BIS | Department for Business Innovation & Skills

A LONG-TERM FOCUS FOR CORPORATE BRITAIN
Call for Evidence Response Form

A copy of the consultation available at: http://www.bis.gov.uk/consultations.

Responses to the Consultation should be received by 14 January 2011.

Completed copies of the response form should be returned:

Via email to: clgconsultations@bis.gsi.gov.uk

Via post to:

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Please tick the box from the following list of options that best describes you:

	Quoted company
	Other company
	Investor or investment manager
	Business representative organisation
√	**Investor representative organisation**
	Non governmental organisation (NGO)
	Trade Union

	Lawyer or accountant
	Other (e.g. consultant or private individual)

Introductory Remarks

UK Shareholders' Association is the leading independent organisation in the UK representing the interests of individual shareholders. We think it unlikely that you will receive many responses on behalf of private investors in comparison with those from institutions. Nevertheless, at the end of the day, it is private individuals who provide the funds the institutions invest and so we believe that it is very important that full weight is given to their representations. We shall, of course, be very pleased to expand on and discuss any issues in our response, possibly at a meeting or otherwise.

Many of the issues that concern us and are referred to in our answers are covered in more detail in the Association's booklet *Responsible Investing*(described by Robert Cole in the Times of 9 January 2010 as 'cogent, relevant, well informed, astute and important'). We will send a few copies with the hardcopy version of this response and it is also available at: http://www.uksa.org.uk/ri2010.pdf

The Board of Directors

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

Comments
There can be no single answer applicable to all companies but, overall, not enough. Among factors militating against a long-term focus are (a) pressure from investors for quick results arising from the short-term priority of many institutional investors (b) ill-judged performance-related remuneration of directors, and (c) possibility of takeover if a rapid improvement in profits cannot be obtained.

Question 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?

Comments
No. The powers in S.793 of the Companies Act 2006 are quite inadequate. As a result the identity of the beneficial owners is concealed. There should be an onus on the nominee to pass a list of the beneficial owners to the company (electronically) at sufficiently regular intervals for the owners to be able to exercise proper ownership rights: voting, information flow, attendance at meetings etc. We desperately need a simple regime whereby private shareholders can have benefits of nominee accounts, such as cheap online trading and confidentiality, combined with all the rights that previously went with certificated holding. This seems to have been achieved in the USA and Australia without meeting the obstacles that are put forward in the UK.

Shareholders and their role in equity markets

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

Comments
This question presupposes that the ONS figures are correct. We strongly recommend that BIS, if they have not already done so, should engage closely with Richard Jenkinson of Junction RDS to examine the methodology behind his figures and decide whether he or the ONS is correct. It should also be remembered that the proportion of shares held privately is higher in small companies than large ones. That said, the reduction in direct private ownership (aggravated by shareholding through nominees) makes it more difficult for the true owners of shares to exercise any influence. Unless drastic steps are taken to enfranchise those holding shares through nominee accounts, this can only get worse with the pressure to move away from certificated holdings. Indeed, we could reach the point when there is hardly anyone left with a certificated holding who would be able to attend and vote at an AGM as of right.

Over and over again we come up against problems caused by absence of rights for those with shares in nominee accounts. Lack of information rights means that they remain unaware of the contents of Reports and Accounts and hence unlikely to attend an AGM which would at least give them their annual opportunity to take up issues with the directors. Equally, of course, they have no voting rights.

We also draw attention to the growth of passive management in pension funds. Those of our members who are pension fund trustees report that funds are facing up to the failures of active management and are obtaining equity exposure through ETFs, Index Funds or derivatives. This has two implications: first the funds no longer have a role to play in the governance of companies; second, the ownership of the underlying shares is unclear to say the least.

Finally, overseas shareholders generally are less likely and able to take on active or pro-active corporate governance roles, thus emphasising the key role that must played by those proportionately few private investors and institutions who have an incentive to watch over the long-term wealth creation of the companies in which they invest.

<u>Question 4</u>: What are the most effective forms of engagement?

Comments
Engagement by those with a direct personal interest in the outcome of their investment. There have to be serious doubts about the likely effectiveness of the official policy of promoting institutional shareholder involvement. Sir David Walker's report (*'A review of corporate governance in UK banks and other financial industry entities: Final Recommendations, 26 November 2009'*) showed clearly the difficulties in that path (paras 5.16-5.20). The corporate governance input of institutional investors suffers from a lack of personal financial commitment (discouraged on conflict of interest grounds) and the fact that most lack corporate management experience. This contrasts with private investors, many of whom occupy, or have occupied, senior management positions.

