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**
Ot	**her company**
	Investor or investment manager
	Business representative organisation
	Investor representative organisation
	Non governmental organisation (NGO)
Trade	**Union**
La	**wyer or accountant**
	Other (e.g. consultant or private individual)

London Stock Exchange Group

LSEG Response to the BIS Call for Evidence: " A Long-Term Focus for Corporate Britain"

14 January 2011 Submitted to: clgconsultations@bis.gsi.gov.uk

Introduction

The London Stock Exchange Group (LSEG) is home to over 2,000 UK companies with a combined value of over £1,750 billion. The LSEG is an essential provider of non-bank finance to UK companies and the access to equity finance provided by its markets has been a major economic stabiliser for UK companies during the crisis. £163 billion has been raised by UK businesses, both large and small, through the LSEG since the run on Northern Rock which compares to the £200bn pumped into the economy through the Bank of England's Quantitative Easing scheme.

The London Stock Exchange also plays a key role in attracting international companies to the UK. Currently over 600 international companies from 70 countries with a combined market capitalisation of £1,825bn are listed on our markets underlining the international scale and global importance of London's financial markets.

Executive Summary

- Liquidity plays a key part in driving the UK economy. Both the diversity of long-term and short-term investors with their different strategies and motivations, and the mix of domestic and international investment, are essential to this liquidity, helping to create a liquid and vibrant equity market. This in turn lowers the cost of capital and makes it easier for companies to raise equity finance (which is especially important for SMEs), whilst boosting returns for investors. The corporate governance regime must recognise and support both short-term and long-term investors and preserve the attractiveness of the UK for international investors in order to preserve this critical liquidity and its wider economic benefits.

- The UK's corporate governance regime delivers the right balance of regulation and flexibility to protect shareholders, and provides a stable platform on which companies can operate. This enhances the UK's attractiveness as an international financial centre. The Government must ensure that any changes to the corporate governance regime are proportionate, preserve the UK's attractiveness and continues to encourage growth in the UK economy.

- To support long-term equity investment in the UK, the Government must address the fiscal barriers that discourage long-term equity investment. We need to achieve a fundamental rebalancing of the economy so that debt and equity are treated equally in the tax system, thereby helping to stimulate private sector led growth in the UK.

- We believe that the current takeover rules apply proportionate checks and balances without distorting the UK's competitive business environment. The ability to buy and sell companies is vital to the open and non-discriminatory business environment which has historically made the UK an attractive place to invest. Any potential changes to the UK's takeover regime which restrict the perceived investment value of UK companies are likely to reduce the attractiveness of equities as an investment class and undermine liquidity in UK company shares. This would risk reducing returns for investors and make capital more expensive for companies, threatening investment and job creation potential in the UK.

The Board of Directors

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

Comments

Under Section 172 (1) (a) of the Companies Act 2006, Directors are required to have regard for the long term consequences of their actions.

In line with this, strategic decisions are based on one essential question: what is the most effective way to leverage the company's assets in order to maximise shareholder return in the long run and achieve other core corporate objectives. A corporate strategy often necessitates a large degree of investment, both in terms of time and financial capital. Once embarked upon, it is difficult to reverse – and to do so would require a strong justification and/or a viable alternative.

The viability of a strategy will be tested against a set of variables on an on-going basis to determine whether changes need to be made. Short-term developments will form a part of this continuous evaluation and may therefore provoke a set of actions; it is necessary to determine whether these developments pose a threat or opportunity to the fulfilment of corporate strategy. However, in themselves, they will not cause a change of strategy. Equally, though Directors are kept regularly informed of day-to-day developments in the business and its environment, they do not base long-term strategic decisions on short term movements in the company's share price.

Arguably the most important question to be posed is whether corporate strategy and management goals are being effectively communicated to external stakeholders. If not, then a change in the company's investor relations approach and/or communications strategy may be required.

