UK equities: an enhanced approach to corporate governance

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Key takeaways

- Corporate governance is at the heart of ESG. It affects all environmental, social and financial decisions.
- We engage with companies to promote good governance standards and hold boards accountable by exercising our voting rights.
- Governance is central to our investment process, championed by dedicated specialists within the team.

The importance of good governance
Governance is integral to all our investment decision-making. We have long recognised that high standards of corporate governance can contribute meaningfully to long-term financial performance. Similarly, low standards of corporate governance can be an indicator of potential risk when making an investment decision.

Good governance is a cornerstone that gives lasting strength to a company. It supports good decision-making throughout the business: from financial and commercial decisions to those affecting environmental and social issues.

While the board of directors is ultimately responsible for the governance of companies, shareholders must also play an important role. Continual review and challenge of how a company is governed should be a function of any responsible active fund manager. This responsibility is also now codified in the UK Stewardship Code (2020), which focuses on making investors and asset managers more accountable to their clients. Good stewardship is synonymous with good governance.

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Our commitment to governance matters
We do not outsource our governance responsibilities. Nor are they anything new. Our approach to governance has been central to our investment processes for many years.

Within the UK Equities Team, there are two specialists dedicated to corporate governance and voting. They work closely with each of the fund managers to identify and consider governance issues and to engage with companies to effect change.

We can also draw on the resources of the Global ESG Team. Its experts provide additional knowledge and analysis, for example, in instances where we feel there is particular risk or insufficient data. They also provide support on matters that have relevance for industry bodies, governments and regulators. Finally, they coordinate issues that have relevance for multiple teams within Invesco.

What are we trying to achieve?
Our approach to corporate governance is centred around active engagement, and our objective is to promote continual improvement.

We understand that corporate governance standards cannot be applied on a 'one size fits all' basis. Companies listed in the UK can be materially different in many ways.

The cornerstone of the UK Corporate Governance Code is the principle of 'comply or explain' and we approach our review of governance with a flexible mindset. Where a company diverges from generally accepted standards of governance, we actively engage with its board to understand ***why*** it believes that this is appropriate. We encourage continuous improvement and hold companies to account where necessary.

Active engagement – at the core of what we do
We monitor both investee companies and potential investments and have a long-established programme of regular engagement with executive directors, non-executives and management.

It is critical that non-executive members of the board provide independent oversight and constructive challenge to the executives of any company. Non-executives should also be members of the audit committee, remuneration committee and nominations committee. We often separately engage with non-executives to better understand this process.

The scope of our engagement can be broad-based, to understand the culture within a company. Alternatively, it can focus on specific issues, including:

- Board composition and committees
- Director succession
- Executive remuneration
- Audit quality
- Environmental issues
- Social issues (such as diversity)

Again, our aim is to bring about improvement.

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473	372	25
No. of company meetings per year	Company meetings where ESG was discussed	Company meetings dedicated to ESG topics

Data: UK Equities Team, year to 31 December 2021.

Industry engagement
As well as carrying out direct engagements, we take our role as investors in 'UK PLC' very seriously. Part of the obligation is to work with industry bodies to engage on governance issues, for example the Investment Association, the Investor Forum and the Quoted Companies Alliance, to name just three. We further engage with government and regulatory bodies on governance reform.

Voting: holding companies to account
Engagement is only part of the process. Boards must be held to account if we are to effect change and bring about improvement. Voting is an important tool in helping us achieve this.

When a company announces a general meeting, whether annual or extraordinary, our governance specialists undertake a thorough review of the meeting materials; the annual report; our internal IVZ voting recommendation; research from the proxy service providers (ISS, Glass Lewis and IVIS); and any other relevant materials.

Where issues are identified, they are discussed with fund manager, the Global ESG Team and (wherever possible) the company. But given the continuous engagement programme, relevant issues have often already been addressed with the company prior to the vote, with a path to improvement agreed.

The voting decision is the responsibility of the fund manager. The fund manager may decide to vote against management if it is resistant to improvement or has made insufficient progress with an agreed plan of action.

A central record is kept of all voting activity. Where a fund manager has voted against an internal Invesco voting recommendation, the rationale for the decision is recorded. This is monitored independently by our Global ESG team and reviewed on a monthly basis by the UK Equities Team. This enables continual review, testing and constructive challenge.

In the instances where we do vote against management, this is likely to form the basis of further engagement with the company. A summary of engagement and voting activity is provided and made available to investors on a quarterly basis.

1,683
Ballots Voted (100%)

184
Ballots against management (10.9%)

363
Ballots against ISS recommendations (21.6%)

Data: UK Equities Team, year to 31 December 2021.

Case study:
UK retailer

We engaged with the company on a number of occasions leading up to the AGM. We identified that some of its governance processes did not meet accepted standards. We spoke to the board regularly about improvements that we would like to see made. Prior to the AGM, we also engaged with a large shareholder to better understand its position and view on certain governance shortfalls.

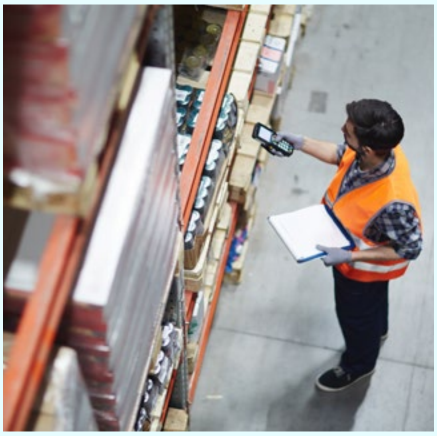
We identified that the company had paid long-term incentives in cash. This is not consistent with good governance standards and can create a lack of alignment between the executive and its shareholders. The primary reason for cash payment was that the majority shareholder did not want to be diluted.

We had various calls with the board, the Remuneration Committee and the majority shareholder. After these, the company agreed to amend the long-term plan and to propose changes to its policy at the 2021 AGM. The policy was amended so that the proportion of shares to cash would progressively increase from a defined minimum, towards 100% over time. While this still falls short of accepted governance standards, it does show material improvement.

The initial proposal presented to us failed to include a financial underpin for the vesting of shares. After our engagement, this also changed. There is now an underpin for the share award based on profitability. Importantly, the award is further subject to a cap on the eventual value of the award at date of vesting. While this is unusual for UK listed companies, it provides comfort that there will not be excessive windfall gains on vesting. This potential exists in other companies' plans.

While the remuneration policy was scrutinised and received 'vote-against' recommendations from various proxy service providers, our engagement allowed us to better understand the obstacles that the company faced with its share register. Given the commitments made to improve governance standards, we were able to support the policy on the basis that a vote against would be a vote against improvement. We will continue to monitor this issue going forward to ensure further improvement in 2022.

Since the AGM, we have met with the company to discuss how governance can be further improved. It has now clearly expressed a commitment to improve diversity on the board. We continue to engage with the company on board succession, which it has agreed to focus on over the next two years. These are all improvements we support.



Investment risks

The value of investments and any income will fluctuate. This may partly be the result of exchange rate fluctuations. Investors may not get back the full amount invested.

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