PIRC

PIRC RESPONSE / JANUARY 2011

A Long-Term Focus for Corporate Britain: A Call for Evidence

The voice of responsible shareowners

We welcome the opportunity to respond to the call for evidence. Pensions & Investment Research Consultants Ltd (PIRC) has been an independent adviser to pension funds and other institutional investors for over 20 years. PIRC's clients have combined assets in excess of £1.5 trillion and include some of the largest pension funds, asset management companies and insurance companies in the UK and overseas. Together, they comprise a diverse group of institutional investors with long-term liabilities and broad fiduciary duties.

PIRC undertakes company research on corporate governance and corporate social responsibility issues at public companies, and provides advice to clients on proxy voting strategies and other active shareowner initiatives. Our comments are based on two decades of practical experience, which inform our views on the strengths and weaknesses of disclosures, governance structures, and the interaction of statute, regulation and codes of practice.

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PIRC'S RESPONSE TO THE CONSULTATION

Overview

PIRC very much welcomes this consultation. We believe that ensuring that the UK investment chain leads to decision making that gives full weight to the longer term is crucial if we are to have a healthy economy and one that is rebalanced following the global economic and financial crash.

Many previous governments have looked at this area and have taken steps that they believed would help. The fact that the Coalition government is coming back to it is a sign that the issues simply do not go away. If there was ever a time to act it is now as Britain needs to find ways of being prosperous without relying too much on one or two sectors.

Of course there are some who believe that all talk of problems in the investment chain system are misguided or, more subtly, that any steps to overcome any issues have in themselves too many offsetting disadvantages. A form of risk averse decision making can ensue.

In addition the strong belief in efficient markets may lead one to think that all information is being optimally used – and so if people are taking short term decisions to the determinant of the longer term there would be opportunities for far sighted market players to get involved and make profits. However recent events have seriously dented academic, let alone popular, views as to the efficiency of financial markets in all circumstances. And such a view puts a very low weight on the negative externalities to society of any tendency to short termism.

It is in the nature of the subject that is very hard to get convincing and irrefutable evidence that any changes suggested would improve things let alone by how much. Opponents of change have often used this as a way of arguing – successfully – against rocking the boat.

We believe that there are a number of places where things are self-evidently not working as well as they could and we draw attention to them below. In many of them it is hard to see that putting them right could have disastrous side effects or even cause much in the way of bureaucratic or administrative cost. In these areas the burden of proof must be on those who do not want to see action taken.

There are others where the arguments are more finely balanced but we feel that they must be on the agenda.

In the annex we give short responses to the precise questions asked in the Consultation document. However, our main contribution is set out in the next sections on how we see the current system and how it could be improved to encourage good decision making that helps bring a long term focus for business in Britain. That in turn leads to a number of specific proposals based on our experience as to how the government could improve things.

We have not covered the waterfront but have focused on areas where our experience gives us particular insights.

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1. The aim of the 'Investment Chain'

> *But the most important threat to the economic role of the listed public company is the growing dissatisfaction of managers and investors with their relationship. Investors and companies have become closer in the past two decades, but in a dysfunctional way. Analysts focus not on business strategy but on anticipating what the company will announce. Companies manipulate that process to present their affairs in the most flattering light.*
>
> John Kay 2004[1]

Much of the money that is invested in our companies comes from pension funds. In theory they are looking at long term returns since that is the nature of their liabilities. They have trustees to oversee their investment strategy. Rather than act directly they hire fund managers who make the investments based on research and other factors. Meanwhile, at least in theory, the company responds to the desires of its owners by making decisions that give a good long term return. Their board designs incentives for the management that push them towards such returns – as well as to being efficient and profit maximising. If shareholders feel that their returns can increase if the company can be taken over or take over someone else then they can make that happen.

All in all, this chain should lead to what everybody wants. In particular we should end up with firms searching for investments and strategies that maximise profits over time (discounted cash flow as some call it) rather than putting undue weight on profits in the short term.

In practice there are problems at every stage of this chain and the net result is that many believe that short termism – the desire to maximise short run returns irrespective of the impact on longer run value and returns – is rife.

