BIS Department for Business Innovation & Skills

A LONG-TERM FOCUS FOR CORPORATE BRITAIN

A call for evidence

OCTOBER 2010

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A Long-Term Focus for Corporate Britain

The UK has well functioning capital markets which are vital to efficient allocation of resources in the economy, and in turn to productivity, growth and future prosperity.

Commentators have suggested that capital markets are increasingly focused on the short-term and that this may be having a detrimental effect on their efficiency, and therefore on the return on investment. There are also concerns that engagement between companies and investment managers may not be promoting long-term business success. The incentives of company directors and those managing assets may not align with the interests of company shareholders, giving managers the scope to profit out of proportion to the value they create for the investor.

This is a call for evidence on the existence of short-termism and market failures in UK equity markets. It aims to identify the issues and their causes, whether in law or behaviour to ensure efficient, effective and transparent allocation of capital and the long-term sustainability of UK companies. It also looks in more detail at issues relating to directors' remuneration and the economic case for takeovers.

Issued: 25th October 2010

Respond by: 14th January 2011

Enquiries to: clgconsultations@bis.gsi.gov.uk

Foreword from the Secretary of State

Successful companies - and the markets from which they raise capital - are vital for the health of the UK economy. And our companies and markets have been immensely successful, attracting investment into the UK and providing the wealth creation which we need to prosper as a nation.

But recent events have exposed weaknesses. We must ensure that growth is not compromised by capricious or volatile markets, or captured by a small number of intermediaries at the expense of the many who provide the capital.

For decades, regulators have had to react to failings of corporate governance – from the excesses of the South Sea Bubble and the Victorian Railway boom to Enron, the financial crisis and beyond. This government is not laissez-faire – regulation is sometimes needed. But regulation can also be a blunt and expensive instrument, and it certainly does not get everything right. The success of the UK corporate governance framework rests on getting the balance right – between regulation and best practice. It involves companies and investors working together.

We are now building on our high standards of corporate governance with a new Stewardship Code, setting out the key role of shareholders in holding directors to account for their strategic judgements and in guarding against boardroom hubris. Putting responsible shareholders back in the driving seat by giving them the information they need to understand the companies that they own and the power to act on it. And just as shareholders can decide to invest only in companies that follow the Corporate Governance Code, so the public can now choose to entrust their pensions, insurance premiums and savings to institutions that adopt the Stewardship Code.

These are all important steps in the right direction. But is there more to be done to secure the growth we need? The paper I am issuing today is a call for evidence from across the corporate world and beyond to examine whether the system in which our companies and their shareholders interact promotes long-term growth - or undermines it. I want a serious examination and debate into the role of investors and the time horizons over which they operate; the factors influencing board decisions; the reasons for the growth of directors' pay; the impact of the investment chain; why returns from equity have reduced; and why takeovers that are economically damaging still take place.

The best solutions are those which are owned and driven by market participants, investors and companies. We need clear, consistent rules which work with the grain of the market.

VINCE CABLE

How to Respond and Help with Queries

When responding, please state whether you are responding as an individual or representing the views of an organisation. If you are responding on behalf of an organisation, please make it clear who the organisation represents by selecting the appropriate interest group on the response form and, where applicable, how the views of members were assembled.

A copy of the response form is enclosed. It is also available electronically at www.BIS.gov.uk/consultations. If you decide to respond this way, the form can be submitted by letter or email to:

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Questions about the policy issues raised in the document can be sent to the same address. A copy of the Code of Practice on Consultation can be found in Annex A.

This document has been sent to approximately 700 interested parties who have asked to be on the circulation list of the Corporate Law & Governance Directorate of BIS, as well as organisations or individuals who have expressed an interest in this call for evidence. Please feel free to pass the document on to anyone you think may wish to be involved in this process.

This call for evidence opened on 25th October 2010; the last date that responses can be received is 14th January 2011.

Coverage

The UK Government is responsible for company law in England and Wales, and in Scotland. The Northern Ireland administration has agreed that, while company law remains a transferred matter within the legislative competence of the Northern Ireland Assembly, the Companies Act 2006 should apply to the whole of the United Kingdom.

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In view of this it would be helpful if you could explain to us why you regard the information you have provided as confidential. If we receive a request for disclosure of the information we will take full account of your explanation, but we cannot give an assurance that confidentiality can be maintained in all circumstances. An automatic confidentiality disclaimer generated by your IT system will not, of itself, be regarded as binding on the Department.

1. Executive Summary

1.1 This consultation takes the form of a call for evidence focusing on the relationship between markets and corporate behaviour.

1.2 The UK has benefited greatly from open, free and well-functioning capital markets. These are vital to efficient allocation of resources in the economy, and in turn to productivity, growth and our future prosperity. It is widely accepted however that markets are subject to failures – they can never be perfect. Government intervention, both through regulation and other measures, seeks to address such failures, while maintaining markets which are as free and open as possible.

1.3 In recent years, some commentators[1] have questioned whether capital markets are working effectively for all participants. For example, some suggest that equity markets are increasingly focused on the short-term and that this may be having a detrimental effect on their efficiency, on the return on investment and on company behaviour. Others argue that the incentives of company directors and those managing assets may not align with the interests of company shareholders. Finally, there has been a wide ranging debate on the economic case for takeovers and the effectiveness of engagement by shareholders in the companies they own.

1.4 Chapter 2 of this paper examines the legal framework underpinning the relationship between companies, their directors and shareholders. Corporate governance rules provide a framework within which companies form, organise and operate. They do this by bridging the gap between those providing the capital (shareholders, the principals) and those they entrust to manage the company (directors, the agents). The rules work to reduce the information asymmetries that arise from this principal-agent relationship. In particular this means that shareholders need to have the information and rights to hold management to account. This relationship lies at the heart of equity markets.

1.5 Chapter 3 considers the role of company directors and the impact that markets may have on company behaviour, discussing some issues that may arise.

1.6 Chapter 4 considers the nature of the investment community in the UK,

[1] For example:
(a) Alan Greenspan, Francis Boyer Lecture, The American Enterprise Institute for Public Policy Research, Washington D.C., December 5, 1996;
(b) The Economics of Short-term performance obsession, Alfred Rappaport, May 2005, Financial Analysts Journal; and
(c) Overcoming Short-termism: A call for a More Responsible Approach to Investment and Business Management, 2009, The Aspen Institute.

including the investment chain and diversity of investment strategies. It discusses issues that may arise in UK investment including the quality and nature of investor engagement with companies; whether investors are increasingly short-term, whether there are principal-agent problems in the investment chain, and whether this matters.

1.7 Finally the paper considers how the relationship between directors and shareholders plays out in two specific areas: directors' pay (Chapter 5) and takeovers (Chapter 6).

2. Corporate Governance and Equity Markets

2.1 This chapter sets out the background on the size of the UK equity market and the legal and regulatory structure underpinning the UK's corporate governance framework.

