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:

Adam Gray
Long-term Focus Consultation
Corporate Law and Governance
Department for Business, Innovation and Skills
1 Victoria Street
London
SW1H 0ET

Name: Kate Jalbert

Organisation (if applicable): The Quoted Companies Alliance

Address: 6 Kinghorn Street, London, EC1A 7HW

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

	Quoted company
	Other company
	Investor or investment manager
x	**Business representative organisation**
	Investor representative organisation
	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
We have addressed this question in our covering letter.

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
Yes. The UK shareholder identification model – Part 22 Information about interests in a company's shares of the Companies Act 2006 – which is typically referred to as s793 (but which actually relies to a large extent for its effectiveness on the supporting legislation in the rest of that part) provides the most comprehensive solution in global markets to the problem of beneficial shareowner identification. We believe that it is imperative in the interests of UK companies that the Government takes steps to ensure that this class-leading regime is not watered down as an unintended consequence of otherwise well-intentioned European legislative activity.

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
There has been a shift over the past period towards UK pension funds holding fewer UK equities. At the same time long-term foreign investors, including sovereign wealth funds, have increased their size and exposure to UK equities. Other developments have included increased short-term holding of UK equities by hedge-funds, high frequency traders and similar. We would note that amongst the small and mid-cap sector these phenomena have been less pronounced than in the FTSE 100, in particular because of less liquidity. What has been relatively unchanging throughout these developments – and an issue that is not fully resolved by the Stewardship Code – is that the fund managers who are appointed by the long-term owners are frequently rewarded and remunerated by short-term measures,

frequently of no more than a year's duration.

One change that has not happened is that the long-term beneficial owners have not remedied the reward structure of the fund management industry that is meant to serve them. We believe that as a minimum the pension funds and other long-term owners of assets should explain the principles behind the remuneration that they have agreed, in particular explaining the time period over which performance is measured, the performance measures used and why they align the fund manager with the beneficial owner and how much of their own wealth is invested in their funds.

Many fund managers engage in trading rather than long-term strategies. Such strategies can move wealth away from the underlying owners and into brokerages via transaction charges, the spread in prices and to the Government via Stamp Duty. As well as disclosure on remuneration, fund managers should provide details on how their strategy is aligned to their clients' interests, in particular explaining how buying and selling strategies are tied into developing sustained, long-term value and managing risk and how the frictional costs of transactions are weighed up against these long-term goals.

It is key that fund managers are transparent about all of these issues in order to encourage a long-term focus.

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

Comments

Engagement, to be effective, is time and resource intensive because it requires detailed research, experienced staff and a longer term perspective in which to affect change. Those who have a shorter term perspective will not be interested in affecting change that can take years to come about.

If engagement was easy, everyone would be doing it. For engagement to be successful and therefore effective, one must identify companies at which there are issues on which to engage, develop an understanding of the issue, and then engage with the company to attempt to affect change. This may take a number of meetings with various board members together with associated correspondence, influencing other shareholders and other stakeholders and voting. Less effective forms of engagement can be limited in their scope and overly rely on voting and letter writing in response to actions of companies. These types of engagement tend to be less effective as they are reacting to what a company has done or is proposing rather than influencing boards proactively to make appropriate changes. One of the dangers of the Stewardship Code is that it is in danger of inadvertently encouraging this less effective form of engagement by focusing on voting rather than longer term, more painstaking, skilled and labour intensive engagement that aims to work over time to influence boards' direction of companies. Our belief is that this is the most effective form of engagement and the only type that is likely to bring about sustained increases in value to companies – which surely is the true measure of its effectiveness.

One important aspect of engagement which we believe is important is that, unless relations with the board have broken down, details of any engagement should be kept confidential between the board and those engaging. Whilst leaks to the media or elsewhere may act as a catalyst for progress over the shorter term, they will sour future relations as trust will be eroded.

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

Comments
This question cannot be answered “yes” or “no”. In the investment firms that merely play lip-service to governance and other long-term matters, there is frequently insufficient resource devoted to them. This compounds the other issues associated with power within investment firms: who is likely to be more powerful within the firm – the firm’s star fund manager or the governance individual or team? There may be some dialogue in these cases, but it may be fairly one way. For integration to work, engagement and voting decisions should be developed from a process that is designed to increase or protect value and manage the equity’s risk. From this approach, it is possible to integrate better the governance and investment teams of firms. An alternative approach is for the underlying beneficial owner to use an overlay service for engagement and voting, taking responsibility for it away from the fund managers. This approach can result in engagement and governance experts benefiting from aggregation of voting strength, which increases their power and concentrates resource so that duplication of effort and atomisation of resource does not take place.