<u>Question 2:</u> 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
Under Section 793 (1) of the Companies Act 2006, a company may give notice to persons whom they have reasonable cause to believe has interests in the company's shares. This notice allows the company to request confirmation of this belief, and certain information on those persons. In practice, this will only apply to those persons who have an economic interest, and whose purchase of those shares has gone through settlement. Day traders, who may temporarily hold the shares, but whose holdings will not go to settlement, will not be included. We do not believe that this is a problem – such people cannot, as they are not registered themselves, vote on key issues at an AGM or EGM. We are unaware of any other US, Canadian or European legislation that provides companies with the ability to obtain this level of detailed information on shareholder structure. In this respect, the UK's legal framework is far more advanced than any other framework in the EU. There are some aspects of Section 793 that could be improved. In particular, more granular detail of what information may be requested under Section 793, for example: the names and addresses of those who have had an interest or exposure to the shares, full details of relevant interests, the nature and extent of the interests, and the circumstances in which they arose. However, an impact assessment would be required to determine what the costs to the investment community would be as a result of any changes and/or any adverse impacts on the investor pool seeking to invest in UK companies (see our comments on the significant benefits of a deep and liquid investor pool on UK companies and markets – questions 3 and 7).

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

We welcome and strongly agree with the acknowledgement in the call for evidence that the huge influx of foreign capital has been beneficial to UK companies and London as a financial centre[1].

The increase in foreign investment has helped to increase the liquidity and efficiency of the UK equity markets. A liquid and vibrant market is good for investors, companies and the UK economy. Investors benefit from a more efficient market with narrower spreads, and consequent lower trading costs. This enables them to secure a better price, resulting in better returns on investment[2]. For companies, it lowers the cost of capital, making it easier for them to raise equity finance[3]. This enables these companies to fund growth, invest in research and development, and create jobs, to the benefit of the wider UK economy.

An example of the influx of foreign capital into the UK has been the increase of investments from Sovereign Wealth Funds (SWFs). The UK has been a key beneficiary of this investment: between 1995 and June 2009, half of the $187 billion invested in Europe by SWFs was invested in the UK[4]. London remains an attractive destination for SWFs due to its structural strengths in financial services and ancillary professional services, as well as a globally respected and well balanced corporate governance regime and an open and non-discriminatory business environment.

It's worth noting that SWFs tend to be long term investors. They therefore tend to take a more strategic and fundamental view of a company's prospects and have high risk tolerances.

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[1] Paragraph 4.3

[2] For example, the liquidity of the London Stock Exchange's equity market, as measured by value traded on the orderbook, increased by 112 per cent between April 2000 and March 2010. In the same period, the average Time Weighted Spread for FTSE 100 stocks reduced by 82 per cent. Greater liquidity and narrower spreads reduce the relative price at which investors buy, and raise the relative price at which they sell, thereby reducing their trading costs and earning a better return on their investments (data from the London Stock Exchange)

[3] The LSE/Oxera report ("The Cost of Capital: An International Comparison" – June 2006) refers to studies showing that the trading costs incurred by investors in secondary markets have direct implications for share prices and a company's cost of equity.

[4] Sovereign Wealth Funds, 2010, IFSL Research

Question 4: What are the most effective forms of engagement?

Comments
Whilst voting is an important form of engagement, it is not a substitute for effective and continuous dialogue and face-to-face meetings between a company and its shareholders. These provide a forum for question and answer sessions on the company's corporate strategy, outlook and financial performance. In this way, issues can be raised, discussed and resolved before votes are held at the AGM or at an EGM Regional shareholder meetings and road shows can also be a useful and effective way of engaging with shareholders. However, these are likely only to be practicable if a large numbers of shareholders are concentrated in particular regions. It is therefore important that companies are able to take a qualitative judgement as to how best to engage with their shareholders.

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

Comments
In our experience, there is sufficient dialogue between internal departments in investment firms.

<u>Question 6</u>: 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?

Comments
Voting is an important form of engagement. However, as stated in our answer to question 4, it is not a substitute for effective and continuous dialogue. We support in general the principle underpinning the UK Stewardship Code (the Code), pursuant to which institutional shareholders are expected to publically disclose voting records, and if they do not, to explain why[5]. Under the same principle, institutional shareholders should not automatically agree with the Board, and where they don't, should actively communicate to the company the reasons why. However, there are a number of issues that should be considered in applying this principle: • Public knowledge of a disagreement could have an adverse impact on shareholder value, whilst not solving the problem; • The cost/benefit of disclosure should be considered, as the costs of disclosure may undermine investor value. Disclosure of voting practices may result in the production of extensive information and statistics being produced, which create additional expense for the institution in question (and on underlying investors therefore), but is not widely used; • Confusion may arise if fund managers are required to vote differently with different blocks of shares at the request of their clients.

