BIS | Department for Business Innovation & Skills

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

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

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

Completed copies of the response form should be returned:

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

Via post to:

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

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

The Board of Directors

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

Comments
The definition of "long-term" varies between different businesses in different sectors. For example, companies in the retail sector may have a long-term focus that lasts for a couple of years whilst research-based pharmaceutical companies have a long-term focus that lasts 5 to 10 years. Therefore, LGIM believes that a Board's long-term focus should reflect the company's strategy and sector and how it is expected to generate "sustainable" value for investors. Furthermore, in some cases, it may not be appropriate for Boards to have a long-term focus as the survival of the Company is dependent on a shorter time frame. Examples of these situations include times of financial and economic stress (e.g. short-term liquidity obstacles) or a business turn-around.

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
The Companies Act 2006 provides a mechanism by which companies can access information regarding the legal ownership of company shares. However, this is easily accessible up to the nominee account level. After this point, getting full and up-to-date information relating to the ultimate beneficiaries of the shares becomes less transparent and more complicated.

Shareholders and their role in equity markets

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

Comments

The UK equity market has become more globalised which has resulted in more international ownership of shares. This has also led to the UK equity market becoming more fragmented, reducing our corporate governance influence on UK Plc companies.

Whilst UK institutions are subject to local best practice (e.g. UK Corporate Governance Code and UK Stewardship Guidelines), overseas companies can choose not to comply with these principles. These institutions tend to follow a global policy which has a different view on corporate governance (e.g. international investors may choose not to exercise their voting rights).

As a result, best practice standards could be reduced and could vary between companies.

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

Comments
There are various types of engagement methods that LGIM utilises which are dependent on the size of the Company, its location and the issue to be discussed. As one of the largest passive investment managers in the UK market, LGIM engages in extensive dialogue with companies as we do not have an option to divest from a Company if performance is not satisfactory. In addition, LGIM exercises its stewardship responsibilities by casting votes at General Meetings which may be a direct consequence of failure by a company to address key issues. LGIM has often found that the most effective forms of engagement take place in private and are face-to-face meetings (both individually and collectively). This may not be suitable for meetings with companies based overseas. Therefore, LGIM will often hold telephone conference calls to discuss important issues with international companies. In addition, the most effective forms of engagement occur where there is input from both parties which have resulted in a common understanding. As a result, changes may take place or further action may be taken before final decisions are made.

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

Comments
In LGIM's case, we feel that we have strong dialogue with our in-house fund managers. Regular meetings are held with both the passive and active equity functions. The corporate governance department is also seated near these respective departments. Due to the internal structure of the investment business, there may be occasions where conflicts arise. To tackle these issues, the Corporate Governance department has a well established conflicts of interest policy. (http://www.lgim.com/corporate_governance_and_responsible_investment.shtml) There are also further safeguards within LGIM including a compliance function that monitors our investment activities and Chinese walls.

<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
As an institutional investor, LGIM has a fiduciary duty to clients to exercise its voting rights responsibly. The right to vote is a basic privilege of share ownership and a fundamental tool used by investors to signal support or dissatisfaction with management actions. Therefore, voting can be seen as a basis for communication with companies. LGIM has provided public disclosure on UK voting since 2008. However, this information has been of limited public interest and the initial start-up costs appear to outweigh the benefits derived from its disclosure on the website.

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

Comments
Short-termism in equity markets creates volatility. Whilst this should not be a problem as it is a feature of stock markets, too much can have negative effects on the value of stock prices and may pressure the management of companies to take unnecessary risks to restore stability. However, it should be noted that different sectors and different markets have their own definitions of what is considered to be short-term. In addition, although performance benchmarks are reviewed annually, reporting by fund managers is done on a quarterly basis which implies that their focus is in the short-term, which may be misleading. Therefore, a greater understanding by asset owners on the way their fund managers perform and how this performance is reported needs to be observed in balance with the long-term view.

<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
LGIM believes it is difficult to encourage long-term focus in UK equity investment decisions because different investors have different investment horizons. In addition, pension fund managers match a client's portfolio to its liability which varies. For example, if a pension scheme is about to mature, short-term performance is required and vice versa. Therefore, a greater understanding between asset owners and fund managers needs to be developed to ensure that mandates are clearly stated and transparent. Another approach to encourage the market to focus on long-term performance is to ensure that remuneration arrangements are linked to long-term value creation. By doing this, it ensures that investment decisions are made based on the consequences in future years. Amendments on rules and regulation (e.g. Accounting requirements) also need to be made to ensure greater transparency.

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

Comments
LGIM acknowledges that there is an agency problem in the investment chain between fund managers and principal asset owners. The UK Stewardship Code is one way of addressing this conflict by allowing investment mangers to provide more transparency on their activities and better informing principal asset owners of the way they discharge their responsibilities.

