: AUDIT, RISK AND INTERNAL CONTROL**

### **Principles from the UK Corporate Governance Code**

- M. The board should establish formal and transparent policies and procedures to ensure the independence and effectiveness of internal and external audit functions and satisfy itself on the integrity of financial and narrative instruments.**
- N. The board should present a fair, balanced and understandable assessment of the company's positions and prospects.**
- O. The board should establish procedures to manage risk, oversee the internal control framework, and determine the nature and extent of the principal risks the company is willing to take in order to achieve its long-term strategic objectives.**

### **GUIDANCE**

Shareholders expect the accounts to present a “true and fair” view of the state of affairs of the business, its assets, liabilities, financial position and profit or loss. This means that profits (or losses), assets and liabilities should be prudently assessed to avoid overstating capital. The Annual Report should cover the key elements of the business, by size and by risk exposures. It should, in a clear and understandable fashion, explain how the company generates value from its key tangible and intangible assets. Reporting should also set out the board's view of the key strategic and operating risks, including environmental, social, governance and reputational risks, facing the business.

In recent years, the Pensions and Lifetime Savings Association has produced a toolkit for members, highlighting the importance of a company's workforce to its long-term success and recommending pension fund investors encourage investee companies to disclose more details of their corporate culture and working practices. Corporate reporting should detail the composition; stability; training and skills; and engagement levels of a company's workforce, explaining how this relates to the underlying business strategy as well as the risks and opportunities that derive from the employment models and practices.

Furthermore, it is crucial that the understanding and reporting of risk remains a dynamic and continually evolving and refining process. Examples of emerging risks may include those from climate change and cyber security; such risks should be appropriately considered, alongside more ‘traditional’ risks which relate to issues such as a company's approach to tax management which, in addition to posing a financial risk, may also pose a risk to its reputation and brand value.

Companies must communicate how these risks are managed and what changes have occurred in relation to these risks over the course of the past year. Where a risk materialised over the past year the report should communicate how the company is responding.

The Pensions and Lifetime Savings Association supports the application of the FRC Guidance on Risk Management, Internal Control and Related Financial and Business Reporting and Guidance on Audit Committees. Shortcoming by companies and their boards in these areas are likely to be causes of concern to shareholders.

We strongly support the on-going evolution of and improvements to audit committee and auditor reporting and are monitoring ongoing policy developments<sup>14</sup> in this area closely. It is important that efforts to avoid 'boilerplate' language are maintained and the audit committee and auditor reports should provide sufficient 'colour' to enable shareholders to form a judgement about the committee's and auditor's work in the year. Particular areas of interest are: critical accounting policies and principles used; level of materiality adopted; assumptions and judgements; and evidence of professional scepticism by the auditor. Also, where a review has been undertaken by the FRC's Audit Quality Review Team, the board should share its main findings and actions that have been taken to respond to any recommendations. The Audit Committee's oversight of auditor independence is also vital.

Lengthy audit tenures have the potential to impact on the actual, or perceived, independence of the external auditor. Auditors need to maintain a healthy level of scepticism over management accounts, rigorously test these and also be willing to challenge their own past judgments. As such the EU Audit Directive and Regulation's requirement whereby FTSE 350 companies should put the external audit contract out to tender at least every ten years, with a maximum 20 year audit firm tenure, should be seen as minimum expectation.

A rigorous tendering process should enable the audit committee to compare the quality and effectiveness of the services provided by the incumbent auditor with other audit firms, including those outside the Big Four. The intention to tender the audit contract should be disclosed in advance within the report and accounts. The tender process should focus on audit quality, including auditors' independence – for instance if a candidate auditor provides non-audit services – and processes to ensure professional scepticism.

Shareholders should pay close attention to the composition, skills and experience of the Audit Committee. Committee members should have recent and relevant financial experience, related to audit, accountancy or investor practitioner expertise. Any Committee member's connections with the current or potential auditor should be clearly disclosed.

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<sup>14</sup> At the time of writing ongoing developments include: the CMA investigation into the statutory audit market; implementation of the recommendations of the Kingman Review of the FRC; the independent Brydon Review into UK audit standards; and the Parliamentary Select Committee for Business Energy and Industrial Strategy's inquiry into the future of audit.

## **SECTION 5: REMUNERATION**

### **Principles from the UK Corporate Governance Code**

- P. Remuneration policies and practices should be designed to support strategy and promote long-term sustainable success. Executive remuneration should be aligned to company purpose and values, and be clearly linked to the successful delivery of the company's long-term strategy.**
- Q. A formal and transparent procedure for developing policy on executive remuneration and determining director and senior management remuneration should be established. No director should be involved in deciding their own remuneration outcome.**
- R. Directors should exercise independent judgement and discretion when authorising remuneration outcomes, taking account of company and individual performance, and wider circumstances.**

### **GUIDANCE**

Remuneration is seen by many investors as a litmus test for wider corporate governance practices; it encompasses board effectiveness and leadership, challenge and oversight as well as strategy and risk management. Shareholders will therefore continue to examine remuneration policies critically, with a view to ensuring that they are closely aligned with their interests and are driving long-term strategic success.

The 2018 Code refers to the need for executive remuneration to be reviewed in line with overall workforce remuneration. This includes the need for the pension contribution rates for executive directors to be in line with those available to the workforce. The last few years have also seen new regulations and expectations placed upon companies when it comes to pay discrepancies based on gender and ethnicity.

The Pensions and Lifetime Savings Association is clear that fair pay policies are necessary (but not sufficient in themselves) to ensure good employee morale. Significant pay discrepancies, including those based on issues such as gender or ethnicity, as well as between a company's senior executives and the rest of the workforce can also be a signifier of wider problems with a workplace's culture and processes.