As the TUC put it in its *Investment Chains* report in 2006:

Put simply, shareholders often respond negatively to short-term difficulties, or lower than expected profits. This attitude makes it difficult for companies to make long-term investment decisions, regarding skills, innovation and research and development, because of the fear, real or imagined, that high, upfront, short-term costs will scare away investors.[2]

Although it is not exactly the same in the USA, a US study in 2006 noted rather chillingly that:

In a recent survey of more than 400 financial executives, 80 percent of the respondents indicated that they would decrease discretionary spending on such areas as research and development, advertising, maintenance, and hiring in order to meet short-term earnings targets and more than 50 percent said they would delay new projects, even if it meant sacrifices in value creation.[3]

It is very hard to categorically prove short termism exists in the sense that long term opportunities for growth and innovation are not taken. Various authors have tried to get at this by comparing rates of R&D, of investment and innovation in the UK and other countries with similar systems to those where more 'patient' capital is available. This sort of comparison does seem to leave a case to answer even if not definitive.[4]

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1 http://www.johnkay.com/2004/07/14/why-a-long-term-approach-is-best-for-companies
2 http://www.tuc.org.uk/extras/investmentchains.pdf
3 *Breaking the Short-Term Cycle*, CFA Centre for Financial Market Integrity/Business Roundtable Institute for Corporate Ethics, 2006
4 *Capital Choices: Changing the Way America Invests in Industry*, Council on Competitiveness and Harvard Business School, Washington, DC, June, 1992.

However we strongly believe that areas where we can see that potential incentives to short termism can be altered, they should be. Some of these will seem marginal and people may say they are not worth the bother and upheaval especially as the results are uncertain and there may be unforeseen side-effects to the system. But if one thinks of an investment chain, then it is clear that a good marginal change in several places has the potential to change the way the whole chain works substantially.

2. The pension funds

At PIRC we operate on a daily basis with the very start of the chain, namely the beneficial owners, the shareholders. The more we can get them focused on the issue of long termism the greater the possibility that the whole chain will work.

Presently there is a tendency for them to pass on their responsibilities down the chain rather than feel 'ownership' of the issue. Whilst a number of local authority pension funds take a more active and involved role in the stewardship of companies, primarily through the Local Authority Pension Fund Forum, this is rare. In our experience most private sector pension funds simply delegate authority to their asset managers. Those asset managers in turn report very little client interest in their stewardship activities.

We believe two steps could make a difference here – helping to shift the mind-set at least a little.

First, we propose that pension fund trustees are required to produce an annual, public review of how they have applied their responsibilities as owners over the year.

In particular we would want this to relate to the Stewardship Code, so bringing pension fund trustees within its gambit at least in an informal way. This could be facilitated by amending the relevant Myners Principle on Responsible Ownership, which requires updating in any case to refer to the Stewardship Code. In addition funds could be required to amend their SIPs to facilitate such a review.

Second, and more radical, we propose that the Government formally define fiduciary duty as it applies to institutional investors' Stewardship activities.

In addition to giving real force to the Stewardship Code, this could enshrine and make explicit some of the more implicit recommendations of the original Myners Review. Certainly there is a pressing need to make clear, once and for all, that there is a fiduciary duty for institutional shareholders to act like good owners.[5]

These proposals arguably matter even more given that we are seeing a move towards defined contribution (DC) pension provision amongst companies and away from defined benefit (DB) schemes.

The pressure on asset managers for short-term performance may increase with this shift. In a DB scheme the trustees can, in theory at least, seek to look at performance over the longer term, and the scheme sponsor, in theory at least, shoulders the investment risk. In contrast in a DC scheme the member bears all the investment risk, with poor returns resulting in smaller pensions. But in terms of timescales, they have only their working life during which to save. As such, in theory, they may not feel they have time to wait for poor performance to turn around and hence may be more inclined than a trustee to replace a poorly-performing asset manager.

In practice it appears that a significant amount of 'switching' does not occur, even when there has been a loss of confidence, such as during the financial crisis.[6] Indeed, the 'inertia' of members of DC scheme members is one of the factors that informed the design of NEST.

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5 See John Bogle's speech for further exploration of this idea. http://johncbogle.com/wordpress/wp-content/uploads/2009/03/iacompliance1.pdf

6 See for example, *The Market Crisis and Investor Behavior: Are Investors Panicking?,* a presentation by Shlomo Benartzi to the ABI Economics and Research Conference 2009

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Nonetheless, the obsession with relatively short-term performance is marked in the retail fund management sector compared to its institutional counterpart. There is an inherent danger that DC members may 'herd' when faced with a poorly-performing manager of their retirement savings.

Turning to stewardship, it seems likely that the market pressure on asset managers to take their ownership responsibilities seriously will be much weaker in a DC world. Asset managers may respond to pressure from trustees representing hundreds of millions of pounds worth of assets. Pressure from individuals with savings in the thousands seems likely to be less effective.

All this means that bringing in countervailing incentives to try to ensure that short termism is held in check makes even more sense than before.

3. Knowing who your shareholders are

Companies are often criticised for not trying to have a good dialogue with their shareholders, but this is particularly difficult if the firm does not know who their shareholders are.

