London School of Business & Finance

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Adam Gray
Long-term Focus Consultation
Corporate Law and Governance
Department for Business, Innovation & Skills
1 Victoria Street
London SW1H 0ET
By e-mail to: clgconsultations@bis.gsi.gov.uk 14 January 2011

Dear Mr. Gray

A Long-Term Focus for Corporate Britain

Thank you for the opportunity to provide comments on the above consultation paper.

Responses to the consultation questions on which we are able to comment are set out below. By way of background, it is London School of Business and Finance's mission to become the first choice for business education in Europe. Through educating the world's most creative, talented and ambitious students, London School of Business and Finance aims to bridge international boundaries and provide individuals around the globe with an opportunity to achieve academic, personal and professional success. LSBF attract over 15 000 quality candidates from over 140 countries worldwide, and continues to experience exponential growth, both on-campus and online, all around the world, while continuing to develop corporate training, partnerships and associations with best-practice organisations globally.

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The Board of Directors

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

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The question assumes a settled definition of "long-term". It would be more helpful to understand the specificity of the term in the context of the business model of the corporation managed by the Board. This is not a simple matter. An organisation such as National Grid, for example, seeking to ensure security of energy supply to the citizens of the UK should surely be expected to have well defined and tightly quantified investment plans for at least the next decade, given the legislative requirements around GHG reductions for 2020, with broader strategic intention towards 2050 for the same reason. A nearer to cash business model such as that of the Fast Moving Consumer Goods (FMCG) sector might be expected to be shorter term (but cyclical and iterative) in its long-term, although wise organisations such as Unilever or SabMiller have been actively monitoring their key scarce resource, water, for at least the last decade, and are thinking forward around how to mitigate against increasing scarcity of that resource.

Unfortunately, at least from the perspective of corporate reporting in the public domain, there is scant evidence of boards of directors of UK listed companies adopting a long-term focus, where this is anything more than the requirement to address whether the corporation they manage is a going concern for "the foreseeable future" i.e. notionally a period of 12 months from the preceding balance sheet date. This is an obviously circumscribed conception of going concern which, however, is established at common law and enshrined in corporate law through the requirement for listed companies to adopt International Financial Reporting Standards (IFRS). Accordingly, policymakers face an institutional bloc if intending to introduce measures that extend corporate accountability and risk management from twelve months to the foreseeable future.

The reasons for short termism are various but may be attributed to the following headings, all of which will be considered in greater detail below:-

- Unintended consequences as a result of trends in corporate governance
- Unintended consequences as a result of trends in regulation and standard setting
- A lack of investor interest in the long-term horizon

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?**

Specifically, the 3% ownership disclosure notification requirement should extend from long equity to short equity and derivative positions including Contracts for Difference individual stocks. Also, where shares are held in trusts and nominee companies a 'substance over form' approach should be encouraged when disclosing ownership.

It would be helpful for those drafting regulation or establishing voluntary codes to explicitly address long-term issues in their work. We welcome the reference to the "long-term consequences" of directors' decisions in Section 172 of the 2006 Act, but note with

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disappointment that the extract from FRC's Corporate Governance Code quoted at 3.3. with the possible exception of the word "strategic", makes no reference to the long-term!

In terms of the equity markets one of the biggest challenges we see facing regulators and policy makers today is the emergence of parallel but substantially large, off exchange share trading capabilities; this is taking place across two distinct, non-overlapping but connected sectors, first, the so-called "dark pools of liquidity" and second, the private, members only markets for unlisted securities that have emerged since 2008. Each offer well capitalised entities avenues for market manipulation the scope of which isn't well known nor fully understood at this point in time.

The rapid growth of electronic trading since 1976 has benefited equity market participants by improving competition, reducing cost and increasing liquidity while insuring better pricing.

One unexpected side effect has been the recent emergence of "dark pools of liquidity".

When we look at public bourses, for example The New York Stock Exchange (NYSE) - arguably the world's single largest cash equity market - we are only seeing a part of the complete picture as we know that not all shares for NYSE listed companies are traded on this exchange.

