RESPONSE TO THE DEPARTMENT FOR BUSINESS, INNOVATION AND SKILLS (BIS) CONSULTATION DOCUMENT "A LONG TERM FOCUS FOR CORPORATE BRITAIN: A CALL FOR EVIDENCE"

The Association of Accounting Technicians (AAT) is pleased to respond to the questions in the BIS consultation document "A Long Term Focus for Corporate Britain: a Call for Evidence". The AAT is a registered charity one of whose object clauses is to advance public education and promote the study of the practice, theory and techniques of accountancy and the prevention of crime and promotion of the sound administration of the law.

The AAT is a global organisation and enjoys a total membership in excess of 120,000 worldwide, which is made up of over 49,000 full and fellow members. The balance consists of student and affiliate members.

Of the full and fellow members there are approximately 3,200 Members in practice providing accountancy and taxation services to individuals, not-for-profit organisations and the full range of business types. Whilst members permeate all levels and sectors of the market they are most active in the Small and Medium Sized Entity market.

QUESTION 1
Do UK boards have a long term focus, if not, why not?

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?

We believe that whilst company boards do have a long term focus, in that they set strategies to meet long term objectives and aspirations, which are almost invariably based on development and growth, they are secondary in importance to short term requirements and pressures from investors, their agents and other stakeholders to meet their expectations. Strategies for consolidation and rationalisation which should be an integral element of long term strategies tend to arise as short term strategies during times of difficult economic conditions rather than in times of prosperity. Strategies to improve efficiency and reduce costs do not pervade during good times when the potential returns are greatest but are seen in bad times when such strategies frequently become a matter of survival.

However, whatever the long term focus might be, Boards are under the greatest pressures to deliver short term results to meet the requirements of investors in particular, but more especially to serve the needs of self interest where directors` remuneration and reward packages tend to be based on the achievement of short term targets, which tend to override long term targets where these are in conflict

Investors and their agents benefit from short term volatility in share prices rather than longer term stability and so create an environment to encourage boards to set strategies which are likely to produce that volatility.

It is reasonable that the boards of listed companies should only be legally obliged to communicate with individuals or entities listed on its share register, and not be put to the

additional administrative burden of trying to establish who the beneficial owners are. Similarly, a trustee or nominee should not be obligated to disclose to the listed company who the beneficial owners are, especially if those beneficial owners are minors.

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

As stated previously, the majority of investors in listed companies and their agents, whether fund managers, brokers, investment advisers, institutions or private investors, are seeking to capitalise on short term volatility in share prices, whether it is to achieve short term gains or to earn commission or mark ups on the turnover of transactions and so exert influence and pressures on boards to meet their aspirations. This situation has been exacerbated by technological developments which provide ready access to price sensitive information and ease and speed of share trading.

QUESTION 4
What are the most effective forms of engagement?

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

QUESTION 6
How important is voting as a form of engagement? What are the benefits and costs of institutional shareholders and fund managers disclosing publicly how they voted?

Voting is important as a form of engagement but by its nature as a form of referendum, it can only effectively provide a useful positive or negative response to a simplified question or issue. It does not accommodate issues which require an “on the one hand and on the other hand” style of debate. As a basis for taking actions it is also not helpful unless the voting produces a substantial majority. A marginal majority decision does not give a board a mandate for action.

Share prices no longer reflect the company’s expected ability to generate operating profits but reflect perceived capital values of a company, reflecting expectations by investors that the company will take advantage of opportunities to add value to the capital base rather than generate operating profits.

The situation where shares are “under valued” (that is capitalised at less than net asset value) produces an anomaly in that the implication is that the company is expected to be loss making and consequently has a “badwill” value element of its net assets. The reality is that the company is probably not meeting the criteria set by investors and their agents to meet their interests with the consequence that the share value is influenced by supply and demand rather than reflecting net assets. These criteria are likely to be most influenced

within investment firms by a lack of common understanding between corporate governance and investment managers.

Just as directors are accountable to shareholders, so investment managers should be accountable to their clients for decisions they take, including any voting, although this does not necessarily require that such has to be public. If there are any issues arising from the way that investment managers exercise votes, and the intentions behind their votes, they should be answerable to their clients, and not the investee company or the public generally.