<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
The cost of voting disclosure should be minimal. The chief benefit of vote disclosure is transparency and demonstration that the institution has voted. It is important however to note the caveats towards voting disclosure being viewed as particularly meaningful. It is a very quantitative measure. We are aware of serious, thoughtful investors who have engaged with QCA members to understand the issues, often obtaining assurances from the company about the future before casting their votes. This contrasted with fund managers who automatically vote in favour of the board or in favour of the recommendations of a proxy advisory service. From mere voting disclosure, it is impossible to understand the thought processes behind the voting nor the care taken or the contact that has taken place between the company and the voter. It is our belief that just voting in line with a proxy agency or in line with the board’s recommendation is not effective engagement. A conversation may be merely to obtain clarification on a point that has not been well disclosed. Engagement as a minimum must be concerned with affecting change. As a minimum, this can only be achieved by explaining the reasons for voting in a particular way. Most engagement will involve far more than this simple step, as it generally takes more than one conversation to make substantive change.

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

Comments
Please refer to our previous answer. We believe that the investment industry needs to be transformed by participants within it. Most notably long-term owners need to ensure that the fund managers that they appoint are aligned both philosophically and via the construction of their consideration to them. The sell-side analysts need to be more demonstrably independent from the companies about which they conduct research and from the trading activity of the banks which employ them. Issuers' boards need to be firmer on the importance of longer term perspectives. Those companies who have refused to provide quarterly results updates should be applauded. Whilst long-term beneficial owners may not constitute a majority of the shareholders of many companies, in most companies they could be a more influential voice. It is important that this voice is heard, rather than that of the fund managers over whom the owners do not exercise sufficient influence. Procedural changes, such as double voting rights for long term shareholders and voting rights only being granted after a period on the register of members, seem to us to be short cuts that carry the substantial risk of unintended consequences. Moreover, the measures would be likely to add cost and complexity to maintaining the register. Similarly, we would not advocate banning short-selling as it is a legitimate component of the market. What is important is disclosure, not just to the market; disclosure to the clients of those who embark on short-selling is key so that the clients are satisfied that such activity fulfils the mandate on which they were appointed. We also believe that the UK system could be used more to incentivise long-term investors. As stated in our covering letter, over the last few years, the tax incentives for long-term investors have been eroded. In our response to HM Treasury's and BIS's Business Finance Green Paper, *Financing a Private Sector Recovery*, we outlined a number of proposals, such as widening the Venture Capital Schemes (VCTs and EIS), reforming capital gains tax reliefs, eliminating Stamp Duty on shares and allowing exchange-regulated company shares to be included in ISAs. We have enclosed our response to the *Financing a Private Sector Recovery* paper and would draw your attention to pages 9 to 14.

<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

We refer to our previous answers: the most important action is for the long-term owners of companies to be more involved in ensuring that the rights and responsibilities of ownership are properly fulfilled. This should happen in accordance with their long-term interests and reflected better in the contracts that they have with their service providers, both the fund managers that they use and any governance and other overlay providers that they may choose.

The benefits would be to ensure that their funds are managed with a long-term perspective and that their fund managers are rewarded on a longer term horizon than the typical 12 month performance period used by fund managers. We would have thought that a minimum of three years would be appropriate.

We would further note that further alignment between fund managers and the beneficial owners might best be achieved by the fund managers having significant co-investment in the investments in which they are investing on behalf of their clients.

We believe a structure in which ownership is aligned with long-term performance, rather than assets under management is rewarded, should provide benefits without increased costs.

The performance fee structures that enable fund managers to take too much of any upside but no risk of downside, other than a reduction in the assets under management fee, seem to us to be flawed.

Moreover, any structure that permits churning of stocks at no cost to the fund manager seems to us to encourage short-term stock selection and a trading mentality rather than a long-term approach. We would suggest that all trading and other expenses must come from the assets under management fee and transparent reporting of the costs of the scheme should be available to clients. Again, such disclosure should enable better transparency and have the effect of increased competition and lower costs.

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

Comments

We have referred to many of these in our responses to previous questions. In summary they are:

- The fund management industry is frequently insufficiently aligned with their clients, the long-term owners themselves.
- The beneficiaries of the pension funds and insurance companies are a further step away – their interests are surely served by maximising long-term performance whilst minimising fee payments and managing risk effectively – a difficult combination but one that cannot be best served by a fund management industry that is rewarded on 12 month performance periods with no risk sharing through significant co-ownership or penalties as a result of under performance.
- Voting and engagement are not properly integrated into the fund managers' processes which in turn are not aligned as well as they should be to their clients.