The Pensions and Lifetime Savings Association's "Remuneration principles for building and reinforcing long-term business success" were published in 2013 in conjunction with Hermes EOS, BT Pension Scheme, RPMI Railpen and USS Investment Management. These set out a framework for remuneration committees to use when thinking through, devising and implementing their remuneration policies. Investors do not wish to micro-manage businesses and thus will hold the remuneration committee accountable for making appropriate judgements. We expect remuneration committees to take ownership of the design and implementation of the remuneration policies and for companies to articulate how their pay policies meet the Principles in a manner which is most appropriate for them:

- 1. Remuneration committees should expect executive management to make a material long-term investment in shares of the businesses they manage**
- 2. Pay should be aligned to long-term strategy and the desired corporate culture throughout the organisation**
- 3. Pay schemes should be clear, understandable for both investors and executives, and ensure that executive rewards reflect returns to long-term shareholders**
- 4. Remuneration committees should use the discretion afforded them by shareholders to ensure that awards properly reflect business performance**
- 5. Companies and shareholders should have appropriately regular discussions on strategy and long-term performance**

Shareholder concern remains high about the size and structure of executive pay packages. Investors continue to express concerns about recent increases in the fixed pay of senior executives (vis-à-vis performance-related-pay) and should continue to press companies to clearly explain their rationale for doing so. As well as being clearly aligned with pay policies in the company as whole, executive pay policy must be mindful of wider societal expectations. We encourage a coherent remuneration philosophy which is consistent throughout the organisation and is clearly linked to incentivising those behaviours which are consistent with the company's purpose and values. Remuneration Committee deliberations should take a critical and challenging approach to pay increases and be prepared to exert downward pressure on executive pay.

We would like to see remuneration policies being designed and put to shareholders with the expectation that they will stand the test of time. As such, remuneration policies should on the whole be put to a vote on a triennial rather than an annual basis. In parallel, annual reporting should be transparent and clearly explain how pay is aligned to performance.

## **APPENDIX 1: DETAILED VOTING GUIDELINES**

### **INTRODUCTION**

In this section we have not repeated the detailed provisions of the UK Corporate Governance Code, but have sought to identify those issues which will be of particular importance to shareholders when assessing a company's compliance with the Code and deciding what voting sanctions, if any, to apply. The order of the guidelines reflects those issues which have seen in 2018 – or are expected to see in 2019 – a significant amount of investor interest or policy change.

Several of the Code's provisions relate to disclosure of information about the board or its governance practices, without which it can be very difficult to arrive at an informed opinion about the quality of its compliance. Poor levels of disclosure are likely to lead shareholders to take a less sympathetic view of explanations of non-compliance.

## 1) APPROVAL OF THE REMUNERATION POLICY

- 1.1. The Pensions and Lifetime Savings Association believes that remuneration should be proportionate and aligned with shareholder interests and long-term sustainable value creation.
- 1.2. The Remuneration principles for building and reinforcing long-term business success are intended to provide high-level guidance to companies about investor expectations of their remuneration structures and practices. The Principles deliberately avoid prescribing specific structures or measures; however, we do expect companies to articulate how their pay policies meet these Principles in a manner which is most appropriate for their company – the Committee Chair’s statement provides useful scope to do this.
  1. **Remuneration committees should expect executive management to make a material long-term investment in shares of the businesses they manage**
    - i. To the extent this is feasible and appropriate the bulk of variable rewards should flow over time from the benefits of being an equity owner.
    - ii. Companies should also consider ensuring that executives are exposed to some tail risk for an appropriate length of time once they leave a company.
  2. **Pay should be aligned to long-term strategy and the desired corporate culture throughout the organisation**
    - i. Remuneration committees should take as a starting point the company’s strategic plan and key performance indicators and ensure there is a strong read across from the company’s strategy to the drivers of executives’ remuneration.
  3. **Pay schemes should be clear, understandable for both investors and executives, and ensure that executive rewards reflect returns to long-term shareholders**
    - i. Incentive schemes should be simple to understand. Firms should avoid operating multiple long-term schemes – we do not believe that a multiplicity of awards, with varying performance conditions helps to motivate executives.
  4. **Remuneration committees should use the discretion afforded them by shareholders to ensure that awards properly reflect business performance**
    - i. Remuneration committees should exercise their judgement about the overall performance of the company when determining awards. In particular, the committee should consider how the results have been achieved, not just what was achieved.

**5. Companies and investors should have appropriately regular discussions on strategy and long-term performance.**

- i. Dialogue should be initiated at an early stage of the decision making process and include those investors who are committed to stewardship.

**1.3** Pay policies should ensure that maximum pay-outs remain in line with the expectations of shareholders and other stakeholders, including workers and wider society. The pay policy should not enable any pay award larger than that necessary to successfully execute the company's wider strategy, and to incentivise and reward success.

- ▶ **If shareholders judge that the company's remuneration policy fails to meet the Pensions and Lifetime Savings Association's Principles then they may decide to vote against the policy.**
- ▶ **Pay policies likely to result in pay awards that could bring the company into public disrepute or foster internal resentment, owing to their excessive value and/or the overly-generous incentives and rewards that they offer, also justify a vote against the policy.**
- ▶ **If the process of engagement prior to the AGM vote fails to produce a remuneration policy that shareholders can support, this represents a serious failure on part of the Chair of the remuneration committee in the most fundamental aspect of their role. As such, a vote against the remuneration policy should in most circumstances be accompanied by a vote against the Chair of the remuneration committee and other committee members, if they have been in post for more than one year.**
- ▶ **In the event of a vote against a revised remuneration policy, if the revised policy continues to fail to meet the principles outlined in these guidelines, it may also be appropriate to vote against the Chair of the Board.**

**1.4** Shareholders will seek reassurance that there is a clear link between strategy, performance and reward. Total remuneration should be structured to reflect the ambitions and risks inherent in the business and be mindful of both the wider economic climate and the impact on the general workforce. Performance pay should motivate management to deliver business results which are both stretching and sustainable but should not result in awards in excess of what is necessary to motivate or reward good performance.

- ▶ **A vote against the remuneration policy may be warranted in the below circumstances:**

- ▶ Insufficient alignment with shareholders. An indication of insufficient alignment may include, but not be limited to, a shareholding requirement of less than 2x salary. Higher levels may be warranted commensurate with higher levels of reward.
- ▶ Inappropriate metrics or insufficiently stretching targets for annual bonus or LTIP and/or a lack of read across between metrics used and the company's strategy.
- ▶ Pension payments or payments in lieu of pension worth over 50 per cent of annual salary
- ▶ Failure to disclose or retrospective disclosure of variable pay performance conditions for annual bonuses.
- ▶ An absence of provisions to enable the company to claw back sums paid or scale back unvested awards –these provisions should not be restricted solely to material misstatements of the financial statements.
- ▶ An excessive amount of flexibility being provided for 'exceptional' circumstances.
- ▶ A recruitment policy that is vague or provides unlimited or substantial headroom over and above existing plans.
- ▶ Guaranteed pensionable, discretionary or 'one-off' annual bonuses or termination payments.
- ▶ Any provision for re-testing of performance conditions.
- ▶ Layering of new share award schemes on top of existing schemes.
- ▶ Excessively generous salary or performance-related pay awards.