Background on UK Equity Markets

2.2 Well functioning markets rely on bringing together users and providers of capital with different investment horizons. The last decade has been characterised by increased financial liquidity, falling costs of trading and increased flows of corporate information, all of which can be seen as positives for capital market efficiency. These developments have helped to lower costs of capital for companies and individuals and to reduce market inefficiencies.

2.3 Whilst companies have a range of finance options open to them (including debt, equity and retained earnings), public equity has always been a significant source of finance for the UK's largest companies because of the flexibility it provides and the ease of accessing finance through the London stock market. London has some of the most highly developed, sophisticated and liquid equity markets in the world, and the London Stock Exchange remains the largest equity market in Europe. In 2009, UK listed companies raised over £70 billion in new equity on the London Stock Exchange. UK equity markets continue to attract investors from all over the world.

2.4 Public equity financing has remained important and has shown its usefulness as the economy has deleveraged. For example, Bank of England statistics show that during 2009 net funds raised through loans fell by £46.3 billion, whilst bond issuance rose by £17.6 billion and equity issues by much more (Figure 1). It is likely that equity issuance will remain an important source of finance for firms as the economy recovers.

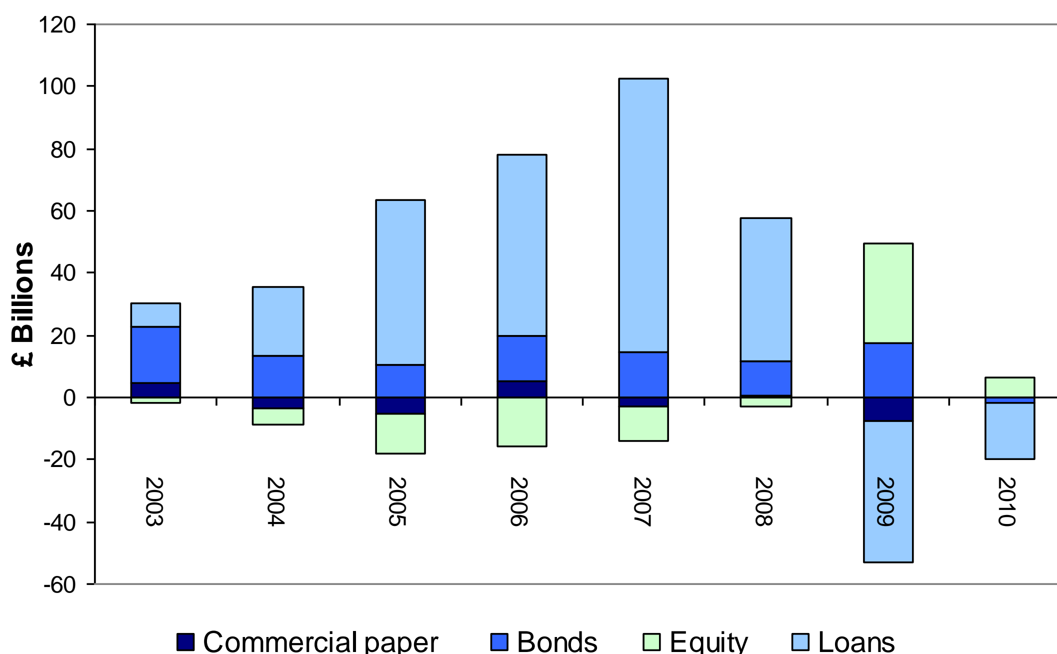

Figure 1: New Financing for Corporates, 2003-2010[2]. Note that data for 2010 refer to period to 30th September.

UK Corporate Governance Framework

2.5 The UK was one of the first nations to establish rules for the operation of companies, and its system of company law and corporate governance has been much imitated around the world. British corporate governance has always been based on the idea that the members or shareholders pool their resources and, collectively, have ultimate control over the company they have set up. The British model puts more emphasis than the US model on the importance of shareholders being able to hold the directors of the company to account, while recognising that the directors must be trusted to set the direction of travel and manage the company's day-to-day business.

2.6 This feature of the UK shareholder model has important consequences both for listed companies (who are the principal focus of this consultation), and for the debate on long-termism more generally. The views of the shareholders and the quality of their engagement with the company matter more in the UK than in many other countries. This is both through requirements for shareholder approval of certain transactions or agreements and, more generally, through the importance of a shared vision for the company. The clearest example of this is the regulation of takeovers, where the UK regulatory framework does not encourage (or in some respects permit) the directors to protect

[2] Trends in Lending, Bank of England, October 2010. Available at: http://www.bankofengland.co.uk/publications/other/monetary/TrendsOctober10.pdf

themselves against hostile bids. Under the British system, the company belongs to its shareholders and they should determine the outcome of a takeover bid.

Legal and Regulatory Framework

2.7 The UK regulatory framework works at a number of levels: the basic framework of company law is set out in the Companies Act 2006, but companies are allowed considerable freedom through their constitutions to adjust or supplement the statutory rules. Case law also continues to play an important role. Regulatory bodies such as the UK Listing Authority and the Takeover Panel set out detailed rules for listed companies, in areas such as the approval of major transactions and the regulation of takeovers. The Financial Reporting Council's (FRC) Corporate Governance Code sets out best practice in areas of corporate governance such as board composition and remuneration policy. Listed companies are required to report on how they have applied the Code, and either to confirm that they have complied with the Code's provisions or, if they have not, to provide an explanation (known as "comply or explain").

2.8 The major principles of the UK framework have remained constant over time:

- shareholders have ultimate control over the company's constitution and the appointment of its directors, and have a statutory right to dismiss the directors;
- directors owe general duties to the company, which recognise both the primacy of shareholders and the need to take an 'enlightened' approach which recognises the importance of wider stakeholders in achieving corporate success; and
- public companies must hold an annual general meeting and send a copy of the company's report and accounts to every shareholder each year.

2.9 Major shareholders and their agents might themselves be subject to regulation. Fund managers are regulated by the Financial Service Authority (FSA); many will, for example, be covered by the FSA's Remuneration Code, and there is a requirement for disclosure of major shareholders' transactions under the FSA's Disclosure and Transparency Rules. The Pensions Act 2004 requires pension fund trustees to have knowledge and understanding of the law relating to pensions and trusts and the principles relating to the funding of occupational schemes and the investment of scheme assets.

2.10 While the principles underlying the regulatory framework have remained constant, the framework has been flexible and has responded to market crises to ensure that the rights and responsibilities of shareholders and directors remain balanced.

2.11 There were two major reviews of company law in the mid-20th century which addressed perceived deficiencies in protecting investors or preventing fraud. The Cohen Report of 1945 recommended that shareholders be given a greater degree of control over directors. It made detailed proposals on directors' remuneration, recommending that payments to directors on retirement should be subject to company approval and that aggregate remuneration of directors should be disclosed. The Jenkins Report of 1962 looked at issues including takeovers, the duties of directors and the rights of shareholders.

2.12 More recently, there have been a number of important developments. Following a full company law review, a major modernisation of company law was completed in October 2009 with the implementation of the Companies Act 2006. Meanwhile, in response to the financial crisis, Sir David Walker carried out a review of corporate governance in the UK banking industry in 2009[3]. The FRC consulted in parallel on more general changes to the UK's Corporate Governance Code, resulting in publication of a revised Code by the FRC in May 2010[4].