[5] The UK Stewardship Code, Principle 6

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

Comments
It is the diversity of long-term and short-term investors with their different strategies and motivations which enables the UK economy to flourish and for London's capital markets to remain as attractive and competitive as they are. The interaction of these investors drives a liquid and vibrant market – as noted in our response to question 3, this reduces the cost of trading for investors, reduces the cost of capital for companies and provides the means for companies to raise equity finance efficiently and cheaply without incurring further debt. This in turn enables both domestic and international companies to invest in growth and create jobs, to the benefit of the wider UK economy[6]. The funding provided by the London Stock Exchange's equity markets since the run on Northern Rock in 2007 demonstrates the importance that equity finance has had in helping to sustain the recovery and drive growth in the wider UK economy. Since September 2007, £163 billion[7] has been raised by UK companies in equity on our markets. This compares to the £200 billion that has been pumped into the UK economy by the Bank of England through its quantitative easing programme. The importance of vibrant equity markets to the real economy is most apparent with our SME market, AIM. Since its launch in 1995, in excess of £70 billion has been raised by SMEs. This financing is fundamental to the operations of these companies: UK based companies on AIM employ in excess of 250,000 people and support a further 320,000 jobs indirectly. Approximately £12 billion is contributed to GDP by AIM companies, with a further £9.4 billion supplied through Gross Value Added and in 2009, £1.8 billion was contributed in tax revenues[8]. Given the reliance on equity finance for growth, maintaining a liquid and efficient market, and a lower cost of capital, is essential to support growth and help to achieve a rebalancing of the UK economy through a private sector-led recovery. We would urge caution with the use of the statistic in Paragraph 4.19 of the call for evidence which states that holding periods have fallen from 5 years to 8 months since the 1960s. This statistic on holding periods is

[6] Please see our answer to question 3, and footnote 2

[7] Both new and further money raised by UK incorporated companies – September 2007 – December 2010. Source: London Stock Exchange Group

[8] "Economic Impact of AIM and the Role of Fiscal Incentives" (Grant Thornton and LSE), September 2010

sourced from the London Stock Exchange and the World Federation of Exchanges[9] and is based on share turnover data. Turnover data is not a reliable indicator of holding periods, as it only reflects the mean measure on how a stock trades its market capitalisation. This mean measure cannot take into account the distribution of trades resulting from short term versus long-term holders which we believe creates an inaccurate picture of actual holding periods. We are investigating more accurate sources of data and would be happy to meet to discuss when we have further information.

If the Government is to continue using share turnover data to calculate holding periods, then it should be noted that data indicates that turnover velocity of UK shares is significantly lower than in Europe and the US[10].

To conclude, the liquidity provided by a diverse range of market participants is highly beneficial to the UK economy: it results in a deep and liquid market that reduces the cost of trading for investors, reduces the cost of capital for companies and lowers the barriers to raising capital in the equity markets. This remains an incredibly attractive framework for international business and the flow of funds, expertise and talent to the United Kingdom. Together, this has consequent beneficial impacts on jobs and growth across the UK.

Question 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?

Comments

As described in our answer to question 7, the confluence of long-term and short-term investment strategies is essential for a vibrant and liquid market. This in turn is key to the capital raising activities of Corporate Britain and to the health of the wider UK economy.

However, we also believe that greater incentives should be offered to encourage long-term investment in UK equities. In particular, the UK operates a fiscal regime that acts as a disincentive for investing in equity. It is clear that the financial crisis of 2008 was a crisis driven by excessive

[9] Via a paper from the Bank of England – 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

[10] The average turnover velocity of UK shares was 101 per cent in the 12 months ending 31st March 2010. This compares to an average of 116 per cent in Europe as a whole, 187 per cent in Italy and 327 per cent and 245 per cent in Nasdaq and NYSE stocks respectively. Source: WFE and London Stock Exchange Group.

debt, not by equity. During the crisis, the London equity markets remained open for business; since the run on Northern Rock in 2007, £196 billion has been raised in London Stock Exchange's markets; £163 billion of this by UK corporations[11]. It is clear that equity finance has a clear role to play in financing and sustaining the recovery; this should be recognised in the tax system.

