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3 November, 2010

Reference Consultation on "A Long Term Focus for Corporate Britain"

Dear Mr Gray,

I wish to submit some personal comments on the above consultation. This is based on my activities as a private investor over many years in which I have managed a largish portfolio of listed shares (indeed some might see me as a professional investor). In addition, I have experience of investment in unquoted companies, and of being a director of both unquoted and quoted companies. My comments in response to specific questions are as follows, with some more general comments at the end:

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

I suggest they generally do not, with a few exceptions. Boards tend to be driven by the demands of their major shareholders (primarily institutions), for consistent short and medium term performance. This discourages strategies that involve short term investment (whether it be in fixed assets, or people) for longer term returns. This is particularly the case for executive directors who tend to have performance based incentive pay packages that only pay out over a relatively short time period. The situation has become much worse in recent years when performance related pay has become a much larger element of total remuneration for directors.

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?

In summary, my answer would be no, the legal framework obstructs companies from knowing who their shareholders are and communicating with them. The big problem is that almost all shareholders now hold their shares in nominee accounts, whether they are institutions or individuals. The beneficial owners are concealed, in some cases by a whole chain of intermediate nominees, trusts, asset managers, etc. Although the Companies Act gives companies the right to demand to know the beneficial owners, this is a time consuming procedure and tends to only be used to identify major holdings (if a holding is split via different intermediaries, it may not even be obvious that there is a common holding). The situation has become more complex over the years as holdings have diversified and foreign ownership has grown. A particular problem is that when takeovers, or other major events, are impacting a company, the share register can change enormously quickly due to the activities of hedge funds and banks investment departments. With stock lending, and short selling also taking place, the share register hardly keeps up with the true position, and the identification of the beneficial owners is in reality almost impossible. The legal framework was devised when share registers were relatively stable and paper based systems predominated. Even the new Companies Act was not updated to reflect the speed of trading and the massive flows of capital through electronic trading systems that now take place. Regrettably the Companies Act provisions seem to have been devised by lawyers who seem to have little understanding the realities of modern investment and share trading practices, and the only way to solve this would be to completely rethink the basis of share registration, ownership identification and shareholder communication.

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

The implications for shareholder engagement and a commitment to a longer term focus for investment as a result of changes in share ownership over the last few years have been totally negative.

More shares are now held by institutions, who have no sense of "ownership" in their investments as many will be simply managing them on their clients behalf (and even they may not be beneficial owners). Indeed many institutional holders will be managing index tracking funds where they take no decisions about the strategy of a company, but simply buy or sell shares depending on stock market trends. Institutions will often have a short term focus because the fund managers are judged on short term criteria – often only a year or two.

The growth of foreign investment in the UK market has also loosened the sense of ownership by investors. Absentee landlords are never as closely connected to their investments as local ones.

The decline of individual investors, who may take a longer term view, and certainly have a clearer ownership position, is detrimental to sound corporate governance and the long term health of equity markets. This has been brought about by a number of factors, which include:

A – Tax incentives and government regulations that have encouraged indirect investment and "collective investment vehicles". For example the tax benefits of ISAs and pension schemes which must be managed by a financial institution (why this is so, I have no idea, because there is no good reason why an individual could not comply with the law, but obviously institutions have been very good at selling their involvement to the Government when new legislation has been established).

B – Over protection by Government regulation, which has discouraged direct investment as it is seen to be more risky than having professionals manage it.

The widespread use of nominee accounts for all investors (but particularly so for private investors) has meant they have lost any sense of "ownership" of the companies they invest in. Most investors in nominee accounts don't get any information from the company, do not get invited to the Annual General Meeting (indeed cannot attend), do not get any clear statement of their ownership (by being issued with a share certificate), and in other ways have lost touch with the management of the companies in which they invest. The new Companies Act did not solve this problem.

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

The most effective form of engagement is undoubtedly face-to-face meetings with investors. That applies whether it is the traditional "analyst meeting" for institutional investors, or the Annual General Meeting. It is unfortunate that the AGM has become rather an archaic forum, rarely attended by institutional investors, and by a small minority of private investors (those not in nominee accounts). It really needs revitalizing. The increase in the geographic spread of investors has tended to make all meetings in London (or other UK cities) more problematic.