2.13 The Takeover Panel published a wide-ranging consultation in June 2010, in the light of widespread commentary and public discussion on various aspects of the regulation of takeover bids for UK companies. The panel issued a statement on 21st October 2010 setting out the changes that it intends to make to the Takeover Code following their consultation[5].

2.14 Finally, one of the most important recent developments has been the FRC's agreement to take ownership of the Stewardship Code[6] for institutional shareholders and their fund managers, with a view to promoting better dialogue between shareholders and company boards and providing greater transparency about the way in which investors oversee the companies they own. This is the world's first investor code to be owned by a body such as the FRC, reflecting the importance of shareholder engagement in the UK corporate governance framework.

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[3] A Review of Corporate Governance in UK Banks and other Financial Industry Entities, HM Treasury, November 2009. Available at: http://webarchive.nationalarchives.gov.uk/20100407010852/http://www.hm-treasury.gov.uk/press_113_09.htm

[4] The UK Corporate Governance Code, FRC, June 2010. Available at: http://www.frc.org.uk/corporate/ukcgcode.cfm

[5] Review of Certain Aspects of the Regulation of Takeover Bids, Takeover Panel, October 2010. Available at: http://www.thetakeoverpanel.org.uk/statements/panel-statements/ps2010

[6] The UK Stewardship Code, FRC, July 2010. Available at: http://www.frc.org.uk/corporate/investorgovernance.cfm

3. The Board of Directors

3.1 The boards of UK companies have been an essential source of strength, both in terms of the performance of the economy and the operation of the wider capital markets. This chapter describes the role and responsibilities of company directors in providing “an effective board which is collectively responsible for the long-term success of the company”[7]. It discusses issues that have been raised that potentially impact on directors’ ability to do so.

Role of the Board

3.2 The board of directors manages the company on behalf of its owners, the shareholders. In doing so, the board carries out key tasks such as: establishing and maintaining vision, mission and values; deciding strategy and structure; delegating to management; and accounting to shareholders and being responsible to stakeholders[8].

3.3 The FRC’s Corporate Governance Code explains that:

> “*The board’s role is to provide entrepreneurial leadership of the company within a framework of prudent and effective controls which enables risk to be assessed and managed. The board should set the company’s strategic aims, ensure that the necessary financial and human resources are in place for the company to meet its objectives and review management performance. The board should set the company’s values and standards and ensure that its obligations to its shareholders and others are understood and met.”*

3.4 Effective boards draw on broad pools of talent with varied and complementary skills, experience and perspectives. The Government believes that members of the board should be selected on merit, against objective criteria, and with due regard for the benefits of diversity, including gender diversity. Recent research has highlighted a lack of female directors in Britain’s top businesses, with women making up only 12.2% of directors of FTSE100 companies in 2009[9]. The Government is committed to addressing this issue, and has asked Lord Davies of Abersoch to identify the obstacles to women becoming directors of listed companies, and to make proposals on what action Government and business should take to improve the position.

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[7] The UK Corporate Governance Code, FRC, June 2010
[8] Summarised from: Standards for the Board, Institute of Directors, July 2006, quoted in “The Effective Board”, Neville Bain and Roger Barker, 2010
[9] Female FTSE Report, 2009, Cranfield University. Available at: http://www.som.cranfield.ac.uk/som/dinamic-content/research/documents/ft2009.pdf

Directors' Duties

3.5 The legal framework does not provide an instruction manual for directors, and their powers are derived from the company's constitution rather than companies legislation. It does however impose duties on directors. Some of these are very specific, such as the duty to prepare accounts, but directors also have general duties, similar to those which the law imposes on others in similar positions of trust. The Companies Act 2006 introduced a statutory statement of directors' general duties. The duty to promote the success of the company in Section 172 of the 2006 Act provides that a director:

- must act in the way he or she considers, in good faith, will promote the success of the company for the benefit of its shareholders as a whole; and
- in doing so, have regard to the long-term consequences of their decisions and the wider expectations of responsible business behaviour, such as the interests of the company's employees and the impact of the company's operations on the community and the environment.

3.6 This duty reflects the view that companies will not succeed in the long-term, and therefore maximise the return for their shareholders, if the directors do not take account of the wider consequences of their actions. For most boards this will be a matter of plain common sense. It should, for example, be clear to directors that there may be severe reputational damage to the company if it, for example, is responsible for major pollution or sells products which have been made using child labour.

Influence of Shareholders and Equity Markets

3.7 Shareholders and investors have a powerful influence on board decision-taking in a number of ways:

- they provide equity funding for listed companies, both through initial public offers and rights issues;
- through the equity markets, they set the price for the company's shares;
- as shareholders, they appoint (and can remove) directors, and hold boards to account for their stewardship of the company;
- under UK Listing Rules, they have to agree to major company transactions; and
- ultimately, they decide on ownership of the company in the event of a takeover bid.

3.8 The quality of the relationship between company boards and shareholders is therefore pivotal to the long-term success of companies. This is reflected in the importance that listed companies give to investor relations, including at board level. It is also reflected in the performance criteria for the remuneration of executive directors, particularly long-term

incentive plans and executive share option schemes, which are often linked to the company's share price or to total shareholder return.

3.9 The board's ability to communicate effectively will in turn have a major influence on shareholders' views on the quality of the board and on the company's investment decisions.

3.10 Effective communication demands that directors know the identity of the owners of the company. Under Part 22 of the Companies Act 2006 boards of public companies may require those who have an interest in a companies' shares (i.e. beneficial owners) to provide the company with information about themselves. Many public companies make use of this in order to enhance investor relations. It has been suggested that better overall transparency would be achieved if this information were required of all investors and not disclosed only at the instigation of the company.

3.11 Disclosure of good quality and relevant information in company narrative reporting is essential if shareholders are to make well informed decisions in their role as company owners. The Government's recent consultation, "The Future of Narrative Reporting"[10], sought views on how to improve the quality of narrative reporting so that shareholders are better empowered to act as effective owners in the long-term, without increasing the regulatory burden on business.

3.12 It is the responsibility of the directors to provide information to shareholders and investors through a variety of mechanisms, including the annual financial report, the half-yearly report and interim management statements. Independent auditors also play an important role by providing assurance on the quality and accuracy of this information. There have however been questions about the role of audit, including suggestions that audits do not address the issues of most concern to investors and are therefore little read. These questions are being considered by the House of Lords' Economic Affairs Committee in its inquiry on "Auditors: Market concentration and their role".

Questions

1) Do UK boards have a long-term focus – if not, why not?

2) Does the legal framework sufficiently allow the boards of listed companies to access full and up-to-date information on the beneficial ownership of company shares?