Indeed, many institutional investors use electronic trading services called "Crossing Networks" to match buy and sell orders. Crossing Networks provide two services critical to the institutional investor - anonymity and liquidity. Such networks allow participants to anonymously buy or sell large blocks of securities, without using listed stock exchanges or impacting publicly quoted prices on those exchanges.

The attraction of such networks to institutional investors is easy to understand: if competitors learn about your market activities they are in a position to disrupt your trades. Disrupting trades may be as simple as front running orders, or attempting to trade mispriced securities before you do. In other words, public activities may lead to price disruption, with risk of trading losses.

There are many such networks, each operating in specific niches or providing specialised services. In 2008 crossing networks accounted for over 10% of all equity market trading. Considering the vast sums of money attracted to dark pools of liquidity, their numbers are certain to continue growing. But precise data about crossing networks is difficult to come by, due to their international scope, intentionally secretive operations, and the fact that they serve the needs of private, institutional class investors.

However the dark pools of liquidity are converging, and, in some cases, emerging into the public eye. Also, consolidation in this sector is taking place at an increasing speed. Goldman, UBS and Morgan Stanley, for example, have agreed to provide shared access to their own dark pools, creating, in a virtual sense, a single, large Crossing Network. As economies of scale are critical to equity trading, other dark pools will be certain to follow.

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As dark pools continue to converge, enlarging their liquidity base while doing so, they are beginning to compete for business with traditional, organised exchanges such as NYSE / Euronext.

We now see dark pools of liquidity converging, growing larger as they do so and in many cases emerging from the shadows to threaten entrenched competitors. This is a scenario that played out to its endgame, may benefit equity market participants, however there have been instances where large blocks of shares have entered the public domain from dark pools, substantially moving price as supply overwhelms demand; it is this possibility for manipulative activity that is of most concern.

While reflecting on dark pools of liquidity, it is important to keep in mind that these services are "non quoting"; in other words, while they provide liquidity they do so at the public price. No firm using these services is getting a better price than traders using public, organised exchanges. Indeed, crossing networks simply match buyers to sellers, who reference public prices to arrive at fair value.

Also, as several firms offer advanced routing services which automatically break up large block trades to suit the limited liquidity each pool can offer, many institutional class investors find that on aggregate, they are paying higher transaction costs than if they had used existing exchanges. This is the price they are willing to pay for anonymity in the harshly competitive world of trading.

The most interesting thing about the dark pools of liquidity is their circularity; while established exchanges are busy acquiring competitors, crossing networks, operating in the shadows, have been slowly building a client base, providing needed, missing services. Now pools of dark liquidity are emerging from the shadows, seeking to obtain fully fledged exchange status and in doing so, completing a circle from secretive organisation to public entity.

From the perspective of this consultation, the central issue is to what extent such dark pools contribute to short termism in capital markets, particularly in the UK, and what, if any, the tenor of the regulatory response should be. We are of the view that the appropriate response is one of *supervision* rather than of *regulation*. It does not seem feasible, nor is it helpful, to seek to end dark pools of liquidity. Of greater importance, we would argue, is maintaining a watching brief of such areas of activity with a view to tackling perverse market trends as and when they occur.

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?**

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While the discussion document points helpfully to the reduction in total percentage terms of the "institutional investor" over the last decade, primarily to the benefit of the "Rest of the World" category, we believe it misses another fundamental trend which is the relative decline of listed equity in UK business as compared to the relative increase of the small and medium size enterprise (SME) and therefore private equity class of investor. These statistics are well documented elsewhere by the Department. The trend is an important one for two reasons. In the first place, there is considerable empirical evidence that a thriving SME sector is good for long-term economic success, both in terms of unleashing innovation, and in terms of creating new jobs. Secondly, private equity's business model is very different to traditional shareholder practice, both with regards to financial engineering and with regards to being outside the public domain. This changing aspect of the corporate landscape cannot be disregarded in policy formulation for a long-term focus for corporate Britain.

