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Mr Adam Gray
Long-term Focus Consultation
Corporate Law and Governance
Department for Business, Innovation and Skills
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Dear Mr Gray

Department for Business Innovation and Skills consultation: A Long-Term Focus for Corporate Britain

I write on behalf of Railpen Investments ('Railpen'), which carries out investment management for the Railways Pension Trustee Company Limited (RPTCL), the corporate trustee of the Railways Pension Scheme, the eighth largest pension fund in the UK, and other UK Railway industry pensions schemes with total assets of c. £18 billion. Railpen Investments welcomes the opportunity to respond to the Department for Business Innovation and Skills consultation: "A Long-Term Focus for Corporate Britain" and we set out our responses below.

The Board of Directors

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

It is our view that the boards of UK companies must have a long-term focus; indeed it is vital that they do. Generally, there is a long-term view amongst the non-executive board members that we engage with. In any event, non-executives tend to be long-serving and it is their role to oversee successive management teams. We observe a longer term focus in terms of strategic planning. However, quarterly earnings guidance can sometimes be detrimental to this long term perspective and may be a driver to a view more focussed on the short term. This would impact the view that the executive management team take so it is a vital role for the role of the Chairman and the Board collectively to ensure that a longer term perspective underpins corporate decision-making and planning.

Companies have a difficult balance to strike in providing and holding back transparent information. Some major companies have consciously taken a more explicit long term view. We note that Unilever was praised for giving up earnings guidance in 2009. GlaxoSmithKline also ended its long-running practice of providing the market with short-term earnings forecasts in 2009. Its chief executive, Andrew Witty, said at the time that he

wanted the market to focus on long-term goals rather than the next quarter or two of trading. It could be argued that a lack of guidance might be a good thing for some analysts as it might force more of them to think independently.

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?

We think it is reasonable that companies should be able to identify their underlying shareholders. Asset owners are currently placed under responsibilities in the UK to disclose their beneficial ownership of shares above 3% of total issued share capital. In addition, Section 793 of the Companies Act 2006 also gives companies significant powers to require a person it knows, or has reasonable cause to believe, has an interest in its shares (or to have had an interest in the previous three years) to confirm or deny the fact. However, custodian arrangements and the widespread use of nominee accounts can make it difficult in practice for companies to identify shareholders.

As a pension fund which invests entirely through external fund managers, and which directs its own voting rights across the major markets in which it invests, this causes a further level of opacity in terms of companies understanding who their beneficial owners are. A Company may routinely engage with its top 10-20 shareholders; however, companies should be cognisant of the fact that a major shareholder holding, say, 5% of the shares may not be directing the voting over that entire holding. We anticipate that this will become more of an issue as pension funds take a more engaged approach to their responsible investment activities, and seek less to assume that their fund managers will vote on their behalf. Or at the very least, there will be more oversight by pension funds of the voting activities of asset managers, such that company management may be supported less.

However in our own case, our UK holdings are held in the name of our nominee subsidiary, Junction Nominees Limited, which is well known to companies and the market generally. We recognise that this is not always as clear cut for other institutional investors and we believe it would be helpful if investors, custodians, registrars and issuers could provide a more comprehensive service and improve disclosure.

We also note that stock lending can be a complicating factor in that legal title passes to the borrower whilst the economic interest remains with the borrower. It generally follows that voting rights are lost, particularly if the stock is lent on to other parties further down the chain, notwithstanding clauses in standard lending agreements to use reasonable efforts to implement the lender's voting wishes. This leaves lenders particularly exposed during a takeover as the key decision making power passes to the borrower. We believe that it would be helpful for the Government to look at this complex area and consider whether any legal changes are possible that would strengthen the rights of lenders of securities.

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?

The implications are profound and can be summed up by observing that the former preponderance of long term domestic UK shareholders, and insurance companies and pension funds in particular, has been eclipsed by overseas shareholders who in the aggregate now hold around 60% of UK equities. However, domestic investors still maintain significant influence in the UK market and it does allow cross-border investor relationships. We ourselves work with overseas asset owners on UK and overseas issues to the extent we are allowed under concert party guidelines. Railpen is promoting an initiative to promote engagement between shareholders and directors in US companies primarily, where we are requesting companies to provide investors with a "Fifth Analyst

Call" to discuss issues around the proxy statement and corporate governance issues. We consider this could have implications for the UK too.

4) What are the most effective forms of engagement?

As an asset owner, we firmly believe that it is imperative that our voice is heard. We sometimes disagree with the position that the fund managers take on corporate governance issues. For example, we do not agree that it is necessary for the annual election of all directors in the UK and consider that there are other ways to address the issue of better quality boards.