As far as solutions are concerned, we would suggest:

- Greater transparency should be available to the underlying beneficiaries from the trustees of the pension schemes, concerning of how they manage the scheme in the

interests of the beneficiaries, taking account of ethical, environmental, social and governance issues (whilst respecting the necessary confidentiality of engagements). Owners might like to consider overlay services that specialise in these issues to develop coalitions of owners, aggregating their resources so that the resource is not atomised and voting strength may be aggregated.

- Such transparency should include better disclosure of fee structures, details of co-investment and other risk management measures.
- There should be better alignment of investment strategies, based on longer term considerations rather than trading outlooks.
- Fund managers should have longer term remuneration structures that reward longer term good performance and risk management rather that shorter term results.

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

Comments

We do not believe that the costs of greater disclosure either by the fund managers or by their clients would be significant. However, we see significant benefits in greater disclosure:

- Trustees and other agents of the beneficial owners would have a greater sense of different approaches in the market and could more readily assess what was available and what most readily fitted their longer term requirements; and

- Underlying beneficiaries would be able to challenge the trustees if they felt mandates were awarded that were not properly aligned.

We further believe that such transparency would help discussions between the board and its owners and their representatives, as it would assist the board in understanding better their register of members.

Directors' Remuneration

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

Comments

The data provided on pages 25 to 29 of the consultation document refer to FTSE 100 chief executive average remuneration. It is important that Government understands that the pay of directors of FTSE 100 companies is not representative of the rest of companies in corporate Britain.

Pay increases in Small Cap and AIM companies over the last 10 years have been modest. According to the Manifest/MM & K survey salary increases for Small Cap and AIM have averaged 5% per annum over the last 10 years. Total remuneration in Small Cap companies, is twice the level of salary, and in AIM companies is 1.5 times: this is significantly different to the FTSE 100, where total remuneration is nearly 4 times the level of salary and confirms that the levels of performance related pay in Small Cap and AIM companies is not excessive, nor have they grown disproportionately.

There is no evidence to suggest that pay levels, in general, in Small Cap and AIM companies are excessive. Nor has there been wide condemnation of pay in Small Cap and AIM companies: this is in sharp contrast to the amount of negative publicity about pay in FTSE 100 companies and in the large banks.

Turning to the question posed, with regard to process, the main reason for the increase in directors' remuneration is that remuneration committees have made awards to executive directors and shareholders have approved (in retrospect) such arrangements by the annual vote on the remuneration report and by voting on new long-term incentive plans. There is no requirement for AIM companies to vote on the remuneration report or new long term incentive plans. We see no reason for changing the current regulations; although in some cases we would encourage greater disclosure along the lines mentioned in Q13 below.

Further, the directors who are on the remuneration committees have been elected by the shareholders.

Turning to the question posed in respect of pay levels, we need explain the reasons for the increases which have occurred. These could, for example, include increased responsibilities of directors, changes in competitive/market rates and/or the benefit to the companies of a greater proportion of remuneration being related to performance. The pressure to perform has increased the responsibilities of executive directors and has led to a greater proportion of remuneration being related to performance. The UK is now much more part of a global economy and this creates pressure to pay globally competitive market rates. However not all industries are affected in the same way or to the same degree. Additional factors which create pressure on remuneration levels in Small Cap and AIM companies are pay market comparisons to global companies (there is a trickle-down effect of the big increases made to CEOs of big global companies which have trickled down to increases in their divisional directors' remuneration with which Small Cap and AIM companies compete for talent) and private equity and venture capital funded companies (who typically offer much larger incentives to the management of their investee companies).

Some commentators have suggested that excessively powerful CEOs and executive teams have been able to exert their will and extract rents in excess of those commercially justifiable. We do not believe this has occurred in smaller quoted and AIM companies. The evidence provided above is paragraph 2 confirms that pay increases in smaller quoted and AIM companies have been in general modest.

Hence, we find these reasons for increases in directors' remuneration are entirely appropriate, in respect of the QCA membership, small and mid-cap quoted companies.

It is not for the QCA, the representative body of the small and mid-cap quoted sector, to comment on the appropriateness of levels of remuneration of FTSE 100 companies, nor about the processes by which pay in FTSE 100 companies is set.