A widely held, but vaguely articulated unease exists around the perceived increasing incursion of non UK shareholders into long established UK corporations – this being most widely expressed around Kraft's recent acquisition, and subsequent partial dismantling of Cadbury's operations. At the centre of this unease is the ill-defined notion of "public interest". And this notion is itself predicated on the primacy of the shareholder perspective at the expense of any other stakeholder, of whom the major classes are the employees and pensioners (deferred, current, in-payment) of the affected organisation. We would be happy to contribute to a debate around the nature and specification of "the public interest", noting that very often in these instances it is associated with an historic perspective, i.e. the very 'long-term' with which this consultation is concerned.

The trend to short-termism in the equities market has been well documented with annual turn-over rates of the New York Stock Exchange increasing from 25% in the 1960s (Bogle, J. (2008). "Black Monday and Black Swans", Financial Analysts Journal, 64(2), 30-40) to over 100% in 2002 (Drew, M. (2009), "The Puzzle of Financial Accounting and Short-termism", Australian Accounting Review,19(4), 295-302).

Such short-term, opportunistic behaviour stands in sharp contrast to the role of institutional investors assumed by the so-called 'universal owner hypothesis' (Gjessing, O. and Syse, H. (2007), "Norwegian Petroleum Wealth and Universal Ownership", Corporate Governance: An International Review, 15, 427-437). The universal owner hypothesis assumes that the presence of a rational and informationally efficient capital market is misguided, and treats corporate governance, investor governance, and environmental and social issues as sources of information asymmetry in financial markets. Hawley, J.P. and Williams, A.T. (2007), "Universal Owners: Challenges and Opportunities", Corporate Governance: An International Review, 15 (3), 415-420, deploying the universal owner hypothesis posits that because large institutional '*shareowners'* own the majority of capital markets, what may be negative externalities for one company in the portfolio can be expected to have direct and often costly impacts on another holding. Because of their relative significance in capital markets, institutional owners such as pension funds and insurance companies cannot divest from developed companies without eroding share price on exit (Monks, R.A.G. and Minow, N. (2001), Corporate Governance, 2nd Ed.,

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Blackwell). As a result, today's institutional investors *must* be concerned about the long-term governance standards and operational strategies of the firms they hold in their portfolios.

It is well-documented in the scholarly literature that institutional investors and companies alike have various obstacles for long term strategies, including short-termism generated by intermediary contracts structured on volume of investment trades rather than on predetermined rates of remuneration, a gravitation towards defensive decisions, and general reluctance to integrate long-term considerations into core operational processes.

Fiduciary obligation of financial institutions has, perhaps in consequence, become a matter of intent rather than of display. A pension executive's fiduciary obligation to the beneficiaries of a particular scheme of arrangement is interpreted as long-term and permitted as short-term (Austin, R.P. (1989), "The Role and Responsibilities of Trustees in Pension Plan Trusts", In T.G. Youdan (Ed.), Equity, Fiduciaries and Trusts (111 at 126), Toronto: Carswell). Fiduciary obligation is long-term in the sense that the length of a time taken for a salaried employee-cum-plan member to realise accrued benefits is between twenty and forty-five years. Fiduciary obligation in practice is the short-term necessity of ensuring the trustee has sufficient cash inflows to cover its immediate pension payments. The latter requirement is furthered by the high degree of short-termism in capital markets (Laverty, K. J. (1996), "Economic "short-termism": The Debate, The Unresolved Issues, and the Implications for Management Practice and Research", The Academy of Management Review, 21(3), 825-860).

Further, several countries, including the Netherlands, UK, and Australia, have created markets of commercially competitive fiduciary management that bear little relation with the economic and social interests of members.

