BIS | Department for Business Innovation & Skills

A LONG-TERM FOCUS FOR CORPORATE BRITAIN
Call for Evidence Response Form

A copy of the consultation available at: http://www.bis.gov.uk/consultations.

Responses to the Consultation should be received by 14 January 2011.

Completed copies of the response form should be returned:

Via email to: clgconsultations@bis.gsi.gov.uk

Via post to:

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Organisation (if applicable):

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

	Quoted company
	Other company
	Investor or investment manager
	Business representative organisation
	Investor representative organisation
	Non governmental organisation (NGO)
	Trade Union
	Lawyer or accountant
X	**Other (e.g. consultant or private individual)**

The Board of Directors

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

Comments

Question 2: Does the legal framework sufficiently allow the boards of listed companies to access full and up-to-date information on the beneficial ownership of company shares?

Comments

Shareholders and their role in equity markets

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

Comments

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

Comments

Institutional investors and shareholder engagement are needed to make sure companies adhere to the corporate governance codes. Institutional investors influence the companies they invest in through shareholder activism and their vote which hopefully will lead to development of policy within the companies they invest in. However, in recent years, there has not been proper dialogue between institutional investors and the company they invest in. ”An ongoing dialogue with its investee companies” is needed to bring about change within the organisation. The ISC which represents a number of investors is quite clear that the influence shareholders have on the companies they invest in is worthwhile.

Many examples of the practices investors should be actively encouraged to perform are; monitoring performance, periodically checking whether the board is effective, working efficiently and “intervening where necessary”.

Focus Lists

A key method Hermes use to reinforce the need for companies to engage with the institutional investors is with the creation of a focus list. This is a list clearly displayed on their website and states any company which they feel are not operating correctly. This has been found to be very effective as many companies once on the list strive to correct the issues identified, and should be utilised further by many other long term shareholders.

ISC upholds this view that shareholder activism is key to enforcing corporate governance procedures and is a tool that can force change within an organisation. Hirschman proposed that the investors work within an “exit and voice framework arguing their dissatisfaction to management”. This activism can be essential in making sure the management know that the investors feel the strategy the board is undertaking is not in the best interests of the company.

Sell shareholdings in firm

However, if investors feel that the strategy the board is undertaking is not correct, it can be difficult for them to make the company formulate a change of policy. Shareholders can't simply sell their stake in the company as it could destroy synergies of the portfolio they are trying to create. (Mallin (2004).

Selling off their interest in the company is usually the very last step; a better approach would be to make their opinions heard and work with the board to formulate a strategy that both can agree.

Remuneration policy vote

This is then why the vote by shareholders on director's remuneration can be a powerful tool, to increase value for shareholders. By making the vote binding it will give more power to long term shareholders who look after the long term interests of the company. Investors have the power to show their dissatisfaction to any poor linkages of pay and performance using this vote. This can have a "positive impact on pay and performance sensitivity". (Hartzell and Starks, 2003)

However, as this vote is not binding, investors do not have the power to force a change in the remuneration structure and the "Agency Theory" problem, of the separation of ownership and control is widened. (Berle and Means, 1932)

Voting is clearly and important tool in the shareholders arsenal to show dissatisfaction of a poorly performing company. However, the fact that the remuneration vote is non binding seems to be a serious failing of corporate governance.

Recommendations

This is why one of my recommendations is to give more voting rights to those shareholders that hold on to shares for the long term interest of the company, this therefore would counter act the cross shareholdings of banks in rival banks which my research found has created a conflict of interest, in regards to remuneration and the use of voting and comparator groups.

Myners (2009) has called for "differential voting rights for different classes of investors". My research does not advocate those proposals as they would change the hierarchy of shareholders, and have a negative effect in distorting market competition. Though, the impact of this banking shareholding arrangement needs to be examined further, and whether it is specific to the banking sector or whether it has applications in other areas

of the market.