Clearly this has become more difficult these days both because of the fact that many more shareholders are not British and because share ownership turnover has increased. Indeed in recent times we have seen the rise of high frequency share trading underpinned by computer algorithms - which clearly make engagement hard!

At present boards can make requests to know who their shareholders are through the Companies Act 2006. However this is clumsy and takes time. It can also set up unwanted incentives – in that to make a deliberate decision to request such information may be taken to signal that something is going wrong.

In past times it may have been argued that there was a prohibitive cost to shareholders in letting the company know they have bought into know this. But with electronic communications the marginal cost must be very low.

We therefore propose in future that there is compulsory disclosure of shareholder ownership.

We do not expect such a change to be revolutionary in its effects or to lead automatically to engagement, but it opens the door to a more open and transparent system and the possibility of different strategies from both shareholders and the company.

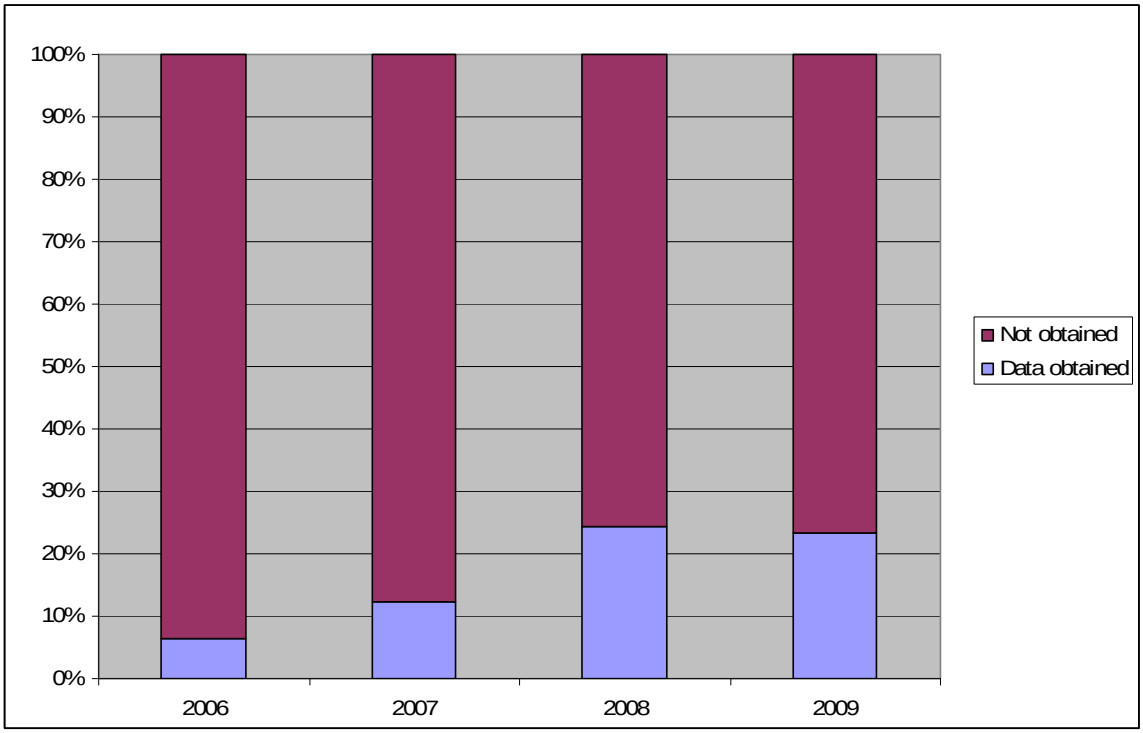
4. Knowing how the shareholders vote

For the investment chain to work properly it is best if everybody knows how shareholders are exercising their ownership rights. This is not only transparent and so enhances accountability but allows different players to see trends emerging.

We therefore propose compulsory disclosure of voting records.

We know that there have been many attempts to increase disclosure through voluntary means but as the data we have collected shows, it has not managed to make disclosure the automatic reflex. In 2009 PIRC undertook a sweep of voting disclosures by UK asset managers to try and establish how voting rights were exercised at UK-listed banks in the years up to and including the financial crisis (enclosed separately). The table below sets out the proportion of data on voting we were able to collect out of the total sought, across the four years analysed.

Data sought and obtained on shareholder voting at UK-listed banks 2006-2009



The arguments against such disclosure have always been weak. There is an assumption that it is much better for dialogue to happen privately and behind closed doors. To do anything else unsettles markets and leads to conflict. But there is no reason that such pressure cannot and would not continue if the way the shareholders ultimately voted was public. Indeed it might well promote such dialogue.

