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
X	**Non governmental organisation (NGO)**
	Trade Union

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

The Board of Directors

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

Comments

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

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

The increasing share of international investors' ownership in UK markets and companies, as well as the significant international holdings of UK investors, highlight the fact that the UK must not act in isolation. The UK Stewardship Code is an important step forward, and it is crucial that the UK engage proactively within Europe and globally to achieve high standards of stewardship and engagement, as well as the high levels of corporate transparency that facilitate this.

The increasingly rapid turnover of share-holdings, as described in the consultation document, does have implications for corporate governance in the UK. There is already a well-recognised problem of short-term pressure for institutional investors to generate returns, and consequent pressure from those investors on companies to deliver high performance in the short term. This was clearly identified in the 2001 Myners Review referenced in the consultation document.

Evidence from research conducted by Mercer and Trucost for WWF has shown that this short-termism is a significant barrier to consideration of climate change-related factors in particular as a long term issue for investment decisions.

The 2009 "Carbon Risks in UK Equity Funds", published by Trucost with WWF-UK and Mercer, contains evidence of investors' use of climate change disclosures. Mercer undertook interviews with a range of fund managers including many of the biggest in the UK (perhaps a more representative sample of the mainstream than some other sources cited in the literature review).

The survey found that managers did not include climate change factors such as GHG emissions in their investment process. The primary reasons given by investors were:

- Lack of expectation that governments would achieve their carbon targets or establish a global carbon price
- Short-term pressures to generate returns
- And the lack of standardised reporting frameworks to deliver comparable, accurate, reliable data on company emissions.

The report found that the perceived barriers were greater than the reality in some areas, and that the wait-and-see approach from investors could expose pension funds to future financial risk and result in missed opportunities to position to benefit in a low carbon economy.

This report also found that carbon exposure among pension fund portfolios is considerable and that mandatory corporate GHG reporting could help to improve investors' willingness and ability to manage that risk.

This problem is exacerbated by the decrease in the average period of time for

which stocks are held, which has been accompanied by a rise in the volume of trading activity and the volatility of financial markets.

In addition the growth in the use on institutional investors and other intermediaries has added significantly to the length and complexity of the investment chain. This has raised difficulties in terms of agency and accountability, with individuals feeling that their ability to influence is diminished and many fund managers feeling that they need only deliver (largely short-term) returns to satisfy internal performance criteria, rather than delivering the kind of transparency and accessibility that would allow beneficiaries to engage more and influence how their pension funds and fund managers behave as engaged owners and long term investors.

Addressing this deficit ultimately will need individuals to be better informed and more engaged and institutional investors to be more transparent, accountable and responsive.

The short-term incentives and targets of many institutional investors may not be a good match to the long-term investment needs of ultimate beneficiaries such as pension holders and insurers. So, increased attention to long-term value may help to align investment practices more closely with customers' needs and wants, as well as aligning the allocation of capital more closely with the long term requirements of today's urgent and capital intensive infrastructure priorities, for instance for a low carbon energy transition.

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

Comments
Shareholders, institutional investors, and other stakeholders have a number of engagement tools available to them ranging from private meetings and investor briefings, right through to shareholder resolutions and public engagement via the media. This diversity of engagement tools is important in itself and it is important that it is maintained and reinforced. Private and technical meetings with analysts are extremely important, but it is also vital that smaller, less well resourced and individual investors are able to access key information about companies' performance and strategy. This means that public disclosure and transparency are crucial. Shareholder resolutions can be a valuable tool to focus attention of questions of crucial significance, especially in areas where investors are not fully satisfied with the outcomes of other engagement efforts. In the UK, such resolutions are used much less frequently than in the US. As a result, there is a certain amount of stigma attached to them and they are viewed as something of a 'nuclear' option. Anecdotally, there is a feeling that this reluctance may be reinforced by the concern that investors who are seen to be 'awkward' may not retain access the level of face-to-face and private communication that might otherwise be expected. Shareholder resolutions can be instrumental in raising the profile of important strategic and operational issues and securing engagement at board and senior executive level. They can also be effective in bringing additional information into the public domain – allowing investors to make a better assessment of the board's analysis and management of key decisions, risks and opportunities. This has been the case in 2010 with the resolutions at both BP and Shell AGMs, which generated new information, increased awareness, and greatly enhanced dialogue on the risks associated with highly polluting tar sands extraction and processing parts of their business. The difficulty and cost of tabling shareholder resolutions can be very great and is a significant obstacle. Measures to simplify and facilitate the process would be beneficial.