Collaboration amongst investors, or collective engagement, is a critical success factor for improving corporate governance standards in the UK. We observe an increasing appetite for such collaboration amongst UK based institutional investors, whether informally or on a more formal basis.

However, it is by no means commonplace and there is often a certain reticence expressed by some shareholders about collective engagement. We consider collective engagement a key way in which shareholders can effectively hold companies to account on a whole range of governance issues and was one of the drivers for the establishment of our UK Voting Alliance with the Universities Superannuation Scheme.

We hope that collective action by the willing becomes more visible as engagement practices develop in response to the introduction of the Stewardship Code in the UK. Railpen was one of the first asset owners to sign up to the Code and led a group of other asset owners in a public initiative to endorse the Code through an open letter to the Financial Reporting Council in September 2010.

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

We observe a clear disconnect in some investment management houses, where the corporate governance function is still very much a silo activity. However, in general, we consider that corporate governance specialists have moved on from being in the basement[1] and there is more of an awareness and acceptance that good corporate governance structures matter and can be a key component of risk management and protection of shareholder value.

Where there still remains somewhat of a disconnect, this filters through into dialogue with company representatives, where Investor Relations staff talk to the investment analysts and governance concerns are not raised, and then the Company Secretarial department liaises with the corporate governance staff and hear concerns about succession planning and pay structures. We do not see these aspects of business as mutually exclusive, provided investment houses can apply an integrated approach.

One further consideration is that even if the investment view of a stock is positive, and there are governance issues to be considered, these are not incompatible views in general. However, companies are now very much aware of these mixed messages that can come from the same investment house and some capitalise on this disconnect by downplaying the importance of corporate governance.

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[1] In 2007, Lord Myners said portfolio managers who make investment decisions often seemed at odds with corporate governance specialists. "I frequently find when I talk to institutional investors that the portfolio manager, who I regard as the owner of the shares of the company on whose board I sit, is very content with what we are doing, but there's somebody in the basement who is responsible for governance who has got an issue, and there's a dislocation between the two." His criticisms echo those made earlier in 2007 by company directors, notably Terry Smith, chairman of Collins Stewart, and by Sir Christopher Hogg, the then chairman of the Financial Reporting Council, which monitors the UK Corporate Governance Code. Sir Christopher admitted to concerns that fund managers regarded the job of monitoring governance as a "costly, distracting and irrelevant chore".

We welcome the UN's Principles for Responsible Investment efforts to overcome this disconnect by requiring the integration of environmental, social and governance (ESG) issues into investment management decision making. However we wonder how many asset manager signatories apply this in a fully integrated way.

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?

We believe that voting is an important first step in engagement but is not enough in itself. Non-voting investors will not be taken seriously but sometimes more is needed than just voting. Please see our response to question 4 above on the most effective forms of engagement.

We agree that the post hoc disclosure of voting can be helpful to clients, companies and the wider public and support the intent of principle 6 of the Stewardship Code on voting disclosure. We encourage our external asset managers to do so too. The additional costs in making such disclosure are not significant on the basis of our own disclosure experience.

We publicly disclose our UK voting record on our website in respect of all UK company meetings held after 1 January 2010, subject to a waiting period of 3 months from the end of the month in which the meeting is held so that we can balance transparency without undermining our dialogue with companies.

We indicate by company where we have voted against or abstained on a management resolution proposed by the company and where we have voted for, against or abstained on a resolution proposed by shareholders. We are exposed to all stocks in the FTSE All Share Index so if a meeting or resolution is not shown this means that we voted in favour of the management resolution(s) concerned. Where we oppose or abstain on a management resolution at a UK meeting we routinely write to the company in advance of the meeting to tell them why which we believe is helpful to companies as many complain that many investors never bother to provide any rationale for opposing management resolutions.

We note that the Companies Act 2006 contains a reserve power for the Government to impose voting disclosure. We would note that this has been tried in other jurisdictions, such as the USA, and whilst it has led to greater transparency it has not necessarily led to any great change in voting habits.

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

There are short term issues but not all are harmful. Some are necessary and actually helpful in sustaining a liquid market which is to the advantage of most participants and society as a whole.

Often the clients of fund managers have a long term perspective, such as Railpen as a pension fund asset owner whose time horizons are long term but decision-making made on our behalf by our asset manager intermediaries are not long term. It is correct to acknowledge that there are principal-agent issues in the investment chain but the real issue is whether they necessarily operate to the disadvantage of the client.