We note there is further support for mandatory voting disclosure at the European level. The EC summary of responses to its recent Green Paper found that: “The vast majority of respondents that provided an answer to this question are in favour of mandatory disclosure of voting policies and records by institutional investors. They consider that such disclosure would have a positive impact on the awareness of investors, optimise investment decision of ultimate investors, facilitate issuers' dialogue with investors and encourage shareholder engagement.”[7]

[7] http://ec.europa.eu/internal_market/consultations/docs/2010/governance/feedback_statement_en.pdf

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5. Asset managers

Pension funds delegate much of their decision making to asset managers and so many people look to them for the source of short termism.

A fundamental critique of investment analysis has been developed by Alfred Rappaport. He warns that even though investment professionals believe that discounted cash-flows (DCF) are in theory the right model for valuations, because such analysis is time-consuming and speculative, a focus on short-term earnings has come to dominate[8]. This tendency is accelerated because of the way that they are rewarded and judged.

The heart of the usual criticism is that they are, or at least feel that they are, assessed in practice on how they do in the short term not the long term. Although one might think it a useful tool for transparency and a way of getting over the inherent principal-agent problems, it is strongly argued that quarterly reporting has forced asset managers to make decisions to ensure that these 3 monthly reports look good irrespective of the longer term. Many asset mangers feel that their job will depend on this, and indeed few have contracts that insulate them from that – ie last for several years irrespective of short term returns.

Asset managers themselves have reported that the pressure for short-term performance can lead them to increase their exposure to companies they consider overvalued, for fear of recording relatively lower returns.[9]

This area clearly does need change but it is one of the harder areas to find an unambiguously positive change. We would not suggest banning quarterly reporting since the transparency and accountability it gives has value. What we want is to encourage asset managers to resist the extreme pressure of maximising returns each quarter without risking pension funds being trapped for a prolonged period with a asset manager who is clearly underperforming.

There have been previous attempts to do something about this. The Myners Review's solution to the perceived problem was to clarify the understanding between fund managers and their clients about time horizons and the length over which performance would be measured.

The Review stated that: "Funds should provide fund managers with clarity about the period over which their performance will be judged – and hold to that under the terms of the contract, unless clearly abnormal circumstances arise."[10]

It is not clear, however, that this recommendation has either been effectively implemented, or that it has resulted in changed behaviour. Research carried out by the DWP on the implementation of the Myners principles found that many schemes had not made clear to their asset manager(s) that they would not be sacked early for underperformance,[11] though subsequent NAPF research painted a more optimistic picture.[12]

Clearly it is key that asset managers who balance the short and long term correctly are appointed and that requires trustees to look out for the right things. Therefore we believe it is important that trustees think carefully about how they structure asset management mandates. This might include consideration of trading costs – both which

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[8] *The Economics of Short-Term Performance Obsession*, Alfred Rappaport, Financial Analysts Journal, 1 May 2005

[9] See for example Chris Cheetham's paper, *The role of institutional investors in the boom and bust*, featured in *Boom and Bust: the equity market crisis – Lessons for asset managers and their clients*, European Asset Management Association, 2003

[10] See pages 88-89, *Institutional investment in the UK: a review*, HMT, 2001

[11] *The Myners Principles and occupational pension schemes, volume 2 of 2*, DWP Research Report 213, page 115, 2004

[12] http://www.napf.co.uk/PolicyandResearch/DocumentLibrary/~/media/Documents/NAPF%20Policy%20Documents/0016_Institutional_investment_in_the_UK_six_years_on_0107.ashx

party incurs them and the extent to which the offset gains from turning over stock – and the way that asset managers are rewarded.

We propose that asset management firms provide investors with more information about their incentive structures to enable this.

There are dangers in going further, towards absolute limits on portfolio turnover, as this may have perverse outcomes. Our instinct however is that we are likely to need to go further if we want to underpin long termism and look to bring in something closer to a requirement to act differently rather than just an 'understanding'. This should include insisting that a certain percentage of any fee structure for clients as well as the asset manager's internal bonus arrangements relate to long term returns. But before taking that step we think more information is required.

We propose that independent research is undertaken into investment management contracts. This should encompass the structure of financial incentives used by asset management firms and the impact these have on asset manager behaviour and performance. It could also consider whether mandate design could mitigate short-term pressure in the investment chain. This research should be conducted with urgency.

6. Directors' pay - remuneration committees

The way directors' pay is set has consequences – especially as it sets up the incentives that in theory they respond to. But it also determines what level of remuneration our 'captains of industry' obtain, which has social and 'political' consequences. Indeed it may be argued that the attempts to give proper incentives to good behaviour has not worked and that various long term incentive programmes in fact just give lots of money to senior management and achieves very little beyond that.