<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
LGIM believes that there may be some argument for increased transparency with regards to the remuneration of fund managers and their mandate investment targets as this is not public knowledge. However, the way it is communicated needs to be taken into consideration to ensure no confidentiality rules are breached. There is also limited public disclosure regarding the proportion of performance fees linked to fund managers pay. However, as this is linked to the performance of the fund, the main area for further transparency should be to ensure that incentives are appropriately benchmarked and challenging performance targets are set. Focus should not be solely on quantum levels because the size of the funds differs and fund managers are more likely to receive significant bonuses only when above average performance has been achieved.

Directors' Remuneration

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

Comments

The main reasons for the increases in directors' remuneration that LGIM has experienced are retention, benchmarking, recruitment, motivation for the completion of a successful transaction or strategy, and taking on additional responsibilities

In our experience, most of the increases have been caused by benchmarking exercises conducted by remuneration consultants. Furthermore, globalisation has increased the size of businesses and has placed more emphasis on the retention of key employees.

LGIM believes that remuneration should be linked to a sustained improvement in a Company's performance, but there have been only a few incentive schemes which have time scales which extend beyond 3 years.

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

Comments

LGIM believes that a Company's Remuneration Committee should be comprised of independent Non-Executive Directors.

However, if a Remuneration Committee believes that it would benefit from the input of other parties, these individuals can attend Remuneration Committee meetings by invitation. This may include remuneration consultants, shareholders, Unions or employees. LGIM supports this approach because it allows the Remuneration Committee to gain access to different resources without experiencing any conflict with the associated parties.

Ultimately, the Remuneration Committee should make the final decision and be held to account for their choices. Therefore, it is up to the independent Non-Executive Directors to ensure that compensation is linked to long-term performance and aligned with shareholders' interests.

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

LGIM feels that shareholders' effectiveness to hold companies to account over pay varies on a case by case basis. A number of factors need to be

considered including different shareholdings of investors, the Company's location, size and performance. The issues which are linked to total remuneration include: performance conditions, shareholder dilution from incentive schemes and directors' contract length are examples of issues that have been addressed over recent years.

LGIM believes that it is best practice to put to shareholder approval additional areas of pay such as significant discretionary payments. This provides more transparency and enables shareholders to express concerns before awards are granted.

Question 14: What would be the impact of greater transparency of directors' pay on the:

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

Comments

LGIM feels that greater transparency on director's pay will benefit shareholders and enable them to better judge the link between pay and performance.

LGIM is particularly supportive of a results-based approach to remuneration disclosure whereby companies state clearly and in a comparable manner, the short/long-term targets set for Executive Directors, to what extent they have been achieved during the performance period and the resulting pay out. In addition, there needs to be a stronger explanation from companies on the reasons for choosing benchmark and how this data was verified.

With regards to disclosure on annual bonus payments, companies should disclose how the 'basket of performance targets' decided by the Remuneration Committee, links to the overall corporate strategy and its objectives. This may not necessarily be linked to the short-term but investment in the business for longer term prosperity. In addition, non-financial measures should be taken into consideration as it could affect the Company's sustainability.

Takeovers

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

Comments
LGIM believes that Boards do understand the long-term implications of takeovers as it their legal duty to look after the interests of all investors. Furthermore, although there are a few contentious takeovers that occur during a year, it should be noted that the majority are by mutual agreement. However, one element which could be improved in this area is 'transparency' and communication to shareholders on the benefits of the transaction. For example, with regards to the proposal by Prudential Plc to acquire AIA, the circular document to shareholders was 936 pages. Every investor cannot be expected to examine and consume this amount of information without adequate explanation by the company. In addition, corporate transaction fees charged by investment banks should also be examined carefully as this is a cost to the Company and taken on by investors. Therefore, companies need to be clearer on the benefits and risks of the transaction in order for shareholders to better understand and judge the long-term implications of the deal.

<u>Question 16</u>: 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
If shareholders of an acquiring company were invited to vote on all takeover bids, this would be very costly for investors. LGIM feels that the current Listing Rules which requires 'Class Tests' to be performed in order to categorise and highlight financial transactions is an appropriate tool of investor protection. Currently, a Class 1 transaction (where by a 25% materiality threshold is exceeded) is at the correct level to judge the significance of a transaction. Therefore, the regime in place is appropriate. However, direct communication from acquiring companies to shareholders is always welcomed in order to debate the benefits and costs of the transaction being proposed.

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

Comments
Whilst corporate governance is a focus for mainly equity holders who have voting rights, debt holders should also be taken into consideration when examining financial transactions.