**1.5** The resolutions on the remuneration policy and annual remuneration report are viewed independently by shareholders. While one does impact the other, a vote for or against one does not necessarily require a vote for or against the other. It is important for both shareholders and companies to communicate in order to understand the rationale behind voting decisions.

## **2) APPROVAL OF THE REMUNERATION REPORT**

**2.1** Remuneration committees should exercise their judgement about the overall performance of the company when determining awards. In particular, the committee should consider how the results have been achieved, not just what was achieved.

▶ **Where remuneration committees have failed to exercise discretion and pay awards fail to reflect wider circumstances such as serious corporate conduct issues which have arisen. Alternatively, if discretion has been used in an upwards direction without appropriate explanation then shareholders may wish to vote against the remuneration report.**

▶ **Remuneration practices which are likely to cause concern and may trigger a voting sanction against the remuneration report in the absence of a convincing explanation include:**

- ▶ Annual pay increases in excess of inflation or those awarded to the rest of the workforce.
- ▶ Over frequent re-benchmarking.
- ▶ An awarding of a 'sign-on' bonus without the inclusion of any conditionality and which pays for awards not already vested at previous employer.
- ▶ Ex-gratia and other non-contractual payments.
- ▶ Change in control provisions triggering earlier and/or larger payments and rewards.
- ▶ The absence of service contracts for executive directors.
- ▶ Inappropriate or inadequate use of discretion, for example not scaling back awards in light of *how* performance was achieved, or in light of wider factors relating to the company, and its conduct, reputation and relationship with key stakeholders.

**2.2** The resolutions on the remuneration policy and annual remuneration report are viewed independently by shareholders. While one does impact the other, a vote for or against one does not necessarily require a vote for or against the other. It is important for both investors and companies to communicate in order to understand the rationale behind voting decisions.

**2.3** As with the remuneration policy, a successful remuneration report requires the Chair of the remuneration committee to work effectively with shareholders to understand their concerns, and to exercise their judgement and discretion appropriately. Failure

to do so represents a significant failure to carry out their most important duties as committee chair.

- ▶ **In most circumstances, shareholders should vote against the re-election of the remuneration committee Chair and other committee members, if they have been in post for more than one year, , if they vote against the remuneration report.**

**2.4** The PLSA's series of AGM reports highlight how high levels of shareholder dissent on remuneration related votes are too rarely heeded by companies:

- ▶ **Given that the vote on the remuneration report is advisory and that many companies are too slow to heed the message on remuneration, it is more appropriate for shareholders to vote against any remuneration report that they feel unable to support, rather than abstain.**

### **3) SUSTAINABILITY**

#### **EMPLOYMENT MODEL AND ISSUES**

- 3.1** Companies' directors have a duty to promote the success of the company for the benefit of its members, but to have regard for other stakeholders, including workers, customers and the wider environment and society at large. Positive relations with key stakeholder constituencies are of clear importance to a company's long-term performance.
- 3.2** Boards should communicate how stakeholder relationships are managed and how stakeholder perspectives are fed into boardroom considerations.
- ▶ **Shareholders should consider voting against the annual report and accounts or the re-election of the Chair where they believe that key stakeholder relationships are being neglected and the board is not adhering with the spirit of requirements to have for the concerns of stakeholder constituencies.**

#### **CLIMATE CHANGE**

- 3.3** Amongst sustainability issues, climate change has gained particular prominence. Research demonstrates that failure to sufficiently mitigate global temperature increases will have devastating environmental, social and economic consequences. Global commitments to limit temperature increases through the mitigation of greenhouse gas emissions will also have a significant impact on the viability of business models across a wide range of sectors.
- 3.4** Companies in sectors affected by climate change and efforts to mitigate it should undertake rigorous examinations of whether their business model is compatible with commitments to mitigate global temperature increases and how they plan to address the issue of climate change. This also requires climate-related expertise at board level.
- ▶ **Where, after attempts by shareholders to engage on this issue, companies fail to provide a detailed risk assessment and response to the effect of climate change on their business, and incorporate appropriate expertise on the board, shareholders should not support the re-election of the Chair or other key directors.**
  - ▶ **Shareholders may also wish to consider supporting relevant climate-related or similar resolutions. Key issues to be considered when**

**doing so should be the proportionality and achievability of the resolution.**

#### **4) ANNUAL REPORT & ACCOUNTS**

- 4.1** A company's financial statements should present a true and fair view of the underlying economic position. Its annual report as a whole should offer a fair, balanced and understandable assessment of the company's position and prospects. This reporting should cover both the financial and non-financial, and outline how the board has fulfilled its responsibilities. Boilerplate disclosure should be avoided.
- ▶ If the audited accounts are deemed to fail to provide a true and fair view of profit or loss, assets or liabilities, then shareholders should consider voting against the adoption of the report and accounts, auditor and/or Audit Committee chair. Examples of misleading accounts include overstating profit or assets, or understating likely liabilities (e.g. pension liabilities, climate-related liabilities),
  - ▶ **In extreme circumstances shareholders may wish to vote against the re-election of the Chair, or submit a shareholder resolution.**

#### **STRATEGY AND BUSINESS MODEL**

- 4.2** Shareholders expect a clear elucidation of the strategy, culture and business model and for the clarity on these areas to flow through all areas of the annual report. The strategic report should provide a clear articulation of how the company's key assets – including human, physical and intangible assets - are engaged in the generation of sustainable value creation and clear connections made to the chosen financial and non-financial KPIs and the reciprocal link with executive pay.
- 4.3** In 2016, the PLSA published a 'toolkit' for pension funds, identifying improvements to reporting of corporate culture and how the company's employment model and working practices relate to its underlying purpose and business model. A company's workforce is critical to its long-term success, and strategic information in this respect should be a key component of the annual report.
- ▶ **Disclosure of the business model and strategy which fails to convey how the company intends to generate and preserve value over the longer term may lead to a vote against the report and accounts, or the submission of a shareholder resolution.**
  - ▶ **A company's employment model and working practices are a critical component of its business model and long-term performance. In the event of failure to provide a fair and balanced explanation of the composition, stability, skills and capabilities and engagement levels of the company's workforce a vote against the annual report would be appropriate.**