A recent study for the Coalition government found that "in 2009 median pay for FTSE 100 chief executives has risen to 88 times UK median earnings....up from 47 times in 2000" and more surprisingly that "chief executive pay for Britain's leading listed companies rose by around eight times between 1986 and 2010.. an even faster rate of increase than in the US over a comparable period'.[13]

There is surprisingly little evidence that the extremely high pay – relative to the average worker – has achieved that much and at least some evidence that it has achieved little at all including some from LSE[14] and from the recent Hutton report on public sector pay.[15] The argument that high pay is needed to attract the best and stop good British mangers from being lured abroad is also hard to substantiate and it is well known that the strongest correlation of the size of the overall pay packet is the size of the company.

Remuneration committees are key to pay setting and despite reforms of their make up to keep them more independent, the trends in pay do not seem to have altered.

As PWC put it in their 2009 Review of Executive Compensation:

Many institutional shareholders believe there is a tenuous link between pay and performance. The shareholder perception is that incentives ratchet up each year in line with annual benchmarking while incentive design and performance measures chop-and-change depending on management's expectation of them paying out (or not).Underlying these perceptions is a feeling that remuneration committees are not being tough enough and exercise poor discretion that always favours executives.

13 *Hutton Review of Fair Pay in the public sector: interim report;* December 2010, HM Treasury
14 http://www2.lse.ac.uk/newsAndMedia/newsArchive/archives/2009/06/
15 *Hutton Review of Fair Pay in the public sector: interim report*; December 2010, HM Treasury, especially chapter 3

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We believe that one of the reasons for this is a tendency for like-minded individuals to reinforce each other's existing views, and push them further. More detail on how this works was set out in a recent PIRC paper[16] where we made the following observations about its applicability to corporate governance based partly on the work of Cass Sunstein:

.. he argues that [the tendency to reinforcement] would back the argument for independent representation on boards, with independent non-executives providing a challenge to group-think. But the point could be applied specifically to remuneration.

For example, it has long been argued by some that remuneration committees are too clubby, as those that sit on them are often directors of other companies too. Sunstein's book [Going to Extremes] provides some theoretical weight to this argument. Typical remuneration committee members are likely to think that large rewards are necessary to recruit and retain the best executives. Put in a room together discussing this issue they seem likely to reinforce these views and push them even further.

Cranfield researchers also looked at this issue recently via a survey and concluded that often "companies used performance-related pay because their peers did, and because that legitimised them in the eyes of the establishment".[17] Group think indeed!

One step worth taking is therefore to try to break up this group think. To do this we propose a number of options be examined. The last two are more speculative and are put forward in that spirit.

First, change the information remuneration committees have to consider when setting top pay. For example, companies should be required to consider information on internal pay ratios.

Second, change the composition of remuneration committees a little in order to challenge group think. The objective would be to extend membership to those who might hold different views, this might include employees, representatives of the public, institutional shareholders and so on.

Third, change the remit of the committee so that they have to justify with evidence the results of their previous actions in terms of levels and bonus schemes and its effects on performance.

Fourth, tighten the remuneration reporting requirements. This could include discussion of the effectiveness of remuneration policy, and how pay across the company is taken into account.

16 *Pay and behaviour: PIRC Client Briefing / August 2010*
17 https://dspace.lib.cranfield.ac.uk/handle/1826/962

7. Directors' pay – making voting more effective

Most CEOs champion the goal of maximizing shareholder value but without embracing the essential determinant of value—risk-adjusted, long-term cash flows. Instead, they are obsessed with Wall Street's earnings-expectations machine and short-term share price. Sacrificing the company's long-term prospects to meet quarterly earnings expectations in an attempt to temporarily boost the stock price represents the antithesis of sound shareholder-value management. A driving force for such behavior can usually be traced to executive compensation schemes.

In the early 1990s, as corporate boards endorsed shareholder value, they became convinced that the surest way to align the interests of managers and shareholders was to make stock options a large component of executive compensation. By the end of the decade, stock options accounted for more than half of total CEO compensation in the largest U.S. companies. Options and stock grants also constituted almost half the remuneration of directors. But short-term thinking and earnings obsession did not decrease; they increased.

Alfred Rappaport, *The Economics of Short-Term Performance Obsession*[18]

There have been many attempts to get a better handle on directors' pay. The introduction, from the 2003 season, of a shareholder advisory vote on remuneration was intended to improve oversight (and presumably restraint). In analysis we carried out with Railpen, PIRC concluded that the introduction of the vote had been positive in terms of enhancing company-shareholder engagement over remuneration.[19]

However the introduction of the vote has not halted the growth in what we consider to be excessive executive reward. We consider this is in no small part due to the supine stance adopted by both individual institutions and their representative bodies. According to our most recent analysis, votes against remuneration reports hit a low in 2008. In 2009 there was a significant spike in opposition, but in 2010 voting has almost returned to pre-crisis levels.[20] Despite the opportunity to vote it is clear that many shareholders still do not exercise this right effectively.