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

Comments

The UK Corporate Governance Code states that the membership of the remuneration committee should be at least two non-executive directors (one of whom could be the chairman but he/she should not chair the committee) for those companies which are outside the FTSE 350. (The membership should be at least three, for those companies in the FTSE 350). This recognises that it might be onerous to require the committee size to be more than two. The QCA's *Corporate Governance Guidelines for Smaller Quoted Companies* (September 2010) also stresses this point.

As we have noted in response to question 11, we do not see any particular problem with the way in which pay is being set in Small Cap and AIM companies. We therefore can see no benefit of widening the membership of the remuneration committee to include people other than the chairman and non-executive directors of the company.

What is really critical, here, is that the committee does its job well. The QCA is of the view that this is not always the case and is in the process of developing a Remuneration Committee Guide, which is expected to become recognised as best practice for smaller quoted companies.

The effect of widening the membership would be to put too much strain on resources of smaller companies and so divert the time spent by non-executives from more important tasks.

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

When a problem becomes apparent, there are effective mechanisms for shareholders to engage with companies to make their views known. In almost all cases a constructive dialogue occurs.

However, current disclosures are in many cases not transparent. Nowhere in the Listing Rules, directors' remuneration report regulations or the UK Corporate Governance Code is there a requirement for the total remuneration to be added up and reported as a single number. (This is an SEC requirement in the USA and the UK has fallen behind in this respect.) The current regulations require that the total shareholder return has to be shown on a graph over a five-year period. We think it would be helpful if the total remuneration of the CEO was also shown over the same period, as this would encourage remuneration committees to give an explanation of why pay had increased or decreased faster or slower than total shareholder return and any other key performance indicators that the company chooses to report on.

We do not think that any further areas of pay should be subject to shareholder approval. This would add to the volume of reporting and the cost thereof, without providing any benefit to shareholders. As noted above, there are already adequate mechanisms for shareholders to engage with directors and make their feelings known. There are many examples of where they have done this in respect of contracts and potential termination payments.

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

The impact would be a reduced cost of capital for those companies which did this. Shareholders would have a better understanding of the company, its strategy, key performance indicators, how it plans to measure its future success and how it is doing to date. It would build trust between shareholders and directors. Increasing trust is a subject at the core of the QCA's *Corporate Governance Guidelines for Smaller Quoted Companies*. This would increase their desire to hold shares in the company, and it would also attract new shareholders. With higher demand for shares, the share price would increase and so the cost of capital for the company would fall.

The second benefit would be greater harmony between directors and employees who could more easily understand and assess the logic behind the directors' pay. The same might apply to suppliers and customers.

It is important to recognise that merely publishing mathematical ratios will not by itself solve the problem. In many cases it is the reasons for the changes in the ratio which shed light on what is truly happening in the company. Future thinking companies will therefore give a useful commentary on the data. For example, a company outsources its call centre to India and the average pay of the employees who are left increases: thus the ratio of directors' pay to average employee pay goes down. Some years later, in a bid to improve customer service, the company wishes to close its outsource arrangement in India and open a new call centre in Essex, and as a result the average pay of its employees decreases and the ratio of directors' pay to employees' pay increases. Only when the data are supported by useful commentary and interpretation can meaningful conclusions be drawn.

With reference to the issue of commercial confidentiality (para 5.15 of the consultation to which we are responding), this applies particularly to annual bonus targets, but may also affect disclosure of certain LTIP targets. We think companies should have to disclose more about bonus targets in general terms in advance and then have to explain how actual performance has been in relation to targets after the event.

It is also important to distinguish between performance measures (eg profit, ROCE, cash flow) and performance targets (12% growth, 8% ROCE, £25 million of cash flow). We support disclosure, at the start of the year, of the former, but not the latter as this is market sensitive information.

Takeovers

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

Comments

When the Companies Act 2006 (then the Companies Bill/Company Law Reform Bill) was debated in Parliament there was a significant public debate around the duties and responsibilities of directors. This resulted in the common law being distilled down to the general statement of directors' duties contained in sections 171 to 177 Companies Act 2006.

Of particular importance is the duty set out in section 172 Companies Act 2006 for a director to act in the way the director considers, in good faith, would be most likely to promote the success of the company for the benefit of the members as a whole. Section 172 Companies Act 2006 then sets out a non-inclusive list of considerations to which a director should have regard (which have become known as the "stakeholder factors") when considering what would be most likely to promote the success of the company for the benefit of the members as a whole. The list of stakeholder factors specifically includes an evaluation of the likely consequences of a decision on the long term and the need to act fairly between the members of the company.