**RISK MANAGEMENT AND LONG-TERM VIABILITY**

- 4.4** Shareholders expect to see appropriate prominence given to risk management, and in particular a focus on risk in the context of the business strategy, its size and global footprint, its assets, liabilities and the wider political and regulatory environment.
- 4.5** Shareholders expect that company directors articulate whether they have a reasonable expectation that the company will remain a viable and sustainable enterprise for the foreseeable future, and certainly over a period matching the planning and investment horizon. Directors *should state whether they expect the company to meet its liabilities as they fall due over the period of their assessment, drawing attention to any qualifications or assumptions as necessary*. In assessing viability they are expected to consider all risks which might impact the ongoing viability of the company over this period, including those matters such as a licence to operate. Disclosures should build on the disclosures contained within strategic reports and be concise, thoughtful and company specific. Greater reassurance is likely to be gained from assessments which are evidently open and transparent rather than ones which appear boiler-plated and heavily caveated.
- 4.6** Directors should articulate why they have chosen a specific time-frame, taking account of FRC guidance that *the length of the period should take account of the board's "stewardship responsibilities; previous statements they have made, especially in raising capital; the nature of the business and its stage of development, and its investment and planning periods."*<sup>15</sup>
- ▶ **Poor disclosure of the strategy and risk exposures may lead to a vote against the report and accounts.**
  - ▶ **The lack of a disclosed review of the company's risk management and internal control systems would likely result in a vote against the report and accounts.**
  - ▶ **The lack of a viability statement, looking out over multiple years, or one which does not evidently consider a full range of risk factors would likely result in a vote against the report and accounts.**
  - ▶ **In the event of extreme concerns or persistently poor disclosure shareholders may consider voting against the Chair and/or submitting a shareholder resolution.**
- 4.7** Companies should consider the broader strategic risks, including environmental, social and reputational risks, facing the business and give comment on those in the annual report.

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<sup>15</sup> FRC, 2014. *Guidance on Risk Management, Internal Control and Related Financial and Business Reporting*. [Online] Available at: <https://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/Guidance-on-Risk-Management,-Internal-Control-and.pdf> [Accessed 1 December 2015] p.19.

**4.8** In addition, shareholders expect that where a risk has materialised within the year that the company sets out how it has responded and what efforts have been taken to mitigate the risk going forward.

- ▶ **A lack of, or poor quality, reporting on environmental, social and reputational risks may warrant, after engagement, a vote against the annual report and accounts, or the submission of a shareholder resolution.**

#### **BOARD EVALUATION**

**4.9** An effective board evaluation process, utilising at least every three years an independent external facilitator, is seen by shareholders as an important part of a company's governance processes. Companies are expected to provide details of the approach adopted and broad conclusions reached from the evaluation in their annual report.

**4.10** At a minimum, the board should seek to provide the following details:

- ▶ When the review took place and when a subsequent review is planned;
- ▶ What was specifically reviewed (including rationale behind this decision);
- ▶ Who conducted the evaluation, and whether they were internal or external appointments (including rationale behind their selection);
- ▶ The nature of the process;
- ▶ The key findings and lessons learned; and
- ▶ Any follow up required, and by whom.
- ▶ **In the event of limited or boilerplate disclosure about the board evaluation and review of corporate governance arrangements, shareholders may wish to vote against the adoption of the report and accounts;**
- ▶ **Subsequently if practice does not improve (or there is consistently no independent board evaluation conducted) dissent may be escalated to a vote against the Chair of the company.**

#### **BOARD DIVERSITY**

**4.11** Shareholders expect companies to explain what steps they are taking to bring diversity in all its guises to their boardroom. The report & accounts should include a description of the board's policy on diversity – including professional, international and gender diversity - any measurable objectives that it has set for implementing the policy, and its progress against these objectives.

**4.12** The progress in recent years towards meeting the Davies target of 33% of women on FTSE 100 Boards has been positive but there is still considerable room for improvement in some cases and shareholders expect this momentum to be maintained.

- ▶ **Shareholders could consider voting against the Report & Accounts if a diversity statement is not disclosed, or is not considered satisfactory.**
- ▶ **If there is no clear evidence that diversity is being sufficiently considered by the board then a vote against the Chair (or Chair of the Nominations Committee, if not the same individual) may be warranted.**
- ▶ **The Davies Report and 33 per cent target is a useful benchmark for gender diversity, and a failure to move closer to the target is one example of a criterion that could justify a vote against the re-election of the Chair or Chair of the Nominations Committee.**
- ▶ **Similarly, the 2016 Parker report proposed an ethnic diversity target of no ‘all white’ boards by 2021 and progress towards this target is another useful measure of whether diversity is being sufficiently considered.**

#### **CHAIR AND DIRECTORS’ JOB SPECIFICATIONS/TIME COMMITMENT REQUIRED**

**4.13** It is important that shareholders have access online to the terms and conditions on which directors are appointed and that due consideration has been given by the board and each director to the time commitment required, particularly in the event of a crisis developing.

**4.14** The issue of time commitment is especially pertinent to the role of chair, particularly where a company is both complex and global in scale and furthermore if it operates within a highly regulated sector such as financial services.