In more detail, many institutions appear to have taken the view that the only issue to consider in remuneration policy is performance linkage. The scale of rewards has been largely ignored, providing that 'challenging' performance criteria are attached to them.

This whole agenda has been give extra importance following the financial crisis where it has been argued that having the wrong incentives via pay leads to action (excessive risk taking) that produces short-term profits but can be near-fatal if things go wrong. We therefore believe it is important that the vote that shareholders have on remuneration carried real weight.

We propose that the advisory vote on company remuneration reports should become binding.

However this will only be effective if shareholders themselves are accountable for how they exercise their ownership rights. Therefore in addition, as noted earlier, we propose that public voting disclosure should be made mandatory.

Many of the changes suggested in the Walker Review and FSA Remuneration Code that seek to restructure reward in order for it to incentivise long-term performance are useful.

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18 Financial Analysts Journal Volume 61 • Number 3
Available at http://www.expectationsinvesting.com/TCO/EconomicsofShortTerm.pdf
19 *Say on Pay: Six Years On, PIRC/Railpen*, 2009.
http://www.pirc.co.uk/sites/default/files/documents/SayonPay.pdf
20 To end June 2010 the average oppose vote on a remuneration report resolution at a UK-listed company was approximately 6%. In the 2009 season the average oppose vote was 17.5%, PIRC data.

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We propose that the case for implementing the measures suggested by Walker and the FSA in other sectors is thoroughly examined.

The case against this is that banking and financial services are a special case in that the externalities from a failure of governance (especially over pay) are so clear that there is a case for such interfering in pay.

There is something in this. However we think that if such measures are brought in for banks and seem to work without causing too many problems then they would be a useful addition to pay setting in the whole of our corporate sector.

7. Company takeovers

It is often argued that the fear of takeover leads managers to focus on the short term, the short term movements of the share price and therefore leads to a bias towards short termism. Some have argued previously that if there is a problem then this is in the way that directors perceive (perhaps wrongly) what shareholders expect of them, not a reflection of actual investor activity.[21] Nonetheless if the perception of hostile investor reactions affects board behaviour in this way this should still be a matter of concern.

We support the need for an open and thriving market for corporate control to ensure that managers do not pursue their own aims at the expense of shareholder interests and that pressure for efficiency is always present.

But given that most evidence suggests that takeovers are rarely in the long run interest of the acquiring firm, it is hard to argue that markets work efficiently here.[22] There is therefore a strong case for making the process of company takeovers a little harder so that more thought and care is taken about the decision. By putting a bit of 'sand in the wheels' we can achieve this.

The Takeover Panel has recently proposed some new measures including that potential buyers would have to make a firm offer within four weeks of announcing an approach and disclose information on financing, and that there should be additional disclosure of financial and legal advisers' fees related to mergers. These measures may help and the best policy now may be to see how they play out. But our suspicion is that they will not go far enough.

We therefore propose that the situation is reviewed in 3 years and meanwhile analysis is made of three options:

- **The introduction of a minimum holding period before shareholders are able to vote on deals**
- **The requirement that acquiring firms give their shareholders a vote on all proposed takeover deals**
- **The case for raising the threshold for a successful takeover to two thirds of shareholders, a 'super majority' for such a profound change in the status of a firm and one that is similar to the threshold found in many other organisations for significant changes to fundamental characteristics and control.**

[21] See for example, *Short-Termism on Trial*, IFMA, 1990
[22] See for example *Beating the Bears*, KPMG, 2002, and *Which Deals Create Value?*, LAPFF, 2007

8. Information on company strategy and longer term plans

Many of the problems that run through the investment chain and lead to short termism come from companies being unclear about where they are heading in the long to medium term, and how current performance relates to that. Of course those down (or up) the chain then need to respond to that information intelligently, but if they do not have it then they will naturally resort to giving undue weight to evidence about very short term performance.

A report by a panel of investors, asset managers, and corporate issuers in the US under the banner of the CFA Institute[23] concluded that a way to reduce dependence on quarterly earnings guidance was to:

"Improve communications and transparency: More meaningful, and potentially more frequent, communications about company strategy and long-term value drivers can lessen the financial community's dependence on earnings guidance."

This links in many ways to the narrative reporting consultation[24] that BIS is currently carrying out and to which PIRC has previously responded.