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

QUESTION 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?

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

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

Short termism in equity markets is a problem in that it creates instability as a result of volatile share prices which are not a fair reflection of value to investors in the company concerned and encourages pressures on boards to act against long term benefits where they are in conflict with short term benefits.

Not only does short termism seek gains from the impact of successes achieved by companies but also encourages the seeking of opportunities to take advantage of disaster or depressed situations which in some cases might themselves be short term.

Volatility of share prices over daily periods (or even hourly periods) cannot be an encouragement to long term stability. Volatile prices cannot provide a true reflection of the value of a company but reflect perceptions and confidence levels. Such volatility encourages investors seeking short term gains, particularly by those who are professional investors and rely on such gains for their personal income. While it is not practical to regulate markets to avoid such volatility, it is possible to consider disincentives, as well as incentives to hold investments long term.

There is a good example of the adverse effects of short termism within the banking sector where over recent years, senior management have faced pressures to achieve short term results which have resulted in staff restructurings, with “retirement” packages for those over the age of fifty five, resulting in the loss of experienced middle management coupled with expansion into high risk activities outside of the management abilities of the remaining less experienced management. However given the current economic and political situation as regards the banking industry, it should be possible to tighten regulation of the activities of banks pay package structures based on a requirement for the complete separation of

speculative investment activities from retail banking and financial services so that the consequences of short term activities in speculative sector do not impact on pay structures in the retail banking sector.

There is greater stability in the listed property investment sector as a result of investment made by such companies usually being for a longer term view and with the practical difficulties of realising investments in property at short notice having a dampening effect on the volatility of share prices in this sector.

There appears to be a more stable equity market in the non listed sector with private equity investors, such as venture capital funds, generally providing funds directly to a company (and not its shareholders) with a view to returns over a period of at least five years, although this still has an element of short termism, but is not as extreme as the listed sector.

A further comparison can be made with owner managed businesses in that the owner manager invariably seeks to achieve reasonable short term results but has a view to major returns being achieved in the longer term, possibly over the working life of the owner manager. As a consequence, the nature of management decisions and style of business operations reflects these objectives. However the operational methods of owner managed businesses are also influenced by difficulties in raising finance for high risk situations, the burden of employment regulations and reluctance to take unnecessary risks once a perceived level of comfort is reached and all of these factors tend to lead to greater long term stability in owner managed businesses.

As the benefits of short termism tend to favour the “professional” investor and directors equally, it is necessary to create a situation to counter these influences.

We would suggest that the most effective way to influence the long term focus of listed companies generally is to introduce in each company a shareholders’ representatives governing body (replacing remuneration committees and effectively trustees for the shareholders) to whom the board is fully accountable for the consequences of day to day management and for both short term and long term strategies and consequential actions. Such an arrangement might also eliminate the need for non-executive directors sitting on the board as their role could be carried out more effectively in the governing body. Members of such boards should be suitable professionals who would be paid a statutorily set salary for part time appointments and statutorily set powers and responsibilities.

If boards are to carry out their duties and responsibilities effectively they should not be expected to account for their actions and decisions on a daily basis but should be called to account at periodic intervals which should be no less than quarterly. A report on three months’ activities, summarised annually provides the most effective form of engagement between shareholders and the board and dampens volatility in share prices.

Coupled with this restriction on corporate governance should be a taxation review aimed at encouraging long term holdings of investments. A variation of the HMRC approved Enterprise Management Incentive Scheme for private companies should be devised for use in listed companies so as to provide the necessary drivers to long term growth and reward for both directors and investment managers. At the same time there is a need to review the tax system whereby substantial tax benefits attach to long term gains and bonuses, also having the beneficial effect of encouraging provision for retirement.

We have previously commented on the adverse effects of undue influence from agents in the investment chain which could be addressed to some extent by the foregoing

suggestions, as could their mandates and pay structures. We do not consider that more transparency in the role of fund managers will alone produce any change in their short term attitudes.

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

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

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

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?