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 note that some commentators have suggested rewarding long term holders through increased dividends or additional voting rights. Whilst these options are superficially attractive, we believe that they would seriously undermine the principle of one share one

vote and could potentially entrench management. They would be difficult to implement and open to anomalies and abuse.

However, we feel that the Government could look at the tax regime, given that taxation is very much in the Government's control, and examine whether or not current taxes on individuals, companies and institutions act as a deterrent to long term investment in equities.

It can be argued that investment in gilts receives much more favourable tax treatment in that transactions do not suffer stamp duty, interest is paid gross and investors do not suffer capital gains tax on disposals. By contrast equities suffer stamp duty on purchase, dividend income is taxed and paid out of company profits that have suffered corporation tax and gains are subject to capital gains tax whilst bonds are only subject to income tax. In addition, the capital gains tax regime no longer explicitly favours long term ownership with the abolition of the taper relief in 2010.

A further tax anomaly can be seen in relation to remuneration with concerns about the inconsistency between the Financial Services Authority's encouragement of the use of deferred bonuses as a way to address concerns about short-termism in the pay structures of financial institutions, and the new tax regulations from the Inland Revenue which seem to discourage deferral of payments on tax grounds.

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

Clients need to be more aware of the potential agency problems and possibly to be more demanding in what they expect of their asset managers. Trustees need to be aware that fund managers will act rationally to market/client demands with the correct incentives and monitoring.

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

Investment management fees are critical and will make a significant difference over time to performance – asset owners ought to work together to keep such fees within reasonable parameters.

Directors' Remuneration

We attach for reference a report on the UK's experience of an advisory vote on remuneration that shareholders in UK companies have had since the introduction of the Directors' Remuneration Report Regulations in 2002. This report was published in September 2009 by Railpen Investments and the UK proxy advisory firm Pensions & Investments Research Consultants (PIRC). We will refer to aspects of this report in our answers to the questions in this section.

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

There are many reasons for the increase in directors' remuneration. See Chapters 1, 'The context and trends prior to the vote' and Chapter 4, 'The context and trends prior to the vote' of the Railpen/PIRC report, which tracks the history of remuneration practices and pay levels in the UK in recent years

We identify two major drivers to remuneration increases: market forces, or paying the going rate, and better disclosure requirements. The two are inter-linked. In the latter, we consider that it is better for shareholders to be informed than to have opaque disclosures on incentive structures and overall remuneration. We would also observe that whilst there was a ratcheting up of pay levels in the years immediately following the increased disclosure requirements, this effect will neutralise over time. In terms of market forces, it

is paramount that the UK remains a competitive arena in which to attract and retain talent but we are not convinced with the arguments provided by companies in terms of the threat that executives will leave the UK to work elsewhere, or will leave public companies to work in private equity or similar such arguments. See pages 23-24 of the Say on Pay report under the heading 'But pay continues to go up'.

We would also observe that there needs to be a more rigorous discussion about the effectiveness of incentive pay, or lack thereof. This seems to us to be the real debate that should be had around executive remuneration, which has been stifled by a populist media debate focused primarily on the level and quantum of bankers' bonuses. Whilst there are entirely legitimate questions to ask in these austere times, they do not get to the heart of shareholders' concerns about remuneration and incentive pay. An insightful quote from Jerome van der Veer, when he was departing as Chief Executive from Royal Dutch Shell, and in the wake of their remuneration report being defeated in 2009 gets to the heart of the matter:

'You have to understand: if I had been paid 50% more, I would not have performed any better; if I had been paid 50% less, I would not have performed any worse.'

The question we should be asking as shareholders is (i) how many other executives think like this about their incentive pay packages; (ii) is the whole concept of achieving an alignment of interests between shareholders and their agents (ie directors) through incentive pay the wrong approach?; and (iii) do current incentive packages encourage an excessive level of risk that is detrimental to the creation of shareholder value?

A further area for consideration is that if directors do not understand the pay schemes they participate in, how incentivising can they be? Anecdotally, many Remuneration Committee members that we engage with observe that they are dubious about the effectiveness of long term incentive plans, which leads to an unhealthy focus on the annual bonus scheme which would engender, one would consider, a short term mindset by directors. A more effective way of structuring remuneration should be devised that serves the interests of both shareholders and companies.

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

The Remuneration Committee is a Committee of the Board and so we would expect it to be made up of Board members. Whilst they should take independent, external advice, they should ultimately take full ownership of the process and be accountable for the decisions they make.

We are dubious that a widening of the membership of Remuneration Committees would have an effect that would be in shareholders' interests. We do not think there is a necessity to extend the remit of the Remuneration Committee but instead we need to see better and more robust decision making by the Committees themselves.