[10] The Future of Narrative Reporting – a Consultation, BIS, August 2010. Available at: www.bis.gov.uk/consultations

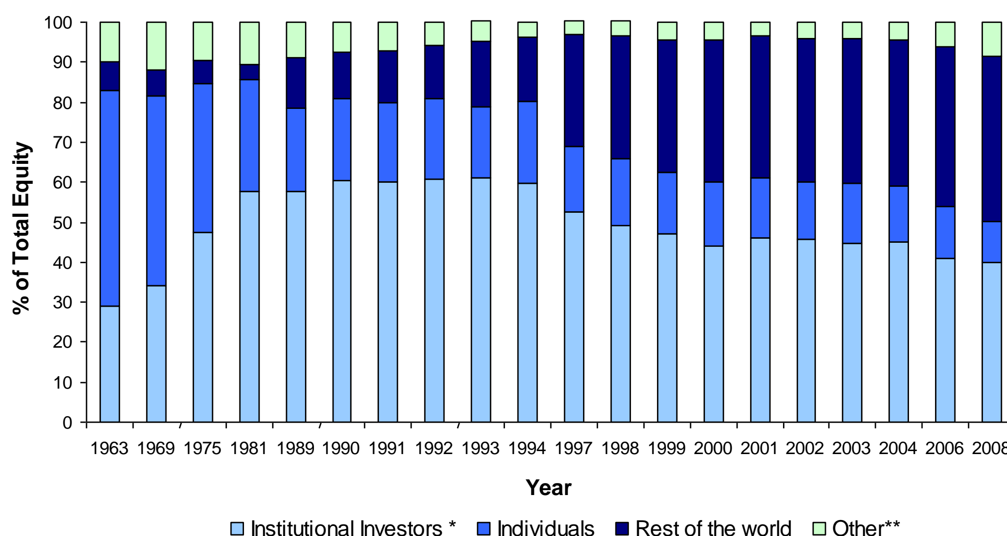
4. Shareholders and their Role in Equity Markets

4.1 This chapter describes the current picture of UK investors in equity markets. In particular it considers the nature of UK share ownership, the investment process (including the role of the investment chain), and the diversity of investment strategies. It then discusses some issues that have been raised about the role of shareholders in equity markets including:

- the nature of shareholder engagement;
- potential short-termism by investors; and
- principal-agent issues in the UK investment chain.

Nature of Share Ownership

4.2 The nature of shareholders in UK companies is diverse and changing (see Figure 2). Individuals once held the greatest proportion of total equity. Over the years, their proportion of total ownership has been declining. By the 1980s share ownership in the UK was dominated by domestic institutional shareholders. More recently, there has been a relative decline in the share of UK institutions and a corresponding rise in the share of non-UK ownership, such as overseas pension funds and sovereign wealth funds. Around 15% of funds invested worldwide by sovereign wealth funds and 49% of those invested in Europe[11] are invested through the London markets, often in companies which themselves are international.



*Institutional Investors include: Insurance companies, pension funds, unit trusts, investment trusts, other financial institutions.
**Other includes share ownership other than Individuals, Rest of the World and Institutional Investors.
Source: National Statistics on share ownership

Figure 2: Main share ownership categories in the UK, 1963-2008

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[11] Sovereign Wealth Funds 2010, IFSL Research, International Financial Services London, March 2010. Available at: http://www.ifsl.org.uk/media/2172/CBS%20Sovereign%20Wealth%20Funds%202010.pdf

4.3 These changes reflect the increasing globalisation of investment opportunities post-1980, a period which has also seen UK investors purchasing an increasing amount of non-UK based assets and UK-based companies increasingly accessing capital from outside the UK. The consequences of the international investment market have been overwhelmingly positive for the UK, both in terms of the ability of UK companies to access capital and the continuing success of London as a global financial centre.

Question

3) What are the implications of the changing nature of UK share ownership for corporate governance and equity markets?

Investment Chain and Role of Fund Managers

4.4 The chain of ownership and control is much more complicated than the theoretical model would suggest. While there are still private shareholders in companies, most holdings are aggregated into bigger "institutional" managed pools of capital provided by pension funds, insurance companies, various forms of collective investments and sovereign wealth funds. Institutional shareholders currently account for 77% of the Investment Management Association's (IMA) members' assets under management in the UK[12]. The IMA estimates that its members managed around 40% of total UK equities by domestic market capitalisation at the end of 2009; this compares to an estimated 48% in 2005, with the change likely to reflect the rise in the proportion of UK equities owned by overseas investors.

4.5 As agents of end investors, investment managers invest money on behalf of a range of institutional and retail clients. Investing on both a pooled (co-mingling the assets of different clients) and segregated (offering specifically tailored portfolio management) basis, they operate according to mandates which state the aims of the fund and the investment policy it should follow. Where the mandates are segregated, these mandates may reflect clients' specific needs. Where pooled, by definition, the investment approach has to be acceptable to all clients using the particular fund vehicle.

4.6 Investment managers adopt a range of investment strategies, both active and passive. Passive management commonly involves matching a market benchmark, although such approaches are becoming

[12] Asset Management in the UK 2009-2010, IMA Annual Survey, July 2010. Available at: http://www.investmentuk.org/research/ima-annual-industry-survey

increasingly varied. Active management is fundamentally about value added through the selection of stocks and securities (so-called ‘alpha’). The IMA’s 2009-2010 asset management survey estimated that of the £3.36 trillion of assets under management by IMA members in the UK (including a range of non-IMA members estimated to be £3.9 trillion managed in the UK in total) almost 80% was actively managed, with the remainder (20%) passively managed. As passive management is concentrated in the equities market, the proportion of equities managed in this way is substantially higher.

4.7 Given their role in allocating capital from those who wish to invest (whether institutional or retail investors) to those who need capital, the role of investment managers is therefore critically important to the effectiveness of our capital markets and, ultimately, the performance of listed companies.

4.8 The way in which individual portfolio managers invest will vary considerably both between and within investment management houses. While the central approaches to active investment are often seen as ‘value’ (where the market is seen to be undervaluing certain assets) as against ‘growth’ (where significant future earnings potential is anticipated), the reality is far more diverse and the impact on market turnover complex.

4.9 Investment managers will also have a range of approaches to engagement, the ultimate aim of which is to achieve value for their clients. Thus some believe that actively engaging with investee companies will achieve better returns. Others believe the best way to send a signal to a badly managed company and maximise returns is to sell their holding. This is not, however, to say there is a simple division of views, rather there is a spectrum. Most would argue that exercising ownership responsibilities is important, but also that selling shares can impact the share price and can sometimes send a more salutary lesson to the Board than any amount of engagement.

Shareholder Engagement

4.10 The quality and nature of the relationship between company boards and shareholders is pivotal to the long-term success of both companies and investors. Investment criteria and investor behaviour have a major impact on board decisions. The board’s articulation of its strategy and shareholders’ view of the quality of the board will in turn have a major influence on their investment decisions. It follows that where shareholders are interested in sustainable returns over the long-term, their behaviour will help boards to shape a coherent strategy.

4.11 Engagement between investors and companies takes many forms. At its most fundamental, the ability of investors to buy and sell shares acts as the key signal to management of its performance. Investment managers talk to companies about their performance and strategies in

discussions relating to investment activity, as well as maintaining ongoing dialogue on corporate governance issues.