Financial performance needs to be seen against the longer term business plan. This is naturally helped by a shift from quarterly to annual guidance, something that has some momentum in the US.[25] As the CFA puts it:

"This would offer skilled analysts and asset managers an opportunity to differentiate themselves and add value by conducting insightful research and building superior valuation models for their clients."

On the other hand if the company can produce appropriate, high quality performance information on a frequent basis then the tendency to base everything on quarterly earnings guidance will lessen.

In any case broker research needs to be improved and focused more on the longer term. The Business Review needs to be very clear on where the company is heading. Plain language is needed rather than legal or accounting terminology.

None of this is helped by what the FRC pointed out recently - that bid prospectuses often do not correlate well with companies' own strategy statements.[26] It concluded:

"Overall, the results were disappointing. In some cases it was difficult to identify the required accounts disclosures and in other cases the information provided in the business review and the audited accounts was either insufficient or inconsistent. Nearly all the companies included in the study gave a logical and seemingly comprehensive account of the reasons and expected benefits of the acquisitions in their business reviews. However, we were able to find a coherent and consistent link between the information in the business review and the intangible assets recorded for only four transactions. Furthermore, we concluded that none of the descriptions of the factors giving rise to goodwill in the audited accounts was informative."

Overall there is a lot that can be improved on the communications front.

We propose that the Government convene a group of issuers, investors and other stakeholders to explore these issues. This group come forward with new proposals on how to improve information provision to enable all parties to have a greater focus on the long term.

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23 *Breaking the Short-Term Cycle* (2006), CFA Centre for Financial Market Integrity/Business Roundtable Institute for Corporate Ethics, Discussion and Recommendations on How Corporate Leaders, Asset Managers, Investors, and Analysts Can Refocus on Long-Term Value
24 http://www.bis.gov.uk/Consultations/the-future-of-narrative-reporting-a-consultation
25 CFA op cit claims that in 2006 43% gave only annual guidance
26 http://www.frc.org.uk/publications/pub2206.html

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ANNEX

Responses to Consultation Questions

The Board of Directors

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

They often try to but are pulled in many different ways. Various different elements of the system – from broker analysis to focus on short-term relative investment performance to the structure of remuneration – create a culture that does not encourage long-termism.

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?

No. While they can request such information this is a cumbersome and unnecessary burden on companies. We therefore believe that they should have it as a right.

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?

This makes engagement harder due to foreign ownership and much shorter holding periods on average. However it also means that we need to work harder to make sure that long termism is not sidelined.

4. What are the most effective forms of engagement?

Good relations between shareholders and company are desirable. This requires information, the right incentives and trust. It also needs to be forced to some extent. In our experience of company engagement, face-to-face meetings are critical.

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

This is improving, but in our experience there is still a disconnect in some investment institutions. In addition we would draw attention to the potential danger from 'integration' of governance within the investment process, which has become something of an article of faith.

The dangers are two-fold. On the one hand if the investing institution really does integrate governance into investment decision-making, there is a concern that asset managers might be encouraged to sell out of companies where they have concerns, rather than engage. On the other hand, and perhaps more likely, the result of 'integration' will be that portfolio managers have a greater influence over, say, voting decisions. In our experience where this is the case - unless the portfolio manager has some knowledge and understanding of governance - this can lead to support for management even where there are questionable structures or policies because the manager likes the company and its management. This appears to be symptomatic of the 'halo effect'.[27]

[27] http://www.mckinseyquarterly.com/The_halo_effect_and_other_managerial_delusions_1928

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 not the only form of engagement but getting the voting framework right also encourages the kind of dialogue that we want to be seeing behind the scenes. We are concerned that asset managers in particular often seek to counter pose voting and engagement when they are part of the same process. As a result some asset managers seek to make much of assurances (sometimes of the vaguest kind) given to them by companies in 'exchange' for not voting against. We have found that that this can hamper successful engagement. For example in our experience of facilitating the Local Authority Pension Fund Forum's engagement with Marks & Spencer over a major breach of the Corporate Governance Code, we found the voting decisions of some asset managers weak in the extreme.

We are also concerned that this type of behaviour by asset managers leads to a distortion of the signalling function of voting. If investors vote for a resolution despite having significant concerns this deprives the wider market of important feedback. We would also pose the question whether companies abuse the supine nature of some institutions' voting, granting flimsy concessions in order to secure support.

We believe there is also a significant accountability gap here, as comprehensive and independent analysis of voting behaviour is not available in the UK (in marked contrast to markets in which disclosure is mandatory[28][29]). This is something that BIS itself could consider undertaking. We have enclosed our own attempt at such analysis with this submission.