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

Comments
In discussions with investment firms there is evidence that in some companies the different functions do engage, but in the course of shareholder resolutions at BP and Shell in 2010, anecdotal evidence suggested that there was some weakness in engagement due to a gap between the knowledge and interaction of sustainability of ESG analysts and financial analysts. So, for example, BP's crucial projections for oil production and revenues based on a particular energy demand scenario were accepted by financial analysts. But they were almost certainly unaware of the fact the scenario used implies no more action to combat climate change and shift to low carbon energy and a potential temperature rise of 6 degrees Celsius by 2100 – and that the scenario in question is explicitly acknowledged by its authors (the International Energy Agency) to be neither intended nor suitable as a basis for future strategies. If such a scenario were manifested it would decimate the global economy (and, by extension, cause a collapse in the value of investors' assets) and render the associated financial projections meaningless. When discussing the relationship between environmental risks and their financial and strategic implications, there was a feeling among some stakeholders that companies were able to take advantage of the fact that many fund managers and analysts were not well placed to engage them simultaneously on the technical details and relationship between these key areas.

<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
See comments above in question 4 on shareholder resolutions. Voting, on resolutions and other votes, is a vital part of the engagement process. As noted above, it often appears that investors in the UK are more reluctant than their US counterparts to use this form of engagement. Transparency around voting is very important. Individual investors need to know how those who manage their investments are voting on their behalf. Public disclosure of voting decisions can provide significant additional benefits: it could enhance competition by providing consumers with the

information to decide which managers are performing best or most in accordance with their interests and priorities. It can also help to counteract the secrecy and opacity that surrounds these practices at present, encouraging individual investors to assert their rights and institutional investors to respond with enhanced standards of engagement and communication.

The barriers to public disclosure of voting records appear not to be very great in terms of cost or administrative burden, and the benefits would be substantial. For this reason we believe high levels of public disclosure should be established throughout the investment chain from fund managers, to pension funds, and to individual investors.

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

Comments
See response to Question 3, for comments on short-termism and reference to the Trucost report, *"Carbon Risks in UK Equity Funds"*. As explained throughout this response, increased transparency and accountability throughout the investment chain could facilitate long term investors to engage with those who manage their assets and make choices about different providers and products in the market that support their long term outlook. Many asset owners like pension savers have a clear and inherent long term outlook, but the intermediaries who act on their behalf are frequently incentivised to seek short term gains to maximise their own income, potentially at the expense of asset owners. Reforms should aim to remove such mismatched incentives and transparency will be key to that process.

<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
Greater transparency, especially in terms of how companies link historic and current performance to key strategic objectives and principle risks (including environmental, social and governance risks) and opportunities, is important in facilitating a longer term outlook in investment decision making. Investors need this information to be of high quality if they are to be able to use it to decide on share acquisitions that will be held for long periods. Too many companies are making a large number of generic 'boiler plate' disclosures about a large number of risks; whereas the type of information that is required is a more detailed and decision-useful range of information about a select range of key risks, combined with contextual information to clarify the choices made about which risk factors are highlighted. With regard to environmental factors, climate change provides a clear example of an issue that presents great risks and opportunities for business. Companies are reporting more information about their carbon emissions and the strategies for dealing with the effects of climate change and a low carbon economy. However, the level of detail provided is often insufficient for a real analysis of the risks (especially in the long term). Furthermore, information

about specific impacts or targets is often seriously out of step with forward-looking strategic information relating to the same issues, which in turn can be inconsistent across various reports and communications.