4.12 UK company law provides shareholders with a wide range of rights in order to underpin effective engagement, including the ability to make decisions at general meetings of the company. Over recent years the level of voter turnout at shareholder meetings has risen steadily to the current level of 68% among shareholders of FTSE350 companies [13].

4.13 In addition the UK government believes that shareholders have responsibilities to engage as stewards in a constructive dialogue with the companies in which they invest. The UK Stewardship Code[14], published by the FRC in July 2010, sets a clear benchmark of the behaviour expected of all investors and an expectation that they disclose how they have applied the Code. The FSA has consulted on proposals to introduce a mandatory requirement for authorised asset managers to disclose whether or not they comply with the Code, details of which will be added when available. The FRC has encouraged all institutional investors to publish (by the end of September 2010) a statement on their website of the extent to which they have complied with the Code.

4.14 However the responsibility for monitoring company performance does not rest with fund managers alone. Pension fund trustees and other owners can do so either directly or indirectly through the mandates given to fund managers. Their actions can have a significant impact on the quality and quantity of engagement with UK companies. The FRC is therefore encouraging all institutional investors to report if and how they have complied with the Code.

Issues

4.15 The quality and quantity of engagement is very difficult to measure as so much of it necessarily takes place in a confidential environment, restricting information about practice and consequences. Nevertheless it is claimed that engagement is falling short because not enough effective engagement is taking place on issues of substance. Some chairmen have complained that too much engagement takes the form of discussion about quantitative analysis rather than business fundamentals. Equally some investors feel that boards do not take engagement seriously.

4.16 A second, related issue which has been discussed recently is whether, even where effective engagement takes place, this may not drive the investment decisions of fund managers. For example, in some large investment management firms, corporate governance teams may have a strong and effective relationship with the Board, but ultimately

[13] ISS 2010 Voting Results Report – Europe, Institutional Shareholder Services, Sept 2010. Available at: www.issgovernance.com

[14] Available at: http://www.frc.org.uk/corporate/investorgovernance.cfm

investment teams have the final say on investment decision making.

Questions

4) What are the most effective forms of engagement?

5) Is there sufficient dialogue within investment firms between managers with different functions (i.e. corporate governance and investment teams)?

6) How important is voting as a form of engagement? What are the benefits and costs of institutional shareholders and fund managers disclosing publically how they have voted?

Drivers of Short-termism

4.17 By short-termism, we mean the focus of investors and managers on short-term returns at the expense of those over the longer-term.

4.18 Information failures exist in most markets, and equity markets are no exception. Such information asymmetries may drive both investment strategies and corporate behaviour towards a focus on the short-term. Several authors have in recent years pointed out the costs of an increasing focus on short-term returns[15] and the misallocation of capital that it can cause.

4.19 Increased turnover of shareholdings has been observed in equity markets. This is the result of factors such as improved technology, increased information, an expansion in the variety of investment strategies and herd behaviour amongst investors who focus more upon the direction of share prices than the longer term investment strategies of the companies in which they are investing. The Bank of England is one of the commentators evidencing increased short-termism, pointing to shorter holding periods for shares, which have reduced from 5 years in the 1960s to less than 8 months in 2007[16]. At the same time there has been a great increase in the level of high-frequency trading which now accounts for 30 to 40% of European trading in equities and futures[17].

4.20 Drivers of short-termism include herd behaviour amongst investors and

[15] The Economics of Short-term performance obsession" Alfred Rappaport, May 2005, Financial Analysts Journal
[16] Patience and Finance, A. Haldane, September 2010, Bank of England, at Oxford China Business Forum, Beijing. Available at http://www.bankofengland.co.uk/publications/news/2010/067.htm
[17] *ibid*

fund managers, which can result in asset bubbles where prices deviate significantly from underlying values. Models based on a behavioural finance approach have been developed, and used, in an attempt to explain why the price differentials observed during asset bubbles arise[18]. Such short-term investment behaviours may result in an inefficient allocation of capital, where those companies with potential for sustained growth in the longer term do not receive the financing they require.

4.21 Though long-term investors with an interest in fundamental value might be expected to correct short-term exuberance and the consequent movement of prices away from their fundamental value, the persistence of these trends can provide excess returns for some short-term investors.

4.22 The Bank of England has recently highlighted evidence[19] that increased liquidity and information availability have led to increased trading and share price volatility in the UK and with high dividend payouts being maintained despite variation in profits. This development is one of a number that could arise due to principal-agent problems in the extended investment chain.

Agency Problems

4.23 The principal-agent problem that exists between the shareholders of a company and the directors may also encourage short-termism in UK companies. It can be difficult to measure the performance of a company against its longer term strategy. This can lead shareholders to focus upon the shorter term indicators such as quarterly reports and share prices which may not reflect fully the underlying value of the company.

4.24 This focus upon share prices and short-term indicators may lead to directors being discouraged from taking a long-term view[20]. If incentives, such as bonuses, are closely linked to short-term indicators then directors will be further discouraged against taking a view for the longer term.

4.25 Principal-agent issues also arise between investors and fund managers, where fund managers can generate income for themselves through fees related to the number of portfolio changes (which could lead to excessive churn in equity markets) yet these may not necessarily result in increased long-term value for their clients. A recent London School of Economics report suggests that high turnover is costly to long-term investors. It observes that “active management fees and associated trading costs based on 100% annual turnover erode the value of a pension fund by around 0.1% per annum. Pension funds are having their

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[18] Inefficient Markets, Shleifer A., 2000, Oxford University Press and Irrational Exuberance , Shiller R., 2001, Broadway

[19] Available at http://www.bankofengland.co.uk/publications/news/2010/067.htm

[20] The Economics of Short-term performance obsession, Rappaport A., May 2005, Financial Analysts Journal

assets exchanged at a rate of 25 times in the life of the average liability for no collective advantage, but at a cost that reduces the end value of the pension by around 30%"[21].

4.26 Where fund managers control the funds of investors, while long-term performance may be measurable, it can be hard for investors to assess whether this represents good performance relative to the risk taken. For example, pension fund trustees may be too concerned with relative performance over a short time period which then drives the focus on short-term returns. This, in turn, may make it difficult to generate and judge the adequacy of absolute performance over the longer run.

4.27 The Myners review[22] pointed out that investors and fund managers are under intense pressure to maximise current performance:

"*External pension fund managers, unit trust and unit-linked managers are under constant and intense pressure to maximize current performance. The current quarter is what matters, perhaps the next quarter, certainly not next year's equivalent quarter.*"

Where investment managers of pension funds (or other funds) invest in the funds of others then there is further reduction in levels of transparency for the ultimate owner/investor.

4.28 Less is publicly available about the pay of fund managers; in some cases their pay may be based on short-term performance criteria and not sufficiently aligned with the longer term interests of their company's clients. These issues are important because they have real impacts on investors and companies. Investors suffer if the fund managers acting on their behalf take too much out of the system.