- ▶ **In the event of poor disclosure, shareholders may wish to vote against the adoption of the report and accounts.**

## **5) RE-ELECTION OF THE CHAIR**

### **DIVISION OF RESPONSIBILITIES - JOINT CHAIR / CHIEF EXECUTIVE**

- 5.1** Separation of the roles of Chair and chief executive is a cornerstone of good corporate governance in the UK. The contravention of this tenet, by (a) the combination of the roles; or (b) the designation of an executive Chair would cause significant concern.
- 5.2** The temporary combination of the roles may be justified, notably when a Chair “bridges the gap” between the departure of a CEO and the appointment of his/her successor. But companies will not wish to give their shareholders the impression that such short-term fixes are being ill-managed and allowed to persist excessively.
- ▶ **Shareholders should consider voting against the board Chair in the event of the role being combined without a convincing explanation or where an ‘interim’ period extends for more than one year or where there is evidence of poor succession planning.**

### **AVAILABILITY**

- 5.3** Satisfactory engagement between company boards and investors is crucial to the health of the UK’s corporate governance regime. It is crucial that the Chair is engaged with the company’s shareholders on governance and strategy matters and conveys the relevant sentiments back to the board as a whole.
- ▶ **Any decision by the Chair to decline a legitimate shareholder request for a meeting, or to fail to find a mutually convenient time without undue delay, may lead that shareholder to decide not to support the re-election of the Chair at future AGMs.**
- 5.4** Engagement and dialogue offers investors the opportunity to assess the quality of and gain insight into the effectiveness of a board member, in particular the Chair.
- 5.5** Alongside judgements formed through engagement, shareholders will consider the history of the Chair when contemplating support for his/her re-election. Particular care is required where the Chair has had significant involvement, whether as an executive director or non-executive director, in material failures of governance, stewardship or fiduciary responsibilities at a company or other entity.
- ▶ **Given that governance is more about individuals than box-ticking, a shareholder may take a negative voting decision based on the assessment they have formed of a Chair through engagement.**

**INDEPENDENCE**

- 5.6** If a new Chair has been appointed or a successor to the current Chair has been announced/proposed, the board should provide shareholders with confirmation in the annual report that the past/retiring Chair was not involved in the selection or appointment of his/her successor.
- 5.7** If the Chair is not independent on appointment, the company should consult its investors and provide a detailed explanation as to why it considers the appointment desirable. Investors will wish to approach each case on its individual merits. The calibre of the individual, the balance of the board, and the nature of the impediment to the proposed chair's independence may all be factors in investors' deliberations.
- 5.8** The succession of the CEO to Chair is a significant issue, acceptable only on rare occasions. The company should enter into early dialogue with its investors and provide a meaningful explanation for the proposed succession. Investors would expect confirmation that external search consultants had been engaged and that external candidates of at least equivalent stature had been actively and fully considered.
- 5.9** The complexity of the business is an insufficiently persuasive argument in itself to justify succession of CEO to Chair. Given the issues posed by a former CEO assuming the Chair of the board, it is important for shareholder approval to be sought at the AGM coinciding with or following his/her appointment.
- 5.10** The Pensions and Lifetime Savings Association appreciates that voting against the election of a Chair is a decision with broader implications. However, this must be balanced against the requirement for a Chair to have sufficient time to fulfil his/her responsibilities and to be independent on appointment. These are issues which call for extensive dialogue between companies and their owners.
- ▶ **In the above cases, shareholders may consider voting against the new Chair alongside a vote against the individual responsible for the appointment process – likely the SID.**

**BOARD DIVERSITY**

- 5.11** Ensuring the right balance of skills and experience on the board is crucial to ensure that the board is in position to operate effectively.
- 5.12** Shareholders will expect companies to explain what steps they are taking to bring diversity in all its guises to their boardroom, including gender diversity. This section should include a description of the board's policy on diversity – including professional, international and gender diversity - the measurable objectives it has set for implementing the policy, and its progress against these objectives.
- ▶ **The absence of a policy on diversity or the successful implementation of measurable targets, or insufficient progress has been made towards achieving a satisfactory level of diversity on the board may**

**result in opposition to the re-election of the Chair or where different the chair of the nomination committee.**

#### **BOARD SUCCESSION**

**5.13** Board refreshment and succession planning is one of the most important issues for consideration by shareholders. In particular it is crucial to ensure that appropriate and sufficiently flexible succession plans are in place for the CEO and Chair. Board refreshment should be a continuous and evolving process.

**5.14** Shareholders recognise the confidential or sensitive nature of some succession planning issues which may make disclosure more difficult. However, companies should disclose as much information as is feasible about the company's succession plans which:

- ▶ Looks out over multiple years.
- ▶ Covers any identified skills shortages.
- ▶ Pays particular attention to the Chair and CEO.
- ▶ **The absence of a disclosed and reassuring succession plan may lead to shareholders, after engagement, to oppose the re-election of the Chair or where different the Chair of the nomination committee.**

#### **BOARD EVALUATION**

**5.15** The Pensions and Lifetime Savings Association views board evaluation as an important tool for all boards. Companies are encouraged to disclose details of the process and as far as possible the conclusions reached within the evaluation and the subsequent actions taken.

- ▶ **The absence of an evaluation process may lead shareholders to oppose the re-election of the Chair of the company.**

#### **TIME COMMITMENT**

**5.16** The issue of time commitment is especially pertinent to the role of Chair, particularly where a company is both complex and global in scale and furthermore if it operates within a highly regulated sector such as financial services. A chair's time commitment may be questioned where they are a director of more than four companies and/or a chair of two or more global and highly complex companies.

- ▶ **Shareholders may wish to consider voting against the re-election of an over-committed Chair, or submitting a shareholder resolution.**

## 6) RE-ELECTION OF DIRECTORS

### AVAILABILITY

**6.1** Satisfactory engagement between company boards and investors is crucial to the health of the UK's corporate governance regime. It is crucial that the board as a whole is engaged with the company's shareholders on governance and strategy matters.

▶ **Any decision by a director to decline a legitimate shareholder request for a meeting, or to fail to find a mutually convenient time without undue delay, may lead that shareholder to decide not to support the re-election of the Chair at future AGMs.**

**6.2** Engagement and dialogue offers shareholders the opportunity to assess the quality of and gain insight into the effectiveness of a board member. Alongside this, the annual election of directors is important in providing accountability to shareholders.

**6.3** In presenting directors for (re-)election, sufficient biographical details should comprise:

- ▶ A statement of a director's other directorships or trusteeships and responsibilities (including any relevant previous positions held) including those outside the corporate sector.
- ▶ The experience and skills that they are bringing and the contribution that the director will make to the board and/or has made to the board during the year

**6.4** In all cases, the board should explain to shareholders why it believes that the director should be re-elected and confirm that the director has recently been subject to formal performance evaluation in relation to the fulfilment of their duty to act in the long-term interest of the company on behalf of its members, while also having due regard for other stakeholders, as outlined in the 2016 Companies Act and continues to be an effective member of the board.