From a pure accountability and transparency point of view we believe that public disclosure on voting should become statutory. But in addition it would help make those people who are in effect acting on behalf of the ultimate owners, think harder about their decisions and will we believe enhance the possibility of the long term being given due weight. The burden of proof must fall heavily on those who oppose this step to argue that the burden is excessive and/or that the behavioural consequences would be detrimental to long termism.

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

As we have been clear above we think that there is extensive short termism in equity markets and we have given ideas as to how to tackle this.

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 believe there is some merit in the idea of loyalty dividends. Under this system a company could offer increased dividends for long-term investors. Such a system has the benefit that it would financially advantage long-term ownership (probably only slightly) without either preventing investors from selling out or compromising the 'one share one vote' principle.

It is clear that extending holding periods alone will not necessarily lead to any change in behaviour. However it would tilt the playing slightly in favour of 'ownership' over trading, which we believe is desirable in its own right. It may also lead investors to make more long-term assessments of companies' prospects.

[28] Mutual Funds Votes on Say-on-Pay at 'bailout banks', FundVotes, 2008. http://www.fundvotes.com/downloads/BailoutBanks_2008MFSayOnPayVotes_20081016.pdf
[29] *Proxy Voting by Canadian Mutual Funds*, SHARE. http://www.share.ca/research-reports/proxy-voting/proxy-voting-surveys-by-mutual-funds/

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

The investment chain is riddled with principal-agent problems at virtually every step as we have outlined above. We have also given possible solutions.

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

Transparency on mandates and pay would all help. However we may need to go further than mere transparency as we suggest above.

Directors' Remuneration

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

It is very hard to see this being a consequence (or cause) of improved performance or indeed due to an intense market for management skills. We see much of it as a product of poor decision-making by remuneration committees (particularly resulting from group think) and a lack of pressure for restraint (beyond notional performance linkage) from shareholders.

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

We think that research into group decision-making[30] points clearly to the potential flaws in current remuneration committee membership. Mixing up the membership might help challenge group think in a useful and positive way. We fail to see how it could do any harm. We believe that BIS should active explore these issues, and the potential benefits of widening committee membership.

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?

With honourable exceptions, shareholders in general have been poor at holding companies to account over remuneration for a whole variety of reasons. As noted previously, it has seemed almost a point of principle to not take a view on the overall level of reward, provided there is a link to performance.

PIRC has advocated the introduction of an advisory vote on a 'heads of terms', a summary of directors' contract provisions to minimise potential rewards for failure. However this is only likely to be an effective reform if shareholders exercise the right intelligently. For this to happen investors themselves need to be accountable for their activity, which necessitates mandatory disclosure of voting data.

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

- *linkage between pay and meeting corporate objectives*
- *performance criteria for annual bonus schemes*
- *relationship between directors' pay and employees' pay?*

Transparency is currently very much in vogue. On behalf of the taxpayer the government is rightly demanding it in the public sector: it is now virtually impossible for

[30] For example *Going To Extremes* and *Why Societies Need Dissent*.

anyone to be paid more than the prime minister and there is full transparency on many jobs that are by city standards very poorly paid. The Hutton Review is exploring for the Government the introduction of a 20:1 bottom-to-top pay ratio in the public sector. We believe it would appear inconsistent if the Government did not also support at least the disclosure of similar information in public companies.

We see transparency as therefore potentially very useful and the arguments against would need to be very powerful and arguments made that the side effects were powerful here while not being so in the public sector.

But care needs to be taken. In the small world of those who currently set director pay transparency has tended to lead to bidding up so that their directors are paid in the top quartile of pay for directors.

In addition we do need proper analysis of information so that it is used to hold management to account. Just publishing information is of no use unless boards and external groups are evaluating it.

Takeovers

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

Long termism is not as often as it should be a prime motivation for a takeover. Often short-term benefits – including crude cost reduction and competition reduction – take precedence.

There is not enough explanation of the strategy that the acquiring firm intends to take beyond this to allow shareholders to properly assess the potential transaction.

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?

There is a strong case for the shareholders in acquiring companies having to vote – though this is complicated when they are listed overseas. Nonetheless this should be given proper consideration.

Other

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

As we have made clear, the whole investment chain has to be considered as one and so reform in all places of the chain are worthwhile. The pressing need to rebalance the UK economy and make long termism the dominant mood means that we must resist those who argue for the caution of the status quo. Of course we need good evidence and analysis and need to consider possible offsetting and unintended effects of change. But we cannot let such arguments prevent innovation. There is a strong case for change in a number of areas as we have argued and we support the Secretary of State for Business, Innovation and Skills in his bid to undertake reform.

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