4.29 This may be exacerbated through fees which are disproportionate to the returns on investment, incentives focussing on short-term targets and excessively high frequency of share trading (which incurs additional transaction costs). This may in turn make investment in UK equities less attractive, ultimately affecting the availability and cost of equity capital. The asymmetry of information between ultimate investors and the intermediaries acting on their behalf, and opacity of the investment process may allow fund managers to capture increasing rents at the expense of the ultimate investors.

[21] The Future of Finance: The LSE Report, Woolley P., Sept 2010, London School of Economics
[22] Myners Review 2001. Available at: http://archive.treasury.gov.uk/pdf/2001/myners_report.pdf

Questions

7) **Is short-termism in equity markets a problem and, if so, how should it be addressed?**

8) **What action, if any, should be taken to encourage a long-term focus in UK equity investment decisions? What are the benefits and costs of possible actions to encourage longer holding periods?**

9) **Are there agency problems in the investment chain and, if so, how should they be addressed?**

10) **What would be the benefits and costs of more transparency in the role of fund managers, their mandates and their pay?**

5. Directors' Remuneration

5.1 Directors' remuneration is an important aspect of governance due to the conflict of interest which directors face in setting their own pay. It has also long been recognised that pay may provide perverse incentives for directors and affect the quality of the directors' relationship with wider stakeholders, including employees.

5.2 The regulatory response to these issues has been:

- to require boards to disclose how directors' pay is decided, the details of remuneration, and the criteria determining the size of payments in a Directors' Remuneration Report (DRR);
- to give shareholders an annual advisory vote on the DRR (which covers both details of remuneration in the previous financial year and the board's remuneration policy);
- to require prior shareholder approval of remuneration which might either have a direct major impact on the position of shareholders (in particular, through the requirement in UK Listing Rules for prior shareholder approval of Long-Term Incentive Plans (LTIPs) and executive share option schemes) or which gives rise to the most significant conflicts of interest (e.g. the company law requirements relating to payments for loss of office); and
- to create remuneration committees made up of independent directors.

5.3 This framework has put shareholders in a strong position to influence both the structure and amount of directors' remuneration. Anecdotal evidence suggests that this has led to closer engagement between companies and investors, although some argue it has crowded out discussion of wider strategic issues. It is less clear what difference it has made to overall levels of pay or to linkage between pay and performance.

5.4 Executive remuneration in the UK has been rising at a greater rate than the increase in the FTSE100 index, retail prices, or average remuneration levels across all employees for the same period. Table 1 summarises the breakdown of FTSE100 CEO average remuneration and shows that average total remuneration rose from an average of £1m to £3.7m for the period 1998-2009, almost a four-fold increase. Relative to average FTSE100 employees pay, CEO remuneration has increased dramatically since 1998 and has remained at a multiple of over 100 times average employee earnings since 2002.

5.5 FTSE100 CEO remuneration rose annually by 13.6% on average (year on year) between 1999 and 2009. By comparison, an average annual increase in the FTSE100 index of 1% was observed across the same period[23].

5.6 The rise in average FTSE100 CEO remuneration has largely been driven by an increase in LTIPs, whilst options, pensions and bonuses formed a smaller proportion of total remuneration in 2009 than in previous years[24] (see Figure 3). It also shows that, despite the economic downturn, CEO remuneration amongst the UK's top companies has continued to rise on average.

5.7 There is little evidence that company performance is the main driver of the level of executive pay. The greatest determinant of the level of executive pay remains firm size, not executive performance[25]. It has been argued that the corporate governance arrangements currently in place are not working as effectively as they should, and that corporate governance is not contributing to long-term sustainable behaviour in this area.

Year	CEO Total Remuneration	Average Employee Earnings	CEO as Multiple of Average Employee
1998	£1,002,441	£21,540	47
1999	£1,234,983	£20,939	59
2000	£1,686,973	£24,070	70
2001	£1,805,717	£24,170	75
2002	£2,599,551	£24,182	107
2003	£2,786,143	£24,767	112
2004	£3,087,028	£25,955	119
2005	£3,304,533	£27,254	121
2006	£3,308,814	£30,828	107
2007	£3,876,921	£25,677	151
2008	£3,958,000	£30,994	128
2009	£3,747,000	£32,521	115

Table 1: FTSE 100 CEO Average Remuneration Relative to Average FTSE 100 Employee Pay[26]

[23] Data taken from: Manifest, "The Executive Director Total Remuneration Survey 2010" September 2010. Available from http://blog.manifest.co.uk. Note that data from 1998-2001 may not be directly comparable with data from 2002-2009. 1998-2001 data include new recruits and internal promotions.
[24] *ibid*
[25] Why has CEO pay increased so much? Gabaix, X. & Landier, A., April 2007, Quarterly Journal of Economics
[26] See reference 23 (above)

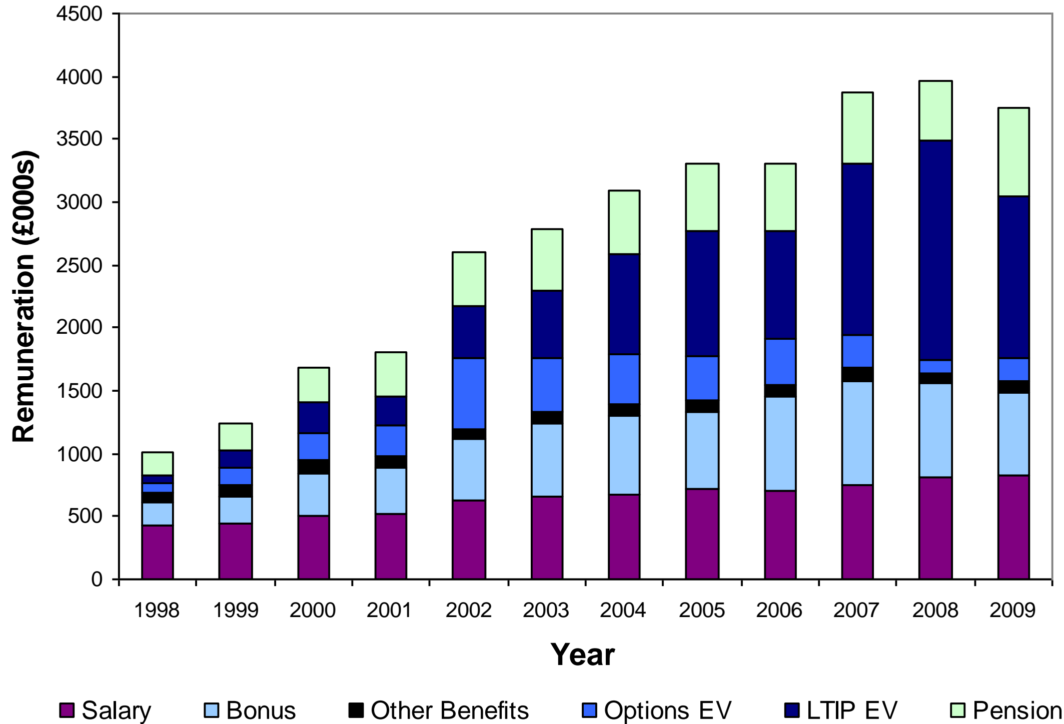

Figure 3: FTSE100 CEO Average Remuneration[27]

5.8 However, executive pay in the UK and Europe tends to be lower than in the US, where regulation in this area has been less rigorous (though this is now changing[28]). This has been consistently reported by researchers in the field. For example, Conyon[29] found CEO pay in the US to be 1.6 times higher than in the UK in 2003. However the same report found that the gap is narrowing; in 1997 US CEO pay was 2.2 times that in the UK.