**6.5** When the director is an independent non-executive proposed for re-election beyond nine years, a particularly rigorous review and evaluation process is to be expected.

**6.6** Boards and shareholders should consider the history of a director when contemplating support for his/her re-election. Particular care is required where a director has had significant involvement, whether as an executive director or non-executive director, in material failures of governance, stewardship or fiduciary responsibilities at a company or other entity. Shareholders rely heavily on the board's recommendation and directors should ensure that re-election proposals take into account not just the individual's performance on the board in question but also any external factors which may be relevant to that judgement.

- ▶ **Shareholders may choose to vote against the re-election of a director:**

- ▶ Where engagement with a director has informed a judgement on his/her effectiveness.
  - ▶ In the absence of a supporting statement from the board.
  - ▶ Where there is clear evidence of poor performance by the individual or the company.
  - ▶ Where there is a record of poor attendance at meetings without a satisfactory explanation given.
  - ▶ Where there is a failure of a specific aspect of reporting – for example an unsatisfactory audit committee report – in such circumstances investors may vote against the Chair of the relevant committee.
- 6.7** Where a company does not undertake annual re-elections, investors should expect a thorough explanation as to the rationale behind this decision.
- ▶ **Over time, a failure to move to annual director elections, especially where unsupported by an acceptable explanation, may lead to a vote against the re-election of the Chair and/or Chair of the nomination committee.**

## **DIRECTOR INDEPENDENCE**

- 6.8** The issue of director independence calls for a particularly thoughtful application of the “comply or explain” principle. The onus is on the company to provide a detailed and considered explanation as to why it considers a director to remain independent despite the existence of one (or more) of the seven factors which the Code suggests may impair independence.
- 6.9** Length of tenure warrants a pragmatic approach from companies and investors. The principal value of the tenure guideline is to drive refreshment of the board overall rather than marking a limit on the value offered by an individual.
- 6.10** As the length of tenure increases directors will be subject to increasing scrutiny as to their effectiveness and independence, the company has a responsibility for explaining why a long-serving non-executive director remains independent and why board refreshment is not advantageous.
- 6.11** In considering the rationale for re-election of a long-serving director, investors will pay particular attention to the Board’s general refreshment and succession planning. It is in the interest of companies that they present as much detail as is feasible about their forward looking and ongoing board succession and refreshment plans.

- 6.12** Furthermore, just as the company has a responsibility to consider independence carefully in these circumstances, equally shareholders will also wish to assess the company's explanation and may take account of some or all of the following factors:
- ▶ Overall corporate governance standards and history and wider independence on the board.
  - ▶ Evidence of independence in the director's conduct.
  - ▶ Confirmation that independence (as distinct from performance) was evaluated.
  - ▶ The length of service of the executives. In general, concurrent tenure of an NED with an executive director for over nine years should lead shareholders to question the NED's independence.
- 6.13** Where a director has served for over nine years concurrently with an executive director, that director should no longer be deemed to be independent. He/she should therefore no longer serve on those committees which should consist solely of independent directors.
- 6.14** Where the presence of one (or more) non-independent non-executive directors impairs board balance, the role of such non-executive directors should be clarified. The company should justify why it believes the independent element is sufficiently strong to counter the imbalance and why the continued presence of the non-independent non-executive director is in the interests of the company and its shareholders.
- 6.15** Where there is insufficient independent representation, investors will require a detailed explanation as to why the company's exceptional circumstances justify the situation. Ideally a timetable for compliance should be provided.
- 6.16** Controlling shareholders (as defined by LR 6.1.2A) overriding the interests of minority shareholders has been the subject of increasing investor concern. Details of the relationship with a controlling shareholder should be disclosed to investors.
- 6.17** Where a controlling shareholder is present, a relationship agreement is expected to be in place and this should detail any entitlements to governance arrangements such as board appointments. Exempting any details which are commercially sensitive, this agreement should be available to shareholders.
- ▶ **Voting sanctions against a non-independent non-executive director would normally be warranted only where the composition of the key committees or the balance of the board was compromised, other than because of the other reasons highlighted above.**

## ATTENDANCE

- 6.18** Where a director has been unable to attend a number of board or committee meetings, both scheduled and ad hoc, a reasoned explanation should be provided in the annual

report. Unexplained low attendance rates will be a factor when shareholders consider the re-election of directors.

- ▶ **Where a trend of low attendance at meetings has been identified, in the absence of a sufficient explanation and perhaps over the space of more than one year, voting against the re-election of the director concerned may be an appropriate sanction.**

#### **TIME COMMITMENT**

**6.19** The non-executive director role is an increasingly demanding one – in particular when chairing a key committee – however, their role is invaluable to the effective governance of the company. It is crucial that directors have sufficient time and energy to fulfil their role properly.

**6.20** Shareholders will be mindful of concurrent directorships and will take account of the size of the company, its complexity, its circumstances and other commitments that a director has in forming a view as to the whether an individual director is over-committed.

- ▶ **For complex companies it may be appropriate to vote against the (re)election of a non-executive director who holds more than four directorships.**
- ▶ **Where a director chairs a number of key committees a stricter view may be adopted, especially where an individual is a director of two or more companies in heavily regulated industries.**