Some companies do provide telephone conference calls and live video events for investors (although many exclude private individuals or only advise a select few of such events), but there is a marked reluctance to use modern technology to involve investors.

Medium to smaller companies tend not to bother at all, partly because their advisors seem paranoid about directors speaking out of turn or saying the wrong thing.

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

I cannot comment on that question.

Question 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?

Voting is enormously important, but the low voting turnout for most companies (even on contentious issues) is a major problem. This is partly because of the nominee chains which obstruct voting, and partly because the logistics of voting are often complicated. Many nominee shareholders are simply not "enfranchised". Those who do have direct voting rights depend on paper voting forms (which from my experience the registrars often lose even if you send them in), or on Crest instructions which are not simple (may have to be done by a third party).

Obviously there are concerns that sometimes votes are not cast when they should be, for example by pension fund managers when the beneficial owners would like them to be. It is also often the case that votes are cast without any considered thought at all. Most resolutions are passed with 99% or more in favour so it is clear that hardly anybody looks at the background or performance of individual directors when voting to re-elect them. Likewise auditors are routinely re-elected, remuneration votes go through with few opposed and share buy-backs are routinely authorized when informed commentators have warned repeatedly against them. Most shareholders seem to lack any confidence in their own judgment, or are unwilling to contradict the board's recommendations. How to turn brain-dead investors into informed voters is a good question, to which I don't have any short answer. But clearly one problem is the size of portfolios, the time it takes to consider the issues, and the reluctance of investors to vote against board recommendations (based on a feeling that they might be excluded from information provision in future, as has happened in the past).

I feel that disclosing voting would impose a large administrative overhead, and it would not necessarily solve the complaints about what happens. It might make it even more difficult for fund managers to take a "contrary" stance if they know their position is going to be publicly disclosed. Their reluctance would not arise if they were the "owners", but those who are bureaucrats never want to risk putting their heads above the parapet of bland anonymity.

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

It is undoubtedly the case that shareholdings are being held for shorter periods. This is partly driven by technology (faster, easier and lower cost trading), but also the increased emphasis on short term speculation rather than long term investment. Whether this is a good or bad thing is debatable. There are sound theoretical arguments that more trading means more market liquidity, and hence more realistic prices. It may result in the more efficient reallocation of scare resources if share prices more rapidly reflect perceived events.

That of course is true of shares traded on the main UK market (FTSE shares) where liquidity has grown over the years, but is in fact absolutely untrue of small-cap and AIM shares where liquidity is a major problem.

I do not believe that there should be a general attack on short term trading. Many experienced investors like myself may have substantial long term holdings, but we also hold some shares for shorter periods (not necessarily because of choice – sometimes companies get taken over soon after we have acquired shares in them, often against our wishes). It would be wrong to penalize short term holdings versus long term ones, for events that might be outside the investors control.

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?

I would be opposed to any moves to reduce liquidity (by for example transaction based taxes) although I suggest that "short selling" and the "stock lending" that often supports it should be examined to try to reduce market speculation.

Obviously another approach that might be considered is taxing short term gains more highly, and longer term gains less. This might have some impact on individual investors, but probably not on institutions who could easily avoid short term taxes, if they pay them at all. In general I would prefer to see a capital gains tax regime that does not tax inflation based gains, rather than one that differentiates between holding periods.

As explained above in my answer to the previous question, there may be substantial economic disadvantages in discouraging short term trading or penalizing it.

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

There are undoubtedly "agency problems". But how to tackle them is a major question. I think the discouragement of nominee accounts and the discouragement of multiple layers of investment management between the beneficial owners and the nominal shareholders would be major steps in the right direction. That could be achieved by appropriate legislation and tax incentives or disincentives. But it would require much more significant changes than the recent attempts to improve corporate governance and shareholder engagement which have been simply "tinkering" with minor aspects and which are not likely to have a major impact.