We certainly do not see the need for Remuneration Consultants to be members of such Committees as this blurs the lines between what their role is, which is to consult and provide advice to the Remuneration Committee but the Remuneration Committee should be able to take that advice or not. Remuneration consultants are commercial organisations and as such, they should advise their clients and provide independent advice and soundings to the Remuneration Committee. However, they should not be engaging on behalf of companies. This is frustrating from a shareholders' perspective because one of the key aspects of analysing remuneration is taking a view on whether the Remuneration Committee collectively has taken ownership of the process and is able to engage with shareholders on the structures and address any concerns raised. It is obvious when a consultant is tasked with engagement that either the Committee does not understand the schemes or does not feel confident enough to engage on the issues and/or has had no input into their structure.

As a pension fund with some employee and trade union representatives on our Trustee Board, we obviously recognise the value in having the employee voice on boards and committees. However, we are unsure how this would manifest itself at public companies, and we would prefer that more consideration is given to strengthen the existing requirements that pay elsewhere in the company influences the decisions that Remuneration Committees take about executive directors' pay.

13) Are shareholders effective in holding companies to account over pay? Are there further areas of pay eg golden parachutes, it would be beneficial to subject to shareholder approval?

We consider that shareholders in UK companies have been, to the most extent, effective in holding companies to account on remuneration through the Say on Pay vote to an extent. Obvious victories, where shareholders defeat a remuneration report due to inappropriate payments made and the money has been paid back by the director are not common occurrences although the extent to which United Business Media's shareholders disapproved of the £2.5 million payment to Lord Hollick for handover to his successor did result in the money being paid back to the Company. Less visible but equally important successes have occurred where shareholders have opposed practices at companies and the company has reacted well and changed its stance. Communication is absolutely key in this regard in that the onus is on shareholders to inform a Company as to why they have not supported the remuneration report. Consultation plays a large role in this process and we consider that companies are generally getting more sophisticated with their approaches to consultation and there is now less 'gaming' apparent in the process.

However, one of the key arguments we concluded from the Say on Pay paper was that shareholders had to use their rights on the advisory vote on pay more effectively. One way for this to occur would be through more collective engagement by shareholders. Whilst this is an emerging practice amongst institutional shareholders in the UK, it is by no means commonplace and there is often a certain reticence expressed by some shareholders about collective engagement. We consider collective engagement a key way in which shareholders can effectively hold companies to account on a whole range of governance issues and this was one of the drivers for the establishment of our UK Voting Alliance with the Universities Superannuation Scheme. We hope that collective action by the willing becomes more visible as practices develop in response to the Stewardship Code.

We also observe good practices in other markets which strengthen further shareholder oversight of pay. For example, in Australia, the Government is currently considering draft legislation under the Corporations Act such that an against vote of more than 25% on a company's remuneration report for two consecutive years would trigger a resolution seeking shareholder approval to convene a general meeting at which all incumbent directors would be forced to seek re-election. Therefore effectively, this empowers shareholders to remove the entire Board of a company in such circumstances. The Bill would also make it a criminal offence for Remuneration Consultant to give advice to corporate officers of a Company who are not on the Board.

14) What would be the impact of greater transparency of directors' pay on the:
(i) linkage between pay and meeting corporate objectives

We would refer you to our response to the BIS consultation on Narrative reporting which we submitted in October 2010. In that response, we made the following observations:

"We very much agree with the Minister's observation in his foreword to the consultation document that it is "very important that there is a clear link between the company's strategic objectives and the criteria for payments to directors". The disclosure of the performance criteria applying to awards which generate payments to directors is fundamental to shareholders' understanding of how directors are incentivised to generate returns for shareholders.

Shareholders need to be able to assess the stringency of the performance criteria, in order to make a judgement about the linkage, or lack thereof, between pay levels and performance achieved. They also need to understand on what basis the performance criteria is being defined; ie. if it is an earnings-based performance criterion, what specific definition of the earnings metric is being used?

Unfortunately, in too many cases, the performance criteria is either not particularly stringent and challenging enough to justify the award levels available or there is not a clear enough linkage between the strategy that the Company is espousing, and the performance metrics that underpin the remuneration systems which shareholders assume drive the Executive Directors to deliver that strategy.

A mapping of the strategy drivers to the bases for performance metrics that underpin the remuneration system would, in too many cases, provide insufficient commonalities between either system, or indeed, none at all. This is where remuneration systems are lacking and we would encourage recommendations that require a narrative on how the specific performance criteria that is chosen underpin and drive the strategy of the company.