<u>Question 5</u>: Is there sufficient dialogue within investment firms between managers with different functions (i.e. corporate governance and investment teams)?

Comments
This is a question that can only be answered by those with direct knowledge of what goes on within investment houses. However, there is an argument that those in the investment team should not be inhibited in their activity by knowledge from the governance side.

<u>Question 6</u>: (a) How important is voting as a form of engagement? (b) What are the benefits and costs of institutional shareholders and fund managers disclosing publically how they have voted?

Comments

(a) Voting is the ultimate sanction and the only democratic form of governance and it is vital that it is as easy as possible for the beneficial owners to exercise their votes.
(b) The benefits of greater voting transparency are difficult to define and there is no guarantee that it would ensure that voting powers were used with proper consideration of the issues. There would also be a mismatch between the volume of information generated and the resources available to use it.

Furthermore there is a 'level playing field' aspect. Private and overseas investors would not be under a similar obligation.
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<u>Question 7</u>: Is short-termism in equity markets a problem and, if so, how should it be addressed?

Comments
. The distinction between short and long term is easy to conceptualise, but much more difficult to apply in practice, because short and long term thinking cannot be compartmentalised in real life. Most business and financial activity involves a combination of the two in varying proportions according to circumstances at the time. So it's hard to be evidential. Nevertheless, there are theoretical reasons why institutional shareholders should be interested in short-term performance. Such shareholders will often be part of large financial groups. They make their money from any and all of the following: advice and funding of takeovers, disposals and other corporate actions; fundraising and flotations; spin-offs from an active stockmarket, such as retail broking, retail fund management, corporate advice; and proprietary trading. These activities are short term, and require no long term view. Governance, however, costs time and, therefore, money. As to how it should be addressed, there is a whole cocktail of factors (many covered elsewhere in this questionnaire) that must be dealt with, but the start, as always, must be recognition – exposure and discussion of the issue so that the search a consensual solution can be found.

<u>Question 8</u>: 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?

Comments

See Question 7. The cost of change would be to those who at present gain from frequent trading. The benefit would be to the rest of us.

Because of the difficulty of separating short- and long-term activity the net benefit to the economy must be a guess. But if we speculate that the neglect of the long-term costs 1% each year (which also compares with the shortfall in non-financial industrial growth in the UK compared with our better competitor countries) this is £10billion per year, compounding.

On a point of detail, information and analysis providers need to be remunerated if markets are to remain liquid and volatility minimised. Remuneration can be obtained either by market activity or by payment for research services. Unbundling of research should in principle lead to lower activity and longer holding periods.

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

Comments

The agency problem in connection with directors is well known. It must be minimised by a) aligning directors' rewards with real corporate wealth creation instead of short term market gains, and b) strengthening the accountability chain between directors and beneficial owners. These matters are covered elsewhere in this response.

We would also mention the issue of commission-based Independent Financial Advisers (IFAs). By directing retail investors into commissioned financial products, and therefore away from direct investment, they have removed whole swathes of private individuals from the governance chain who would otherwise provide some counterweight to institutional pressures

Agency problems in fund management arise from the fact that corporate performance is a function of the real economy, whereas investment performance (defined as absolute return) is a function of the financial markets. This leads to herd-following instead of a focus on absolute performance, making active institutional governance of individual companies an expensive irrelevance. For the manager a fee based charging system as opposed to ad valorem should be encouraged, since it would align revenues more closely with costs.

<u>Question 10</u>: What would be the benefits and costs of more transparency in the role of fund managers, their mandates and their pay?

Comments
Current practice is normally for those who own the funds being managed to be fully cognisant of the fee formula of the management house but to have no information about the remuneration of the individual employees managing the funds day by day. It can be argued that the employees' remuneration is a private matter between them and their employers. However, it is easy to see examples where the form of performance incentive could affect the way they manage the money. For example towards the end of a measurement period an employee might be able to see that only a speculative approach would give him any chance of a performance fee. This would be particularly tempting if he had no long-term personal commitment to his employer. It follows that it should be standard practice for those negotiating management contracts to be told the remuneration formulae of those managing their investments. We cannot see that there would be any additional cost in this.

Directors' Remuneration

<u>Question 11</u>: What are the main reasons for the increase in directors' remuneration? Are these appropriate?