Specifically, while other asset classes such as bonds and cash are subject only to income tax, equities are taxed at purchase, dividend and sale, in addition to the corporation tax paid on company profits. We need to achieve a fundamental re balancing of the economy so that debt and equity are treated equally, in order to stimulate growth in the UK and strengthen our economy.

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

Comments

We are not aware of any problems. Paragraph 4.25 suggests that there is excessive churn in equity markets as a result of portfolio changes on the part of fund and investment managers. It should be noted that such activity is not permitted under the FSA's Conduct of Business Rules[12].

We are unaware of any evidence that suggests that fund managers are incentivised to churn their portfolio. We understand that fund manager fees are normally calculated on an ad valorem basis related to the assets under management in the portfolio – and this is assessed on a medium to long-term basis[13]. Therefore an investment manager is not incentivised to over-trade their portfolio, as the transaction costs would erode the performance of the fund.

The type of fund should also be considered. For example, an indexation fund, designed to track a given index or asset, will ordinarily exhibit a high turnover of shares. This is done to ensure that the price of the fund remains aligned with the given index.

[11] Total equity capital raised by UK and non-UK incorporates on the London Stock Exchange's equity markets between September 2007 and December 2010. Source: London Stock Exchange Group.
[12] 7.2.3 (1) – Conduct of Business Rules
[13] Please see the Investment Management Association's response to the EU Green Paper on corporate governance in financial institutions and remuneration policies, September 2010

<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
No comment

Directors' Remuneration

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

Comments

The numbers presented in the call for evidence on page 26 need to be treated with caution. In particular:

1. The period 1998-2001 is not comparable with the period 2002-2009 because the earlier period includes data on new recruits and internal promotions.

2. Comparison between CEO remuneration and average employee earnings between 2002 and 2009 demonstrate only around a 1 per cent per annum difference in growth between the two groups: in the period CEO remuneration increased by 44 per cent whilst average employee earnings increased by 34 per cent. This is a far more modest difference than suggested by the table on page 26.

3. We would also query the accuracy of the employee earnings data provided in the call for evidence. For example, between 2006 and 2007, earnings purportedly declined by 17 per cent – we believe that this is unlikely to have occurred on a per capita basis.

That said, we believe that any difference that does exist in remuneration increases between CEOs and employees is likely to have arisen, at least in part, for the following reasons:

a) The bull runs of the 2000s, and the impact that this had on executive Long Term Incentive Plans (LTIPs): due to the 3 year performance period over which LTIPs normally vest, it takes time for a downturn to manifest itself in remuneration. Consequently CEO remuneration would only have started to decline in response to the recession from 2009 – it is worth noting that between 2008 and 2009, directors' remuneration declined by 5 per cent, whilst employee earnings increased by 5 per cent[14]. We would expect a similar lag in director remuneration increases when performance begins to improve.

b) The increasingly global environment means that the pool of available people with the right skills and experience to run global and highly complex organisations is limited. UK companies are

[14] As demonstrated in the table provided on page 26

increasingly turning to foreign leaders – today approximately one third of FTSE 100 companies have a foreign CEO[15]. In this environment it is inevitable that market forces will have an impact on the remuneration of top executives.

c) The public disclosure of remuneration may have played an important role in increasing directors' pay. Such transparency has better enabled directors to compare their remuneration packages – which would have an inflationary effect.

We note that shareholders have a number of routes to raise any concerns over remuneration – in particular through ongoing dialogue (please see our response to question 4) and through the annual shareholder vote on the Directors' Remuneration Report. In the last 3 years, only 2 companies have had their Directors' Remuneration Report voted down by shareholders, whilst 2 others did not receive more than 50 per cent in favour due to a high level of abstentions. In our view, this is evidence of the importance, and the ability, of shareholders to raise their concerns during face to face meetings rather than resorting to voting against the Remuneration Report.