The General Principles that preface the Takeover Code further elaborate that boards must act in an appropriate manner in the context of takeovers in order that shareholders are given an opportunity to decide on the merits of a bid and to ensure that the offeree company is not hindered in the conduct of its affairs for longer than is reasonable.

Boards of companies which either make or receive takeover offers must therefore already give detailed consideration to the interests of shareholders. Whist a bid is being conducted board receive a lot of detailed advice and support from a wide pool of experts. It is at this time that offerors and offerees are clearly in the public spotlight: boards must communicate appropriately with shareholders and also a media strategy must be pursued. The context of decisions and announcements made are the subject of close scrutiny: Kraft/Cadbury is probably the leading current example of this.

The Takeover Code, Listing Rules, AIM rules and PLUS Markets rules and the Prospectus Directive set out the nature of the documentation to be prepared, when and how such documentation is to be communicated. At all times, the boards are under a legal obligation to carry out their respective roles with the interests of the members as a whole as a guiding principle. However, this is necessary a forward looking exercise. Accordingly, boards cannot predict what the long term implications of any transaction, least of all a takeover, will be but can only consider and communicate what the board's reasonable judgement of that is: it is our view that boards do this effectively.

Accordingly, whilst boards cannot be said to be able to predict the long-term implications of takeovers, it is our view that boards must and do form a clear view of what they anticipate the implication of the takeover to be and we are firmly of a view that we have in place an appropriate structure in company law, the Listing Rules (as well as AIM rules and PLUS Markets rules) and the Takeover Code for the communication of anticipated bid implications to shareholders and to the market more generally.

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

No. We do not support any suggestion that the shareholders of an acquiring company should in all cases be invited to vote on takeover bids.

There are a number of circumstances in which shareholders must necessarily be invited to vote on aspects linked to a takeover (including the creation of new shares in the capital of the bidder) which arise as a matter of company law. We see no reason why this should be added to.

We believe that a general rule by which shareholders were invited to vote on a takeover bid would be damaging to the competitiveness of the London public market for a number of reasons including the following:

Timing and cost

A takeover bid operates to a very tight timeline with the clear objective that the offeree must not be hindered in the conduct of its affairs for longer than is reasonable. The imposition of an additional shareholder vote would necessarily divert resources within a very short period and could necessarily lead to an unwelcome lengthening of the timetable for a takeover.

To place an additional administrative burden and transactional risk on companies at this juncture will necessarily have a greater impact on smaller quoted companies than larger quoted companies, both because of tighter financial resources and because smaller companies have a shareholder base comprised of less institutional shareholders than a larger quoted company. Accordingly, it is often harder for smaller quoted companies to maintain a quality dialogue with shareholders.

Short termism market distortion

There is a real risk that short termism could be fuelled by a vote of this type as short term investors seek to arbitrage on the success or failure of a takeover bid. There would be a second line of attack because there would be a shareholder vote of the offeror shareholders in addition to the required majority acceptance by the offeree shareholders.

If an offeror shareholder vote was written into law, serious consideration would have to be had about disenfranchisement of offeror shares acquired during the bid period: disenfranchisement is not something the QCA supports.

Second guessing of directors' duties

We have already noted in response to question 15 above the duties to which a director is subject. A board of directors must act in a balanced and considered way to discharge these duties. To create a new shareholder vote by the offeror shareholders on the merits of a takeover bid would significantly undermine the responsibility of directors and the way in which the duties of a director are discharged. A board must have the ability to make commercial decisions without shareholder approval.

As we are all aware, London is and remains a leading market for the listing of international companies of all sizes. A number of these companies establish in one of the jurisdictions of the United Kingdom or have a place of central management and control within the United Kingdom and thus fall subject to The Takeover Code. It would be unfortunate if bids were made harder and, as a result, any of these companies considered a London listing less attractive as a result. A healthy and predictable takeover regime is a good thing for the United Kingdom and the London quoted market. An additional shareholder vote would increase uncertainty and may render that market less attractive.

Furthermore, Prudential's ultimately abortive bid for AIA demonstrates that shareholders do effectively ensure that the views of shareholders are heard. In that circumstance, the bid was withdrawn as a result of bidder shareholder pressure without any formal shareholder vote.

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

Comments
The consultation paper appears to be mainly focused on FTSE100 companies. The QCA does not think there is a problem in respect of smaller quoted and AIM companies. Nor is there any evidence of widespread concerns about private companies. The Government should avoid making new rules which have an unnecessary burden on smaller companies, which comprise the vast majority of UK businesses. It is also necessary to recognise that one size does not fit all and that any rules must be proportionate.