## 7) APPOINTMENT OF THE AUDITOR AND AUTHORISE REMUNERATION OF THE AUDITOR

- 7.1 Separate resolutions should cover the appointment of external auditors and the setting of (or the authorising of the board to set) auditors' fees. This is principally because shareholders may have concerns about the balance between audit and non-audit fees which need to be considered separately, or substantially so, to the appointment of the auditor alone.
- 7.2 Auditor independence is crucial to audit quality; as such investors will expect companies clearly to disclose their policy on audit tendering and audit firm rotation, including when the audit was last subject to tender, overall length of the audit firm's tenure and how they ensure independence is safeguarded. EU and UK rules introduced recently require tenders are undertaken at least every ten years, with audit firms being replaced at least every twenty years.
- 7.3 Disclosure should cover the auditor re-selection decision along with any contractual obligations to appoint audit firms, in the interests of making the criteria used for auditor selection and evaluation as explicit as possible. Companies should also disclose the change of the audit partner and the process carried out by the audit committee to agree this appointment.
- 7.4 It should be communicated clearly that the decision in relation to nomination for appointment of the external auditor and scope of audit work is the responsibility of the audit committee.
- 7.5 Any change of auditors should be explained to shareholders and any plans to tender indicated in advance.
- ▶ **Where the tenure of the external auditor extends beyond ten years and there has not been a recent tender process and no plans to put the audit service out to tender are disclosed, shareholders should consider voting against the re-election of the audit committee Chair [and auditor].**
  - ▶ **Where the auditor has been in place for more than 20 years a vote against the Audit Committee chair and auditor should be considered.**
  - ▶ **This voting sanction may be extended to a vote against the re-nomination of the auditor if subsequently no action is taken.**
- 7.6 Where the auditors have resigned, the resignation letter should be posted on the company's website and a clear and full explanation provided.
- 7.7 Where the auditors supply non-audit services to the company, the audit committee should keep the nature and extent of such services under regular and close review,

ensuring that objectivity and independence is not compromised, or perceived to be compromised.

- 7.8** There should be full disclosure of the value of all non-audit fees including a clear break-down between the types of services received, with tax compliance services differentiated from tax advisory services and non-statutory acquisition-related services separated from statutory services.
- 7.9** The aggregate of non-audit fees should largely be constituted from audit related work. While the use of the company's auditors for non-audit work can on occasion be justified on grounds of cost and relevant expertise, more use should be made of third parties. Companies should spend no more than 50% of the audit fee on non-audit services (or a material monetary sum - £500k), absent an explanation of any exceptional circumstances which may apply. A company's clearly defined policy on non-audit work should form part of the audit committee's report to shareholders.
- ▶ **It would be appropriate to vote against the chair of the audit committee, auditor and/or the audit fees, in circumstances where the non-audit fees exceeds 50% of the audit fee (or a material monetary sum - £500k) in consecutive years without an adequate explanation being provided.**
  - ▶ **Where there are major concerns regarding the audit process and quality of accounts (relating to failure to provide a true and fair view, or visibility over dividend paying capacity) which are not satisfactorily resolved by the board, voting against the re-election of the Chair of the audit committee or the reappointment of the auditor may be appropriate.**
  - ▶ **Where the auditor's report fails to address a key issue of importance, or is otherwise unsatisfactory, shareholder may choose to vote against the reappointment of the auditor and/or the audit fees.**

## 8) APPROVE FINAL DIVIDEND

8.1 Companies should have clear dividend policies which set out the circumstances for distributing dividends and returning capital to shareholders. It is important that the financial position (especially distributable reserves), maturity and strategy of the business, or key issues like the level of Deficit Repair Contributions needed, are appropriately considered and reflected. Dividend policy disclosure should be specific enough to understand what the policy means in practice, including the basis for deriving the proposed level of dividend and specifics of how it is determined. Good disclosure should describe the governance process over the policy decision, the risks and constraints associated with the policy and the timeframe over which the policy is expected to operate.

- ▶ **Investors will form a judgement as to the sustainability and appropriateness of the dividend and vote accordingly.**

8.2 If shareholder approval is not sought for the approval of the final dividend, investors may wish to consider submitting a shareholder resolution or voting against the company's report and accounts, except where companies can demonstrate that changing their practice to seek shareholder approval of the dividend would significantly delay payment, to the material disadvantage of shareholders.

- ▶ **There should always be a cash dividend available as an option to a scrip dividend or equivalent. If such an option is not available, shareholders may vote against approval of the dividend.**

## **9) ISSUANCE OF NEW SHARES**

- 9.1** Capital governance is a particularly important issue. In accordance with company law, companies must secure shareholder approval to be able to issue new shares. Resolutions allowing the company to issue new shares are normally of two types known as ‘Section 551’ and ‘Section 570’ Authorities.
- 9.2** Sections 551 Authorities allow companies to allot new shares. Any amount in excess of one-third of existing issued shares should only be applied to fully pre-emptive rights issues in order to protect against shareholder dilution.
- 9.3** Section 570 Authorities allow companies to issue shares for cash without the application of pre-emption rights. The maximum allowed under the Pre-Emption Principles<sup>16</sup> is equivalent to 5% of the issued share capital at the time of the Authority. An additional 5% is acceptable provided that, in the circular for the AGM the company confirms that it intends to use it only in connection with an acquisition or specified capital investment which is announced contemporaneously with the issue, or which has taken place in the preceding six-month period and is disclosed in the announcement of the issue. A multi-year limit also applies to issues of shares for cash otherwise than in connection with an acquisition of specified capital investment, typically a maximum of 7.5% of shares to be issued over three years without the application of pre-emption rights. Companies should clearly signal their intention to undertake a non-pre-emptive issue at the earliest opportunity and establish a meaningful dialogue with their shareholders. They should also keep shareholders informed of issues related to an application to disapply their pre-emption rights. Shareholders in turn should review the case made by a company on its merits and decide on each case individually using their usual investment criteria.
- 9.4** When presenting such resolutions:
- ▶ Section 551 and Section 570 Authorities should be separated into two resolutions; and
  - ▶ Section 551 and Section 570 Authorities should be renewed annually.
  - ▶ **A vote against would be appropriate where Section 551 and 570 Resolutions (a) are bundled together, or with any other voting issue,**

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<sup>16</sup> N.B. The new EU Prospectus Regulation (which came into force in July 2017) increased the threshold of for the exemption from the obligation up to 20%. The Pre-Emption Group which publishes the Principles has noted that it will not relax its requirements, a move which the PLSA – which sits on the Pre-Emption Group – supports.

**(b) are not consistent with Pre-Emption Principles without a satisfactory explanation.**

## **10) MARKET PURCHASE OF SHARES**

**10.1** Investors are not for the most part supportive of Rule 9 waivers. Waivers are usually sought where a company proposes to institute a share buyback programme in which a large investor or concert party intends not to participate and institutional investors are naturally concerned about the risk of creeping control.