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

Comments

<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

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

Comments

<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

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

Comments

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

Comments

Directors' Remuneration

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

Comments
During my MSc I researched extensively the differing reasons why directors pay keeps increasing far more than the national average. **<u>Talent Management</u>** One reason can be explained through the use of Talent Management or Tournament theory. (Lazear and Rosen, 1981) Tournament theory argues that employees take part in tournaments during work life, with an aim to gain the ultimate prize, in a corporate context; this is the role of CEO. This would mean that the CEO is the one who is not incentivised based on performance, but the high pay amounts are there to incentivise the subordinates into aiming for that role. This theory can also help explain why CEO pay is much more inflated than the other board directors. The difficulty in attracting talent at the top of an organisation can also contribute to higher pay

for those directors at the top. When a company finds a talented individual; the candidate feels he "deserves" the higher pay reward to reward him for his talents. (Rosen, 1982)

This utilisation of talent has been recognised by Galbaix and Landier (2008) who found that "managers of the best ability are paired with the largest firms". In the UK, the largest firms are banks; this may explain why pay at banks is much higher than in other industries.
This role of talent management is further recognised in the Combined Code (2008) which states that "levels of remuneration should be sufficient to attract, retain and motivate directors to run the company successfully" thus undermining the need to link pay to performance.

Money as a Motivator

Money however, does act as a tool to motivate certain individuals.
Employees will only be motivated if they feel the ends justify the means and it is worthwhile. If the amount in monetary terms is enough, then they will be incentivised to achieve. Adams (1963) adds to this in this paper on what he described as " Equity Theory" which noted that the need for equality by individual's, means individuals compare themselves against someone doing a similar job, with similar effort but being paid more. "If the correlation between input and output is too high then they would act to redress the equality and look for work elsewhere or demand a pay rise to reflect their contribution". (Adams,1963)

Therefore, talent management and money come into play in retaining and motivating the employee are is key evidence in why directors pay keeps increasing.

Remuneration Consultants

Finally another accomplice to the ratcheting up of director pay is the use of Remuneration Consultants. Conyon et al (2006) found in the UK 250 largest companies; "remuneration is higher when they engage the services of the two most frequently used remuneration consultants: Towers Perrin and New Bridge Street".

They are highly influential and advise the remuneration committee on an appropriate pay structure for the CEO and board. Remuneration consultants are utilised for their expertise as they understand the relevant laws and have a keen understanding of the market as a whole and how remuneration can be constructed to gain the best from and for the individuals involved. Furthermore, they carry out detailed research on pay practices with sector specific information to help identify pay structures or new methods of calculating pay to benefit the parties involved.

Little is published about how they help influence remuneration and whether they have

helped inflate the pay awards of CEOs. However, in the last recession, remuneration consultants were responsible for the large increases in executive remuneration and research by Crystal (1991) found that some employees were only hired if they proposed an increase in remuneration.

This trend has continued in this recession as research findings by New Bridge Street gives an insight into the advice that consultants are proposing. They suggest a "lowering of targets in bearish conditions and a reweighting of short and long term incentives. (New Bridge Street, 2008)

Worryingly, the report by New Bridge Street (2008) also notes, a "one off higher short term bonus will "fill the gap" in reward because the long term incentive will fail in the next few years". Remuneration consultants argue that now is a critical time to retain key talent.

This ability to manipulate the remuneration structure when the economic climate changes removes the need to incentivise the CEO as the "bar" is lowered when they don t achieve.

Companies regard remuneration consultants as independent as this will legitimise the CEOs pay as outside of the boards control. However, this independence has been argues as a mere fallacy as Murphy and Sandino (2008) found; remuneration consultants will "seek to secure repeat

business from the client and do not want to jeopardise that". By offering additional services, such as actuarial and pension advice the consultants could be overly generous in their remuneration structure created for their clients. This is so that they "protect their other highly lucrative assignments". (Morgenson 2007), (Waxman, 2007) (Cadman, Carter and Hillegeist, 2009)

The literature and evidence from the banks analysed seems to indicate that remuneration consultants do exert a "negative influence on the cash annual incentive of CEOs pay". (Walker, 2009)

Only when shareholders long term interests are aligned with remuneration consultants short term interests, will the long term interests of the company be protected. Furthermore, this highlights the need for tighter regulation of remuneration consultants.

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

Comments

Question 13: Are shareholders effective in holding companies to account over pay? Are there further areas of pay, e.g. golden parachutes, it would be beneficial to subject to shareholder approval?

Comments
In my research attached, it has become apparent that within UK Banking equity markets contain a low amount of institutional investor shareholdings in banks, with in some cases only 10%, of shareholders being Institutional Investors, whereas banks contributing to shareholdings in other bank shareholdings as high as 40%.

This ability for a bank to hold a share in a rival bank can create a corporate governance problem with this concentration of likeminded investors on remuneration. It creates difficulties for other more independent shareholders to hold the company to account.