Remuneration Policy and Remuneration Committees

5.9 The UK Corporate Governance Code states as a supporting principle on directors' remuneration that:

> *"The performance-related elements of executive directors' remuneration should be stretching and designed to promote the long-term success of the company.*"

5.10 It is clearly important that there is a strong and demonstrable linkage between remuneration and the long-term success of the company. The

[27] See reference 23 (above)

[28] The Dodds-Frank Act brings into force widespread financial services regulatory reform in the US in response to the global financial crisis. Amongst its many provisions, it requires the Securities and Exchange Commission to adopt rules about: shareholder approval of remuneration and "golden parachutes", the independence of the compensation committee, remuneration disclosure in relation to company performance and company policy on remuneration "clawback" policy.

[29] How High Is U.S. CEO Pay? A Comparison with UK CEO Pay, Conyon M., Core J., and Guay W., June 2006, Social Science Research Network

Government would welcome views on the effectiveness of the linkage in current corporate pay-setting models and, if there are perceived weaknesses, possible remedies.

5.11 Directors' remuneration is currently determined by remuneration committees composed of non-executive directors. Some commentators have suggested that these committees are neither:

- sufficiently independent and able to align effectively the remuneration of directors to the longer term interests of the company and its shareholders; nor
- sufficiently sensitive to wider factors which may be relevant to the long-term interests of the company and its shareholders – in particular to pay and employment conditions elsewhere in the group[30].

5.12 In addition, the remuneration consultants who advise the remuneration committee have a significant, but not always fully transparent, influence on the remuneration policy of quoted companies. There may therefore be a case for broadening membership of the committee.

Disclosure

5.13 Companies are already required to give very full disclosure of remuneration under the DRR, but there are widely held concerns that they provide so much detailed information that it is difficult to see the wood for the trees. In particular, there are concerns that companies do not provide a clear line of sight between levels and structure of remuneration and directors' performance in meeting the company's strategic objectives.

5.14 The Government does not want to impose further unnecessary reporting burdens but it has asked, in the recent consultation on the future of narrative reporting[31], how reporting can be simplified and provide information which is pertinent and easily accessible to shareholders. One suggestion is that there should be a standard opening page to the DRR which provides this in summary format. Others have called for more information about the comparison between directors' and employees' pay. New regulations introduced by the Securities and Exchange Commission in the United States will require more information of this nature.

5.15 Another area where it is has been argued that further information would assist scrutiny and accountability is the structure of annual bonuses. A

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[30] TUC response to the Independent Review of Fair Pay in the Public Sector, TUC, September 2010
[31] The Future of Narrative Reporting – a Consultation, BIS, August 2010. Available at: www.bis.gov.uk/consultations

recent survey[32] stated that 99% of FTSE companies operate an annual bonus plan and that there has been a significant rise in the average bonus opportunity for executive directors over the past decade. The DRR requires disclosure of total amounts paid in annual bonuses, but not the detail, such as the performance criteria. This is largely in recognition of the fact that performance criteria can include commercially confidential information. Given the increased importance of bonuses as part of remuneration packages, it the government wishes to understand the impact of more detailed disclosure.

Shareholder Approval of Pay

5.16 Shareholders already have a major role in this area, both with regard to approving certain forms of directors' remuneration and through the annual advisory vote on the DRR.

5.17 The Government wishes to understand the effectiveness of the powers that shareholders have to control payments to directors, in particular in relation to payments for loss of office made to directors under their service agreements – so-called "golden parachutes".

5.18 The Companies Act 2006 already requires specific prior shareholder approval of payments to directors for loss of office (so-called "golden parachutes"). These are payments made to directors to compensate them for ceasing to be a director, or losing any other office or employment with the company (including as the result of a takeover). However, shareholder approval is not required if the payment is made under an existing contractual entitlement. Given that this is almost always the case, there is a case for removing this exception to give shareholders more direct involvement in deciding the amount of these payments, particularly if they consider they are not warranted on the basis of a particular director's performance.

[32] Trends in FTSE 350 Incentive Practices 2010, Kepler Associates, August 2010

Questions

11) **What are the main reasons for the increase in directors' remuneration? Are these appropriate?**

12) **What would be the effect of widening the membership of the remuneration committee on directors' remuneration?**

13) **Are shareholders effective in holding companies to account over pay? Are there further areas of pay, e.g. golden parachutes, it would be beneficial to subject to shareholder approval?**

14) **What would be the impact of greater transparency of directors' pay on the:**
    - **linkage between pay and meeting corporate objectives**
    - **performance criteria for annual bonus schemes**
    - **relationship between directors' pay and employees' pay?**

6. Takeovers

6.1 Takeover bids shine a spotlight on issues relating to long-termism and shareholder engagement. The directors of both the bidding company and the target company need to take to take a view on the long-term implications of the bid. Institutional shareholders and fund managers need in turn to decide whether the bid is in the interests of their clients and of those on whose behalf they are making investments. It is also the moment at which shareholders' confidence in the boards they have appointed is thrown into sharpest relief. This is true whether the bid is hostile or, more usually, agreed between the two companies.

6.2 Takeovers are a vital part of a vibrant market economy. It is essential that underperforming companies and their boards can be challenged by the threat of takeover, and many takeovers result in successful companies that are far stronger than their predecessors were.

6.3 At the same time, takeovers raise important economic issues:

- there are incentives for some parties to focus on short-term financial gain rather than a proper analysis of what will make business sense for the companies involved in the long-term. The evidence suggests that many mergers and acquisitions are motivated less by economic value for shareholders and more by managers' own objectives and desire to increase company size[33];
- there is broad consensus that takeover bids result in large share premiums for target firms[34]. However, the returns to shareholders of acquiring firms are often zero or negative. This is because the bidder often incurs debt to make its bid, or pays well above market value for the target company's shares;
- despite the evidence of productivity gains from takeover activity in aggregate, not all takeovers are successful in producing long-term economic benefits[35]. Studies have shown that there can often be productivity gains but also falls in employment, short-term sales of assets and, particularly in hostile takeovers, lower levels of investment[36]. These poor post-merger outcomes might arise because management do not understand the technology, the business model or the working environment of the new company; and

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[33] The determinants of merger waves, Klaus Gugler, Dennis Mueller and B. Burcin Yurtoglu, 2004 Working Paper University of Vienna

[34] (a) Key Drivers of Good Governance and the Appropriateness of UK Policy Responses, Filatotchev *et al*, 2007, King's College London, and Mergers and Acquisitions in Europe, Martynova and Renneboog, 2006, Tilburg University, Centre for Economic Research.