- ▶ **Shareholders would normally vote against the resolution proposing a waiver of Rule 9 of the Takeover Code.**

**10.2** Investors will normally support share repurchases provided local market regulations and relevant shareholder guidance are met. The board should however, demonstrate that the repurchase is an appropriate use of the company's cash resources relative to alternative uses. This should include providing investors with an understanding of the process used to identify when a buyback is appropriate; the maximum price the company would be prepared to pay; and the hurdle rate in respect of the buyback, linking to the overall capital management framework of the company. In addition any share-price related metrics within executive incentive schemes should take account of such activity.

**10.3** Investors should be provided with summary information on the weighted average cost of shares bought, total cost, and impact on key metrics for buybacks undertaken during the year to enable them to assess the impact.

- ▶ **Shareholders will generally support buy-backs if they are a prudent use of the company's cash resources and are supported by cash-flows of the underlying business, and do not introduce excessive and unsustainable leverage.**

## 11) AUTHORISING POLITICAL DONATIONS

**11.1** The Pensions and Lifetime Savings Association opposes the payment of, or facilitation of payment of, political donations as usually understood. However, the broadly drawn legal definition of this term could potentially encompass donations to charities or educational causes. It is therefore common for authorities to be sought on a precautionary basis.

**11.2** It is acceptable to seek authority for a four-year period where the company has no history of making political donations as usually understood. However, where the authority sought exceeds one year, the company should clarify that separate authorisation will be sought at the following AGM should the authorisation be utilised.

- ▶ **A vote against is warranted where a company seeks authority to make political donations, where:**
  - ▶ Political donations as usually understood are not precluded.
  - ▶ No cap is set on the level of donations.

## **12) RELATED PARTY TRANSACTIONS**

**12.1** Alongside appropriate procedures to identify and manage conflicts of interest, boards should have a robust, independent process for reviewing, approving and monitoring related party transactions (both individual transactions and in aggregate).

**12.2** A committee of independent directors, with the ability to take independent advice, should review significant related party transactions and aggregate levels of related party transactions to determine whether they are necessary, appropriate and in the best interests of the company and, if so, agree what terms are fair for other shareholders.

**12.3** The Board should confirm that all related party transactions have been reviewed and approved by the board, or if not how such transactions are monitored. The company should also disclose in its annual report transactions that are significant, whether by virtue of their significance to the business, the individuals involved or the perception of potential conflicts. **Subject to the specific circumstances of a related party transaction, concerns may be expected to arise when they are not:**

- ▶ subject to proper oversight by the board and regular review (e.g. audit, shareholder approval);
- ▶ clearly justified and beneficial to the company;
- ▶ undertaken in the normal course of business;
- ▶ undertaken on fully commercial terms;
- ▶ in line with best practice; or
- ▶ in the interests of all shareholders.

### 13) ARTICLES

**13.1** Any changes proposed to the company's Articles should be explained. In addition, boards should regularly review the company's Articles, consult with major shareholders on material amendments and make the Articles readily available.

**13.2** Investors will normally wish to support changes to the company's Articles, provided that it is clearly demonstrated by the board that any changes will not detract from shareholder value or materially reduce shareholder rights.

**13.3** Changes to the company's Articles should not be 'bundled' into a single resolution when they cover non-routine matters.

- ▶ **Shareholders may consider voting against changes to the Articles if non-routine changes are included in the same resolution.**

**13.4** Where a company seeks to increase its borrowing powers, a limit should be stated.

- ▶ **Where a material increase in borrowing powers or no limit is proposed, it may be appropriate for shareholders to vote against the proposed change(s) to the Articles.**

## **14) SHAREHOLDER RESOLUTIONS**

**14.1** Shareholder resolutions can encompass a wide range of issues. Management should always provide a comprehensive outline of their position on such resolutions and be available to engage with shareholders in order to facilitate an understanding of both the rationale and merits for the resolution.

- ▶ **Shareholders should consider supporting proposals that will protect or further enhance shareholder rights and transparency and is directed towards improving corporate reputation and/or the long-term sustainable success of the company.**
- ▶ **Where a resolution is binding careful consideration should be given to the proportionality of the request.**

## APPENDIX 2: LIST OF RELEVANT WEBSITES

### **Pension and Lifetime Savings Association Corporate Governance and Stewardship website**

<http://www.plsa.co.uk/PolicyandResearch/Corporate-Governance/Stewardship.aspx>

### **Understanding the worth of the workforce: A Stewardship toolkit for pension funds**

<https://www.plsa.co.uk/Policy-and-Research/Document-library/Understanding-the-worth-of-the-workforce-a-stewardship-toolkit-for-pension-funds>

### **More light, less heat: A framework for pension fund action on climate change**

<https://www.plsa.co.uk/Policy-and-Research-Document-library-More-light-less-heat>

### **The UK Corporate Governance Code (2018)**

[www.frc.org.uk/Our-Work/Codes-Standards/Corporate-governance/UK-Corporate-Governance-Code.aspx](http://www.frc.org.uk/Our-Work/Codes-Standards/Corporate-governance/UK-Corporate-Governance-Code.aspx)

### **The UK Stewardship Code (due to be updated mid-2019):**

[www.frc.org.uk/Our-Work/Codes-Standards/Corporate-governance/UK-Stewardship-Code.aspx](http://www.frc.org.uk/Our-Work/Codes-Standards/Corporate-governance/UK-Stewardship-Code.aspx)

### **OECD Principles:**

[www.oecd.org/corporate/oecdprinciplesofcorporategovernance.htm](http://www.oecd.org/corporate/oecdprinciplesofcorporategovernance.htm)

### **ICGN Principles:**

[www.icgn.org/images/Global\\_Governance\\_Principles\\_2014.pdf](http://www.icgn.org/images/Global_Governance_Principles_2014.pdf)

### **IVIS Guidelines:**

[www.ivis.co.uk/Guidelines.aspx](http://www.ivis.co.uk/Guidelines.aspx)

### **GC100 and Investor Group Guidance on directors' remuneration reporting**

<http://uk.practicallaw.com/groups/uk-gc100-investor-group>

### **AIC Code of Corporate Governance:**

<http://www.theaic.co.uk/aic-code-of-corporate-governance-0>

### **QCA Corporate Governance Code for Small and Mid-Size Quoted Companies:**

<https://www.theqca.com/shop/guides/143861/corporate-governance-code-2018-downloadable-pdf.thtml>