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

Comments

We do not believe that there is a necessity to widen the membership of the Remuneration Committee:

- Remuneration Committees are staffed by Non-Executive Directors (NEDs) who are involved in the running of the business, have unique insight to the business and its operations and can therefore fully understand the link between remuneration and business strategy. An external member of the Committee would not be able to offer this insight.

- Shareholders have other routes of influences, namely:

  - Shareholders are provided with an annual opportunity to express their views on executive remuneration through a mandatory shareholder resolution on the Directors' Remuneration Report;

[15] "Route to the top: a Transatlantic Comparison of Top Leaders", E.Marx, Jan 2010

- Shareholders are also provided with an opportunity to oppose the re-appointment of directors where they believe that they are unsuitable or not acting in the interests of the company;

- In our experience it is not difficult to maintain constructive shareholder dialogue on both strategy and remuneration under the existing board structures. Our view is that it is not necessary for shareholders to attend the Remuneration Committee;

- We consider that this may be divisive and time consuming – creating tensions over which shareholders should be entitled to attend.

- We also believe appointments of remuneration consultants as Remuneration Committee members would be inappropriate: such consultants are appointed by the Remuneration Committee to provide independent advice, with the decisions being made by the Committee itself. Appointing consultants as members of the Committee would shift their involvement from independent advisor to decision-maker.

Question 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?

Comments
Yes, shareholders are taking increasing interest in executive pay and meet regularly with companies to discuss this. Furthermore, institutional representatives such as the Association of British Insurers and Risk Metrics provide guidelines on executive pay and advise shareholders on contentious issues. Where executive remuneration is considered excessive or inappropriate, shareholders have the opportunity to vote against the Directors' Remuneration report and indeed have shown their willingness to do so where they consider that alternative forms of engagement have been ineffective.

<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

We support transparency. We believe that there is already significant transparency in the UK on directors' pay – shareholders already require companies to disclose the linkage between pay and performance and are demanding increasing levels of disclosure about targets, particularly around short term incentives such as annual bonuses.

The benefits of greater transparency must be balanced against the potential impacts on the effectiveness of incentives and a company's ability to attract the best talent:

- As noted in our response to question 11, we believe that greater transparency may have contributed to the increase in directors' remuneration;

- By their nature, incentive arrangements are linked to a company's most important strategic objectives. The disclosure of even more detailed performance criteria, annual targets and strategic objectives may therefore be commercially sensitive. If disclosure were mandatory, then the unintended consequence could be to encourage companies to link pay to less important targets and objectives or to move to a more discretionary and less measurable approach.

It is unclear what purpose would be served by placing a greater emphasis on the relationship between directors' and employees' pay:

- As noted in our response to question 11, directors' remuneration has grown at only a slightly higher rate than employee remuneration. We also query the accuracy of the data presented on page 26.

- We consider that such an approach fails to take account of different types of company. The employee profile and pay frameworks vary significantly between individual companies and industries, influenced in a large part by the industry and nature of the workforce. In a highly technical or professional services organisation, pay levels are likely to be higher at all levels than in

those organisations that employ greater numbers of lower skilled staff. By way of example the differential between CEO and average pay at some large retailers is over 100 times whilst for information technology or biotechs the differential can be as low as 8 times[16].

[16] Data sourced from individual annual reports and Datastream

Takeovers

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

Comments
Boards have a fiduciary duty to consider the long term consequences of their actions, and it is our belief that they take this duty seriously. The Board of both the offeror and offeree will carefully consider whether a takeover bid represents value, and whether it is the best use of company assets.

Question 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?

Comments
In the event of a major transaction, listed companies are already required to seek shareholder approval in accordance with the class tests in the listing rules[17]. Companies will frequently make smaller acquisitions, and requiring shareholder approval in all cases could result in disproportionate costs on smaller acquisitions, disadvantage SMEs in particular, and limit inorganic growth opportunities for UK corporations. As an alternative, the current class tests could be reviewed, though there is a general view that the current class tests remain appropriate. Any changes made would need to be proportionate and balanced so as not to disadvantage UK companies abroad or adversely impact scope for growth in the UK.

[17] Chapter 7 of the Listing Rules (LR 7.2.2)

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

Comments
We have no further comments