[35] Economic studies of takeovers have been numerous but their findings have often pointed in different directions. The findings depend on the rationale of the merger, the benchmark used to assess the impact of the merger, the counterfactual, and the time frame under consideration.

[36] An Empirical Analysis of the Effects of the Threat of Takeover on UK Company Performance Working Paper No. 5, Nuttall R., 1999, Nuffield College, University of Oxford

- the empirical literature does not provide strong evidence that target firms have underperformed prior to takeovers, suggesting a limited disciplinary function of the market for corporate control[37]. There are concerns that the constant fear of takeover can hinder growth and stifle innovation (as managers may be inclined to sacrifice long-term investments in order to engage in short-term strategies to bolster share earnings) as well as generating fears among employees about job security.

6.4 Studies of takeovers have been numerous but their findings have pointed in different directions. The findings depend on the rationale of the merger, the benchmark used to assess the impact of the merger, the counterfactual, and the time frame under consideration.

6.5 Researchers[38] have come to the following conclusions from the literature:

- there is broad consensus that takeover bids result in large share premiums for target firms. However, the returns to shareholders of acquiring firms are often zero or negative;
- the overall empirical literature does not provide strong evidence that target firms have underperformed prior to takeovers, but this could reflect that the threat of takeover acts as a discipline; and
- there are productivity gains associated with takeovers, as well as falls in employment and short-term sale of assets. Generally, takeovers, particularly hostile takeovers result in a reduced level of investment and an increase in dividends paid to shareholders[39]. This suggests in some cases that, due to the takeover threat, directors could have incentives to sacrifice long-term investments in order to bolster short-term profitability.

6.6 Takeovers of UK public companies are regulated by the Takeover Panel. The Panel issues and administers the Takeover Code, which is designed principally to ensure that shareholders in a target company are treated fairly and are able to decide on the merits of a takeover bid. The Takeover Code also provides an orderly framework within which takeovers are conducted. The financial and commercial merits of takeovers are not the responsibility of the Panel. These are matters for the companies concerned and their shareholders.

6.7 The Takeover Panel published a wide ranging consultation in June 2010 which addressed certain aspects of the regulation of takeover bids. The Panel announced on 21 October that, in the light of the responses to its consultation, it intends to amend its Takeover Code to:

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[37] Key Drivers of Good Governance and the Appropriateness of UK Policy Responses, Filatotchev *et al*, 2007, King's College London, and Mergers and Acquisitions in Europe, Martynova and Renneboog, 2006, Tilburg University, Centre for Economic Research.
[38] *ibid*
[39] See Reference 36 (above)

- increase the protection for offeree companies against protracted 'virtual bid' periods;
- strengthen the position of the offeree company by prohibiting most deal protection measures and inducement fees and clarifying that offeree company boards are not limited in the factors that they may take into account in giving their opinion and recommendation on an offer;
- increase transparency and improve the quality of disclosure by requiring the disclosure of offer-related fees and requiring the disclosure of the same financial information in relation to an offeror irrespective of the nature of the offer; and
- provide greater recognition of the interests of offeree company employees.

6.8 The Government welcomes the Panel's proposed changes to the Takeover Code relating to the conduct of bids. In particular, it agrees with the Panel that some rebalancing of the rules is needed to check the evolution of market practice which has run in favour of the offeror. In the light of the Panel's review, the Government wishes to look further at broader issues relating to the economic case, and the corporate law framework, for takeovers. In particular, it would like to consider whether:

- on balance, the economic framework for takeovers is likely to improve the long-term competitiveness of UK companies;
- boards consider sufficiently carefully the long-term implications of takeover bids, and whether they communicate these effectively to shareholders and wider stakeholders; and
- shareholders of an acquiring company should always be invited to vote on takeover bids.

Questions

15) Do boards understand the long-term implications of takeovers, and communicate the long-term implications of bids effectively?

16) Should the shareholders of an acquiring company in all cases be invited to vote on takeover bids, and what would be the benefits and costs of this?

7. Consultation Questions

The Board of Directors

1. Do UK boards have a long-term focus – if not, why not?

2. Does the legal framework sufficiently allow the boards of listed companies to access full and up-to-date information on the beneficial ownership of company shares?

Shareholders and their role in equity markets

3. What are the implications of the changing nature of UK share ownership for corporate governance and equity markets?

4. What are the most effective forms of engagement?

5. Is there sufficient dialogue within investment firms between managers with different functions (i.e. corporate governance and investment teams)?

6. How important is voting as a form of engagement? What are the benefits and costs of institutional shareholders and fund managers disclosing publically how they have voted?

7. Is short-termism in equity markets a problem and, if so, how should it be addressed?

8. What action, if any, should be taken to encourage a long-term focus in UK equity investment decisions? What are the benefits and costs of possible actions to encourage longer holding periods?

9. Are there agency problems in the investment chain and, if so, how should they be addressed?

10. What would be the benefits and costs of more transparency in the role of fund managers, their mandates and their pay?

Directors' Remuneration

11. What are the main reasons for the increase in directors' remuneration? Are these appropriate?

12. What would be the effect of widening the membership of the remuneration committee on directors' remuneration?

13. Are shareholders effective in holding companies to account over pay? Are there further areas of pay, e.g. golden parachutes, it would be beneficial to subject to shareholder approval?

14. What would be the impact of greater transparency of directors' pay in respect of:

    - linkage between pay and meeting corporate objectives
    - performance criteria for annual bonus schemes
    - relationship between directors' pay and employees' pay?

Takeovers

15. Do boards understand the long-term implications of takeovers, and communicate the long-term implications of bids effectively?

16. Should the shareholders of an acquiring company in all cases be invited to vote on takeover bids, and what would be the benefits and costs of this?

Other

17. Do you have any further comments on issues related to this consultation?

8. What Happens Next?

8.1 This consultation will close on 14th January 2011. Following analysis of the responses, the outcome of the consultation including the Government's proposals will be published on the BIS website by the 14th April 2011 .

Annex A: The Consultation Code of Practice Criteria

1. Formal consultation should take place at a stage when there is scope to influence policy outcome.
2. Consultation should normally last for at least 12 weeks with consideration given to longer timescales where feasible and sensible.
3. Consultation documents should be clear about the consultation process, what is being proposed, the scope to influence and the expected costs and benefits of the proposals.
4. Consultation exercise should be designed to be accessible to, and clearly targeted at, those people the exercise is intended to reach.
5. Keeping the burden of consultation to a minimum is essential if consultations are to be effective and if consultees' buy-in to the process is to be obtained.
6. Consultation responses should be analysed carefully and clear feedback should be provided to participants following the consultation.
7. Officials running consultations should seek guidance in how to run an effective consultation exercise and share what they have learned from the experience.

Comments or Complaints

If you wish to comment on the conduct of this consultation or make a complaint about the way this consultation has been conducted, please write to:

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