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

Clark, G.L. and Hebb T. (2004), "Pension Fund Corporate Engagement. The Fifth Stage of Capitalism", Relations Industrielles/Industrial Relations, 59(1), 142-171, and Hebb T. (2008), "No Small Change: Pension Funds and Corporate Engagement", Cornell University Press, Ithaca, New York, have connected shareholder engagement with financial reporting by bracketing the two as the principal forms of financial governance. Shareholder engagement describes the ways private equity investors and managers of well-diversified portfolios (such as held by pension funds) communicate with their companies. Typically, dialogue and shareholder resolutions are used to target specific environmental, social, and governance issues in order to raise corporate standards and achieve favourable levels of portfolio risk. There has been recent comment in the scholarly literature that engagement practices allow for risk reduction in the portfolio over time.

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The starting point for engagement practices is the financial report and management discussion thereof. Public engagement practices (e.g., raising shareholder resolutions at corporate AGMs) are muted in the UK if compared with the level of that type of activity in the US. The alternative, being behind-the-scenes consultations to discuss long-term company strategies relative to company financial results, is more common.

Perhaps the prevalence of shareholder engagement practices, as defined, may be used to argue for policy measures requiring financial institutions to show how they take long-term considerations into account?

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

Yes. Short-termism in equity markets is a problem. The consultation refers in paragraph 4.26 to the plight of the pension fund trustee, and dwelling on this role for a short time may be instructive as to how the problem may be addressed.

The pension fund trustee is required to pay attention to three categories of member, namely those currently active in contributing to the scheme; those who have left the employ of the sponsor but look forward to a deferred pension; and those who are currently in payment as pensioners. In all cases the trustee must seek to balance the interests of all three categories, whose proportions will vary significantly from scheme to scheme. Overall the scheme will be required to meet the liabilities of these categories over a time horizon decades into the future.

The trustees are hampered in their discharge of this duty by, among other things:-

- A pensions regulator who requires a “recovery plan” which should be ideally less than 10 years in duration, and be front end loaded
- The thrice yearly assessment of the strength of the employer covenant, i.e. the ability and willingness of the employer to meet future liabilities as and when they fall due, in theory over the life of the scheme, but where practical advice rarely looks out beyond three years of future employer cash flows
- An accounting standard (FRS 17/IAS 19) which requires that a scheme’s surplus or deficit is calculated by comparing the current market valuation of assets to the future discounted liabilities of pension obligations where the discount rate is an unknowable and therefore arbitrary “risk free” rate
- Information from investment managers which, despite protestations to the effect that historic performance is no indicator of future performance, is saturated with historic short term data
- The choice between relatively high, relatively opaque charging structures from actively managed fund managers or low charging structures from herd-behaviour-driven index trackers

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- Considerable information asymmetry between the trustees, their advisors, investors, custodians and fund managers

From the above, we would suggest there is an urgent need to counterbalance the obsession with the regulatory and practical languages of the short-term, as well as reform of the charging structures currently widely used in the investor world.

Emerging research on the use of company environmental reports by financial institutions has found investor demand for policy measures that provide an appropriate mix of short-term and long-term environmental performance targets; robust market-based practices; and the requirement for disclosure of relevant environmental information on a standardised disclosure platform (see, DEFRA[1]).

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?

We have suggested elsewhere – in our response to the consultation on narrative reporting - that much more needs to be done to encourage directors to articulate their business model, both as it currently exists, but also as stress tested in the context of a long-term, carbon and resource constrained future. We firmly believe this adds value to the organisation as well as alerting directors and shareholders to the risks and opportunities facing their organisation, and their mitigation or exploitation.

We would also support any encouragement for investors to interrogate the corporations they invest in as to the long term durability of their business model, including pressing them on sector-wide, apparently perverse micro economic trends, for example rapid accumulations of intangible assets with no evidence of systematic impairment testing, or cumulative declarations of profit ahead of cumulative generation of cash flow surpluses.