One of the reasons for high and increasing directors' packages currently is the culture of fear of key personnel moving on to even greener pastures so that appointments to key positions are themselves seen by both the employer and the employee as short term and not long term career appointments. Remuneration packages for directors need to be targeted at long term performance incentives. It is not uncommon for larger private companies to incentivise directors and senior managers (whose basic pay reflects "market rates") by way of relatively minor annual profit sharing when exceptional results are achieved, and to a larger extent and of greater influence, to share in the longer term success of the company with an equity investment or similar arrangement which provides an exit reward at a specified retirement date so as to encourage retention and performance of key personnel.

There can also be an attitude among directors that it is their personal efforts which earn the profits generated by a company and not the shareholders, so that the directors feel they are entitled to a disproportionate part of any profits generated, not recognising the inability of the company to generate profits without shareholders willing to risk funds they have invested in the company or accepting that the directors should be penalised if they fail to generate reasonable profits.

As indicated previously, the remuneration committees of listed companies should be replaced by governing bodies, representative of shareholders, with greater powers than remuneration committees or non-executive directors, including control over directors` reward packages.

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

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?

The motivation for short term gains can also encourage takeover activity even where the proposed acquisition may not have a long term benefit and many such acquisitions represent a partial but significant asset stripping exercise.

As stated previously, boards will take decisions on takeovers on the basis of short term gains so that there is no great incentive for them to consider the long term implications.

In principle, shareholders should vote on all actions which will have a significant long term effect on the nature or activities of a company. As suggested previously, the introduction of a shareholder representatives governing body could avoid the need for full shareholder communication on such matters.

QUESTION 17
Do you have any further comments on issues relating to this consultation?

There are two distinct capital markets, the investment market which reflects trading between investors, and equity investment reflecting the introduction of capital funds into operating companies. Gains and losses arising between investors have no direct benefit for companies generally. The vast majority of transactions in capital markets do not directly benefit companies themselves as they are between external investors, and it is only by share issues that investors' funds find there way into operating companies. There are indirect influences on company finances through company pension schemes and the influences of major investor bodies. The consequence of inter-investor transactions is the desire for investors to seek gains as quickly as possible. Companies' shareholders being driven by a desire for short term capital gains and their control and influence over directors' leads to the situation where Boards will seek to meet short term expectations in priority to long term strategies.

It appears that the level of interference in company management by investment mangers is excessive. They are tending to take over the role of directors by influencing board policies and do not "take their chances" by reliance on the board, as an individual shareholder would expect.

The statutory requirements for periodic communications between shareholders and their boards encourages a degree of delegation and accountability to the board which can be eroded by the expectations of investor bodies to have on demand informal access to boards which might be perceived as excessive and invasive oversight and influence.

Increased globalisation of equity markets has naturally resulted in greater cross border investment and the consequences of such have been seen in recent times when the actions

of controlling bodies outside of the UK can have a major impact on UK companies and the UK economy.

In the past, long term equity investment was made with a view to generating income by dividends. Growth in capital values for investors was an incidental consequence of dividend returns occurring over a period of years. Boards were looking at strategies to see operating profits increase over the long term and not only influenced by capital growth. Goodwill values represented in share prices were a measure of the future long term profit earning potential of the company.

There appears to be a reluctance for successful companies to return an appropriate proportion of profits to shareholders by way of dividends, and as a general rule, will seek to reinvest for growth and development, feeding the vicious circle of encouraging the realisation of short term capital gains. Incentives are required to encourage dividend distributions by companies as the primary source of returns to investors.

To change the attitudes of boards of listed companies and their stakeholders from short termism to long termism we consider that the most effective impact is through taxation:-

i) incentivising long term gains, particularly on retirement.

ii) incentivising investment income from dividends up to a predetermined level for investors and for example by giving tax advantages for the issue of redeemable preference shares with a minimum redemption period of say, five years so that potential volatility in the share price is influenced by the ultimate redemption value.

iii) incentivising the “rolling up” or “plough back” of exceptional profit sharing bonuses for directors who defer realisation until retirement from the company after a specified minimum period of time.

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