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

Certainly more transparency would assist. For example, the amount of share turnover fund managers exhibit, and the associated costs, is not disclosed at present to the investors in funds. I see no objections to disclosure of mandates and pay either, but I am not sure such disclosures will have any major impacts.

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

The main reason for the growth in directors' remuneration is undoubtedly because board directors control their own pay to a large extent, and there is no real open market for their services. Remuneration committees are not independent, being appointed by the board themselves, and the members may well sit on other boards where their pay might be influenced by comparability issues. In addition, the old puritan ethic of fair pay for a fair days work has been overthrown by society in general where pay is seen to be an object of how much you can charge in any given market – I don't see that changing soon. Also the increase in "incentive" schemes which are great in theory but introduce lack of strict comparability. Such schemes are also open to manipulation, and general obfuscation. Incentive pay schemes do not obviously incentivize large company directors to work harder in any case.

Clearly board directors pay is not under the control of shareholders as it should be. There are two things that should be changed to fix this:

A – Remuneration Committees should not consist of board members, but be directly nominated and elected by shareholders. I would even accept that employees of the company might have some say in the appointment of the Remuneration Committee also.

B – Remuneration resolutions should be binding (for the next year in advance, with a few exceptions), rather than being advisory.

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

Not much unless the proposal to have a completely independent remuneration committee mentioned above is accepted.

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?

No, for the reasons mentioned above. The lack of true shareholder democracy, the problem of nominee holdings, and the fragmentation of investors' holdings, make it very difficult for shareholders to have effective control over directors pay. In any case, institutional investors have low motivations to control shareholders pay – they tend to be on the same gravy-train as the directors.

But I would be opposed to controlling pay by legislation or taxation. There may be room for improved "corporate governance" guidelines on such matters. For example, to stop short term performance based schemes, and reducing performance pay as an overall element of overall pay.

Question 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?

Greater transparency is always a good thing, but remuneration reports are already so complex on larger companies that most investors, and particularly institutional ones, probably only have time to skim them at best. I see no great merit in these proposals, particularly if the means via which shareholders can control pay are so ineffective.

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

I think boards are usually well aware of the possible long term implications of takeovers (both buyers and sellers). Shareholders of bidding companies may not be as aware as they might be of the general failure to realize potential gains from mergers, although clearly some takeovers can be very successful. Many others end in disappointment however for reasons I do not have space to go into.

Regrettably it is often in the interests of the directors of a bidder to undertake such mergers or takeovers – their empires grow and their pay accordingly. So we have the "agency" problem here again.

Shareholders in selling companies tend to accept a financial offer that is advantageous in the short term simply because "a bird in the hand is worth two in the bush". I see no reason to dissuade them from such behavior so long as they are making a rational choice based on all the facts – and a cash offer is usually a simple one. Share offers and mergers are more problematic of course.

I think there are generally no problems with the communication of information on bids to the target shareholders, and few problems to the bidders shareholders either, although the latter tend to optimistic about the reasons for the bid for the reasons given above.

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?

I do not see that this would be justifiable for all takeover bids. Clearly some takeovers are very small in size in relation to that of the bidding company, so the financial risk to the bidder's shareholders is small. However, where the target is a substantial size in relation to that of the bidder, then shareholder approval should be required.

General Comments

I suggest there are two big issues that need to be tackled. Solving the problems associated with them would fix most of the problems raised in the consultation document:

A – The problem of nominee shareholders which undermines the sense of "ownership" by shareholders, undermines voting and shareholder democracy in general, and obstructs good corporate governance.

B – The question of how to control directors' pay which currently provides poor incentives to good management. Instead of a dedication to professional management and good stewardship of a company, directors are focused on short term personal enrichment. Only by giving control of director's pay to shareholders can this be solved.

Tinkering with corporate governance codes will not solve the stated problems. More revolutionary changes to UK Company Law are required. Regrettably many of these changes are likely to be opposed by some sectors of the financial community, because of their own vested interests. But the trends that have been identified in the consultation document are likely to continue, and hence will make matters worse unless some political commitment is made to implement a thorough overhaul of some aspects of UK company legislation and market practice.

Yours sincerely

Roger W. Lawson