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

It is widely accepted that there is a disclosure gap. Asset Managers do not disclose on their fund fact sheets and annual reports the remuneration details of individual fund managers

For Investment Companies with Variable Capital (ICVCs), and similar, the total annual remuneration of the individual fund manager should be disclosed; not just of that ICVC but of all funds they manage for the Asset Manager. If there are concerns about individuals' confidentiality (there should not be as Company Directors are obliged to disclose similar details) then details of the amount paid to the investment manager from that ICVC should be disclosed within a banded report of amounts paid to all individual invest managers employed by the asset management business.

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A similar approach should apply to pension funds.

What would the benefits be? Proportionate pay for fund managers as there would be a temporary outflow of funds to Exchange Traded Funds until management fees and remuneration fell to reasonable performance-related levels (remuneration being based on relative rather than absolute performance)

Directors' Remuneration

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

This section of the document would benefit from greater clarification and focus. The statistics quoted in 5.4 to 5.7 should be well known by now, and in our view are clearly unacceptable. However, three points should be made. The first is that they relate solely to the CEO role, not to other members of the board. The Manifest evidence shows elsewhere that other roles on the board have not increased at anywhere like the same rate as that of the CEO. The second point to make is that the CEO role in non-listed, non FTSE companies, i.e. the majority of the UK's corporate stock, is not analysed here. Thirdly in many FTSE corporations the number of staff designated as "director" has increased significantly over the last decade. Yet the actual remuneration of directors disclosed in financial statements is only that small subset who constitute the commonly called 'main board'. There are research opportunities to investigate the latter two points, and we would be happy to work with the Department in this area. The 'cult of the CEO' needs closer attention, since it is a disturbing trend of recent years.

In our opinion the cult has come about precisely as the long term stability of the board has been eroded. Only twenty years ago, one was accustomed to view an effective board as a series of complementary roles – finance, marketing, technical, HR etc. – led by a Managing Director who enjoyed a relatively modest remuneration differential compared to the other members. In the non FTSE corporate sector, this mode of organisation remains common. What appears to have happened, partly as a result of following evolving corporate government guidelines, is a trend to half or more of the board comprising non-executive directors with fixed terms of appointment; an increasingly brief tenure of the CEO in that role; and an apparent dispensation that the Chairman of a FTSE corporation may chair more than one FTSE company. The latter implies, a) the Chairman's role is not full time, b) there are not enough suitable candidates to be considered as Chairman!

If all had been well at the boards of FTSE corporations over the last three years then perhaps these observations would not be of great importance. However, in the wake of a major banking crisis, and subsequent widespread economic recession we would argue that they are important, and should be at the heart of the UK's 'comply or explain' corporate governance code. We would particularly welcome a review of governance codes in use internationally, or of world

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class importance, such as the King 3 guidelines emanating from South Africa, with a view to learning from the best of them. Within the UK we would encourage study and evaluation of non-conventional forms of ownership and governance as exists, for example, at the consulting engineers, Arup, or the John Lewis Partnership.

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

It appears to us that another unintended consequence of corporate governance evolution in the UK is that membership of the remuneration committee is moving towards being comprised solely of non-executive directors. In a successful organisation there will be a performance appraisal scheme in place which will draw on a diverse range of information to eventually establish an individual's overall remuneration for every role apart from that of main board director. Widening the membership of the committee is likely to be a necessary but not sufficient step in improving the quality of remuneration setting for board members. What is most important is achieving the difficult balance between professional, independent advice, locked into long term stretch targets against levels of remuneration which are not excessive. One way to obtain that advice is by a transparent tendering exercise by the remuneration committee for a fixed term appointment of a remuneration advisor. This might be made the subject of express shareholder approval.

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?

A great deal of media coverage follows shareholder resolutions over pay, however the Manifest, and other data included at 5.4 to 5.7 of this consultation indicates only limited success, certainly in restraining CEO remuneration levels, either absolutely or over time, or when compared to other EU jurisdictions. We would suggest curbing CEO levels of remuneration should be an urgent first step before seeking to address other areas of pay.