For example Bank 1 cannot hold Bank 2s remuneration policy to account as both have similar remuneration schemes.

If Bank 1 voted against Bank 2 at the AGM it would bring Bank 1s remuneration scheme into question. This collective policy means the remuneration package the CEOs are awarded are not challenged to the extent that they should be by shareholders.

Hector Sants, Chief Executive of the FSA noted; "a lesson for you [institutional shareholders] from this crisis must be that greater minterrogation of how well a company is managed is needed". However, as my research evidence shows if the banks make up a larger proportion of shareholders themselves, and all have similar remuneration policies, how can this "interrogation take place"?

The government and FSA need to give independent institutional investors more power to make their vote on remuneration *binding*. The ability for the banks to "*buy into*" these voting arrangements means that they can manipulate the voting mechanism from the inside and destroy institutional shareholder value in the process. I understand that this may be fairly new development as part of the consultation process but is an area where further research will be needed to be discussed further to understand if this arrangement is sector specific.

<u>Question 14</u>: 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

Before 2002, directors did not have to disclose their salaries in such detail as they do now. However, in 2002, Directors Remuneration Regulations made formal disclosure of directors' remuneration mandatory. This it was argued would "ensure greater transparency" and "improve accountability"; it was also argued that the regulation would combat directors being "lavishly rewarded for lack lustre and poor performance". (Patricia Hewitt of the DTI, 2002)

Many of these views however, are echoed today, once the regulations were passed, and with the introduction of remuneration committees, pay actually increased. (Manifest, 2002) This increase in remuneration maybe due to the remuneration regulations increased transparency and allowed investors a vote on pay. However, the vote had no validity because it was non-binding. Manifest (2002) argues that it did not give "investors "teeth" with which to bite at underperforming or over paid directors".

The main point of performance related pay is to incentivise the CEO and directors to perform to a high standard. The Combined Code on Corporate Governance (2008) notes the need to incentivise executives stating that "a significant proportion of executive directors remuneration should be linked to corporate and individual performance" (2003), Para B 1).

Furthermore, "the use of the term "significant" is different from previous versions of the code when only a "proportion" needed to be linked to performance, thus emphasising the importance of this variable element", and the added value to shareholders of linking pay to performance. (Smith, 2008)

However, Talent retention can be paramount to a company's success or failure as those companies that can hire and retain talented individuals may outperform their peers. This is particularly relevant in the current economic climate, as company that can hire talented individuals will be one of the first companies out of the recession to reap the rewards. Jensen and Murphy (1990) note that a "corporate brain drain" can develop if companies do not pay the right amount to attract and retain quality managers. Therefore, companies that are willing to pay higher amounts will attract more talented individuals. Furthermore, within the realms of banking which have a deeply embedded bonus culture that is designed to motivate and attract the top talent and explains why "many CEOs don't work harder for the possibility of being paid more". (Bender, (2004)

One of my recommendations in my study is to link “the Board and CEOs remuneration to a multiplier of the lowest paid employee. (E.g. 20x) This would have the effect in that the company still could reward good CEO’s and directors but if their pay rises then they must bring up the lowest paid employees pay as well. (this would also mean in time all employees pay would need to rise to keep employee pay levels reflective of their grade). However, this policy would mean employees at both ends of the company are rewarded by the company and also would mean in real terms the social and economic levels of the UK would rise.

Takeovers

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

Comments

Question 16: Should the shareholders of an acquiring company in all cases be invited to vote on takeover bids, and what would be the benefits and costs of this?

Comments

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

Comments

Remuneration consultants

Evidence in my research suggests that the remuneration consultants play an active part in the ratcheting up of performance related pay, as even though they are deemed independent, and utilised by the remuneration committee for advice, they have an agenda to ensure that pay that is benchmarked is continually uplifted thus ensuring the consultant gets a larger reward and commission for his/her services and that the consultancy firm he/she works for is retained for further work by the business.

Banks as shareholders

Banks as shareholders or shareholders that work in the same sector as the shares they represent should form part of a wider consultation, as their aims and objectives are clearly different from that of the independent shareholders who want value to be given to the long term interests of their stake. Finally another aspect that has not necessarily been discussed in depth in the pension arrangements for CEOs during the financial crisis. I understand it is a sensitive area but as Graph 3 shows within my research that during the last 5 years the Pension as a component of CEO pay has been rising, and may be an area for research to understand if this is a developing trend.