Investors should be using this information to challenge directors, and we believe that investors need more information particularly in connection with environmental and social issues. For example BP lost 50% of its stock market value in 2010 and investors also lost out in terms of dividend. Were investors fully aware of the potential risks? More and deeper engagement with institutional investors in particular improves investors' ability to assess risk and opportunities and enhances their ability to influence the strategy of companies to manage those risks and opportunities.

Company reporting need not provide all of the information needed to make a full assessment of the likely success of the business in the future. However, it must at a minimum provide shareholders with sufficient information to identify key issues of concern in order that they can conduct their own analysis and press directors and management on their strategy and processes. This minimum standard is not currently being met.

One example of this is the recent 2010 shareholder resolutions on tar sands at BP and Shell. In this case significant investor action and direct engagement was required even to gain access to the basic information about the basis of investment decisions and assumptions on key environmental and social risks, including carbon risk and the cost of cleaning up and restoring the local environment in areas disturbed by extraction and processing of bitumen. The disclosures that were made in response to the resolution revealed information about these businesses that should be available as a matter of course in company reports.

When pressed, companies often point to information that is provided elsewhere in other publications or on their websites. This information is frequently found to be confusingly presented, incomplete, inconsistent, and extremely difficult and time-consuming to locate. It is also largely unverified. This does not facilitate investor or stakeholder engagement.

For more details on the resolutions and their significance in this context, see the report *"Toxic Fuels: Toxic Investments – why we need greenhouse gas reporting", WWF-UK and The Co-operative Bank, Insurance and Investments, 2010.*

A practical step the Government could take is to clarify investors' fiduciary duty obligations. These duties should be perfectly consistent with, and indeed require, a sustainable long term approach to delivering returns which includes consideration of environmental and social factors and their financial impacts. However, the reality is that many institutions take a very narrow view of fiduciary duty, invoking it to support a focus on short term returns and to rule

out innovative sustainability and other investment approaches. Clarification could help avoid such misinterpretation and mobilise fiduciary duty as a driver of sustainable long term investment practices.

Many individual investors and pension holders are concerned primarily with the long term financial performance of their investments – as a retirement fund, for example. They are often unaware of the way in which these investments are managed on their behalf. Initiatives that increase public understanding of finance and investment practices and awareness of their rights and responsibilities as a shareholder, combined with better communication (reporting) from investment managers and pension funds to their clients on their investment policies and priorities has the potential to allow better alignment of these priorities.

This notwithstanding, it is not simply longer term holding periods that are important. It is at least as important that investors are incentivised and enabled to take a long term view on the ability of individual companies or financial products to deliver returns over the long term, and to allocate their assets under management accordingly. An example of this might be that the right framework of low carbon incentives and regulations can provide assurance to investors of a secure rate of return on investments in renewable energy infrastructure and technology now and long into the future.

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

Comments
See above responses.

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

Comments

Directors' Remuneration

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

Comments

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

Comments

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

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?**

Comments

Takeovers

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

Comments

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

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

Comments
UK business has a crucial role to play in achieving and inspiring sustainable development – in the UK, the EU and across the world. A major and urgent transition is required to build a green economy that operates within the planet's capacity to replenish renewable resources, absorb pollution and waste, and maintain levels of biodiversity required for ecosystems to function. Governments have the responsibility to create a policy environment that ensures markets and individual companies have the right incentives to drive efficiency, long-term value, sustainable use of resources, and investment in natural assets. Currently, too many market signals are pointing the other way, causing short-termism in investment and business decision making. This in turn is having severe environmental, economic and social consequences. In taking a long-term view, the Government should take full consideration of scientific assessments of the environmental impact of business-as-usual and short-term thinking, and the risks that this poses to business and society at large. This policy agenda represents a huge opportunity to harness the power and innovation of the private sector to create solutions for people and planet – now and in the future.