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

linkage between pay and meeting corporate objectives

If the emphasis is on *long-term* corporate objectives we believe the impact would be beneficial in achieving a long term focus for corporate Britain

performance criteria for annual bonus schemes

If the criteria for the award of an annual bonus is clearly set down and the criteria are widely applied throughout the organisation, and the year on year increase as a percentage is on a par with

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the rest of the workforce and with increase in shareholder value, we believe the overall impact may be beneficial. We are not persuaded of any causal link between the general offer of an annual bonus, and achievement of the corporation's long-term strategic goals.

We would recommend that annual bonuses are only distributed when free cash flow is generated, not necessarily when profits are declared.

relationship between directors' pay and employees' pay?

The differential between pay as a multiplier has become of interest in recent years, partly driven by the obscene multipliers noted in the US investment banking sector. However, we would counsel caution in the calculation and the use to which such differentials are put. For instance, the juxtaposition of CEO remuneration against the lowest paid member of staff is of limited value. With current reporting disclosure it is perfectly possible to calculate highest paid director or main board *average* director remuneration against the *average* of all other staff within the corporation. It is difficult for us to see the incremental benefits over and above the cost of comparing one role – CEO – to that of another – lowest paid employee.

Takeovers

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?

As is noted in the consultation document, the academic evidence points to a relatively frequent *benefit* to the shareholders of the corporation being acquired, as compared to a relatively frequent *dis-benefit* to the shareholders of the acquiring corporation, so an invitation to vote on takeover bids would be a logical precautionary step to protect shareholder interests.

Other

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

Currently the examples of a long-term focus in corporate Britain are few and far between. They need to be drawn out and celebrated as a demonstration of what can be done, and of how valuable this can be to all stakeholders, not simply investors. We would be pleased to work with the Department for Business Innovation & Skills on such a programme.

Zingales, L. (2009), "The Future of Securities Regulation", University of Chicago Booth School of Business Research Paper No. 08-27; FEEM Working Paper No. 7. Available at SSRN: http://ssrn.com/abstract=1319648, calls for securities regulations that focus on corporate governance. Emerging research on the use of company environmental reports by financial

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institutions (see, DEFRA[1]) extends the call of Zingales by calling for policy measures that focus on the relationships between financial institutions and the companies that they invest in. This research finds that effective policy prescriptions will be those that (i) recognise that investment behaviour is shaped by intermediated capital markets, and (ii) that distinguishes information items used by financial institutions which are firm-specific (such as company environmental programmes) and non-firm-specific (such as carbon prices and energy use subsidies).

The following four policy suggestions are expected to promote long-term focuses at the boards of companies and financial institutions:

- A legal reconceptualisation of fiduciary requirements that connects asset value and portfolio exposure to environmental and regulatory risks.
- Requirement for financial institutions to disclose the adjudged effects of their companies' exposures to environmental risk on their own levels of portfolio risk.
- Requirement to demonstrate the deployment of environmental considerations in organizational articles of association, and insertion of the same as a contractual requirement for service providers and investment intermediaries.
- Requirement for professional education programs as delivered to company directors, investment analysts, fund managers, and fiduciaries to cover environmental, social and long-term governance risks.

Finally, we note that the addressee of this response is different to the earlier addressee of the Department of Business Innovation and Skills' consultation on the future of narrative reporting. There are clearly a range of interconnected themes and issues between these two important projects and we would hope that their results are considered together and thoroughly integrated in the formulation of future policy and regulation.

[1] DEFRA: 'Investor Demand For Corporate Sustainability Reporting' (report for the UK Department for Environment, Food and Rural Affairs, 2010): 86 pp.
Extracts of this report were include in the report 'The contribution that reporting of greenhouse gas emissions makes to the UK meeting its climate change objectives: a review of the current evidence' (Report presented to Parliament pursuant to section 84 of the Climate Change Act 2008), November 2010: 67 pp. (available)
http://www.defra.gov.uk/environment/business/reporting/pdf/corporate-reporting101130.pdf.

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We hope that you find this response helpful. If you require further clarification of any of the points raised above please do not hesitate to contact one of the signatories below.

Yours sincerely

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