One obvious way in which this manifests itself is where the CEO and Finance Director provide forecasts in their quarterly update statements to the market, which indicate strong performance is expected and the performance criteria underpinning the remuneration system would be met easily. This apparent disconnect between what the market is being told and what is disclosed in the remuneration reports needs to be addressed and could be overcome by a more rounded discussion about pay, and specifically the performance criteria chosen, and how it underpins the strategic direction of the Company.

Following on from this, it is important to note here that the current disclosure requirements do include a requirement to explain as to why any such performance conditions are chosen. Some companies do take the time to explain why specific criteria is chosen; for example, that the metrics reflect the key performance indicators of the Company. However, this is by no means routine across all company disclosures and we consider that the disclosure requirements could be better enforced or indeed enhanced specifically to require a more detailed explanation of why specific targets are chosen in order that shareholders can better understand the linkage between performance criteria and strategy."

(ii) performance criteria for annual bonus schemes

We are sympathetic to the concern expressed by companies that the disclosure of the performance criteria attaching to annual bonus schemes is market sensitive information and cannot be disclosed prospectively. However, this should not be used as an excuse for opacity in how the annual bonus scheme operates and shareholders should have a general understanding of what are the key drivers for short term performance. There should also be a significantly strong link between pay and performance. Witness the defeat of the remuneration report at Bellway plc in January 2009, where bonuses were paid to executives, despite performance criteria not being met. This sort of misalignment does not bode well for a Company's reputation and relationship with its shareholders and it often takes a Company a number of years to build up trust that can be destroyed with this sort of practice.

(iii) relationship between directors' pay and employees' pay?

There is currently a requirement for the remuneration report to contain a statement of how pay and employment conditions of employees of the company and of other undertakings within the same group as the company were taken into account when determining directors' remuneration. More tranparency in this area would be helpful especially if:

a) the highest paid employee in the Company does not serve on the Board; as we stated in our response to the Walker Review in 2009, the US system of requiring disclosure of the top highest earners within a company, regardless of whether they are board members, would also be worth considering for the UK context, especially in relation to how the board sets remuneration levels for executive board members and how they take pay elsewhere into the company into account when setting such levels; and
b) there appears to be no consistency between the approach taken by the Remuneration Committee for the executive directors and the pay practices being adopted for the rest of the employees. Certainly, when there is a pay freeze across the organisation but executives continue to enjoy salary hikes, there would appear to be no connection between the pay practices of the constituents.

We would also observe that there should be a general requirement for Remuneration Committees to take the overall performance of the Company into account when deciding on what level of awards and pay is appropriate. Discretion afforded Remuneration Committees in this regard and the trust they engender from demonstrating that the decisions they make are in the long term interests of shareholders is invaluable to the shareholder-director relationship.

Takeovers

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

See answer to question 16 below.

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?

Takeovers in principle facilitate a true market in corporate control which is in the general interests of minority shareholders and the UK Takeover Code has evolved flexibly over the last 40 years to ensure a fair and orderly takeover market. This is not to suggest that UK takeover regime would not benefit from some changes but it is preferable to a situation where companies can erect takeover defences without reference to shareholders or where governments attempt to thwart the operation of the market.

We welcome the recent changes to the Code proposed by the Takeover Panel. If adopted they will result in a general prohibition on deal protection measures including inducement fees and a curtailment of the “virtual bid” process. These will represent significant changes to current market practice in UK takeovers to the benefit of shareholders and other stakeholders. We believe that the Government should also look at competition aspects from a public policy perspective and consider asking the competition authorities to carry out a review.

The Takeover Code requirement to have a fairness opinion is helpful but there is no requirement to publish it and it would be helpful to look at whether this should be a requirement. The Class Tests in the Listing Rules aim to ensure shareholders are consulted on transactions which significantly affect the assets or liabilities of the issuer but may need strengthening. We would also observe that break fees are often egregious. There may be a risk that they are artificially stimulating takeovers and act as a perverse influence on the market and advisers.

We consider that shareholders should have an official say on a takeover and it is not for management or the board to obstruct a bid but to look after the interests of shareholders. Shareholders of the target company need a proper vote and not just a tender.

Giving shareholders of the acquiring company a vote on an acquisition transaction is attractive in principle but may trigger unforeseen or unwanted consequences. This poses

challenges where the bidder is an overseas company subject to the additional or contradictory requirements of a foreign jurisdiction, or an unlisted company. It could potentially put listed UK companies at a disadvantage to unlisted or foreign companies in mergers and acquisitions.

Other

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

No.

Please do not hesitate to contact me should you need further clarification on any aspects of our response.

Yours sincerely

Frank Curtiss
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Railpen Investments