Comments
Greater publicity has undoubtedly had the negative result of permitting, and even encouraging, the ratchet effect because no one wants to be seen to be paying less than the median of comparable companies. It is extremely difficult, if not impossible, for any one board to go against the trend, and the hard truth is that members of a remuneration committee are not spending their own money and most, being directors of other companies themselves, benefit from this systemic weakness.

The use of remuneration consultants has aggravated this by giving boards an apparent justification for the levels of pay that they agree and facilitating the process of comparison with those of similar rank in comparable companies. Remuneration consultants are appointed and paid by the directors whereas to have any pretence to independence they need to be appointed by and to report to the shareholders.

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

Comments

If enough appropriate members could be found this would be positive, but in practical terms we cannot see that this is the solution. To be effective any additional members would have to be independent enough and strong enough to resist the pressures we have described in the last few questions.

A shareholders' committee restricted to beneficial owners could fulfil some of the functions of a remuneration committee while adding balance and independence.

<u>Question 13</u>: 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?

Comments
No. Their vote on this matter is non-binding. So the use of the word "further" in the second part of the question is incorrect. Accordingly it is difficult to see how extending the range of items requiring a shareholder vote would have a significant effect. The position might be different if true shareholder approval were required. Regarding 'further areas of pay' it is quite clear that identical levels of approval should apply to all the terms of a director's appointment that could give rise to remuneration. It is both illogical and dangerous to do otherwise. This is best exemplified by the compensation terms - rewards for failure – routinely written into directors' contracts, not only without shareholder approval but without even prior shareholder scrutiny.

<u>Question 14</u>: 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?**

Comments
As indicated under question 11, transparency in this area has not helped. The opportunity for wealth at the level now available to top directors of big public companies should only be there for those who have taken entrepreneurial risks on their own account, and succeeded. We also question what is different about directors that they apparently need so much in the way of performance incentives to give of their best whereas ordinary mortals do so for a straight salary. The idea that someone in salaried employment can take home significantly more in a year than the average person earns in a lifetime is fundamentally unacceptable. How we achieve that situation is another matter. It is clear that a greater awareness is needed by both remuneration committees and shareholders of the consequences of different types of 'incentive'. There is little

evidence of understanding of the effect of statistical dispersion, which ensures that *all* incentive schemes that reward the upside without a corresponding share of the downside motivate increasing risk and volatility rather than the converse.

Takeovers

<u>Question 15</u>: Do boards understand the long-term implications of takeovers, and communicate the long-term implications of bids effectively?

Comments

Seeing how many takeovers fail to benefit the acquiring company the answer to this question must be in the negative in many cases. It may not just be a question of understanding the long-term implications: the financial interests of institutional shareholders (see Q7) may drive short-termism anyway. A far more critical and independent approach from the non-executives is needed to counter the enthusiasm and hubris of those in executive positions leading the bid, and the misplaced short-term interests of powerful shareholders.
Nonetheless, it is important that UK registered plcs are not put at a disadvantage by governance constraints that do not apply to their overseas peers.

<u>Question 16</u>: 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?

Comments

It is not obvious that this would help. For example, the bid by Lloyds Bank for HBOS required shareholder approval. Private shareholders voted against but the institutions supported the bid and one reason for this must have been the fact that they generally held shares in both companies and so were glad to be receiving an offer for their HBOS shares. It would seem that there was a failure to consider each issue separately on its merits.

One of our members, retired from a senior executive position at the acquiring company, made a special journey to Scotland to challenge the issue at the Lloyds Bank General Meeting and found his comments dismissed out of hand by the Chairman

<u>Question 17:</u> Do you have any further comments on issues related to this consultation?

Comments
To us the big issue is the need for alignment of interests between the ultimate beneficial owners and those running the company. In the not so distant past there was a direct relationship between shareholders and directors and the former were able to exercise a reasonable degree of control. This link needs to be restored. In this context the stockmarket's function as a trading platform has corrupted its function as a mechanism for the recording of ownership: the fact that stock-lending to short-sellers transfers voting rights is one example. One suggestion, explained in detail in our booklet, is to appoint committees of private shareholders with the directors having an obligation to communicate with them and discuss key issues with them. This has been proposed in a private member's bill - 'The Protection of Shareholders Bill' - and also aired in the Walker Review (para 5.17) We would mention one other matter not covered by the questions: the danger of excessive reliance on regulation. Regulators may be conscientious, honest and well-intentioned, but their symbiotic relationship to the industry they are regulating makes them obstructive to any major change that damages the industry - even when for the greater good. Removal of some of the impediments identified in this submission are of that nature.