CBI
THE VOICE OF BUSINESS

A long-term focus for corporate Britain

CBI response to the BIS consultation, January 2011

INTRODUCTION

1. The CBI welcomes the opportunity to respond to the BIS consultation, "A long-term focus for corporate Britain". We believe the objective for this review should be to ensure that the framework for investors and companies is consistent with promoting UK competitiveness and long-term growth in the economy.

2. The big picture backdrop to the review is a need for significant capital investment to drive forward private sector growth and employment. So it is important that the UK is attractive to all forms of investment, both domestic and international.

3. The CBI strongly endorses the view set out in the consultation that the best solutions are those which are owned and driven by market participants, investors and companies, and we agree that clear, consistent rules which work with "the grain" of the market are desirable.

4. A number of the issues raised in the BIS consultation were addressed in the CBI brief "Does ownership matter?" which formed our response to the Takeover Panel's review of the Takeover Code in 2010. We summarise those recommendations below before responding to the specific consultation questions.

PROMOTING A LONG-TERM APPROACH TO COMPANY OWNERSHIP

5. A number of high profile takeovers of UK-parented firms have put the political spotlight on company ownership, corporate governance and the UK takeover regime.

6. The past decade or so has seen significant changes in the capital and ownership structure of UK firms. Key changes include the internationalisation of the share ownership register and a steady decline in the proportion of shares held by "long-term" investors, such as insurance companies and pension funds.

7. The CBI believes that company ownership <u>does</u> matter in shaping the UK's long-term economic prospects.

8. Ownership has a significant influence over investment strategies on issues like research & development, management of brands and intellectual property. It also has significant network effects, with business and professional services activity likely to cluster around the decision-making centre. And ownership has a substantial influence over where companies pay their corporate taxes. All of these issues have a direct bearing on the UK's future economic prospects.

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9. The CBI believes there are a number of significant health warnings to consider in assessing any reforms.

   - First, the critical test for ownership must remain an economic rather than a political issue.

   - Second, it is the underlying business environment that ultimately makes a difference to the ownership and investment location decisions of global businesses. So the government should focus its efforts on ensuring the essential building blocks such as skills, tax competitiveness and infrastructure are in place.

   - Third, the UK should remain fiercely committed to open markets and be careful not to indulge in protectionism. With the majority of earnings for many UK companies coming from abroad and the UK looking to benefit from opening up of markets overseas, this would be counter-productive to our interests. Instead the government should focus its energies on making the case for a level playing field in other markets.

10. With those caveats, what could be done to promote a more long-term focus for corporate Britain? The CBI believes a mix of policy solutions could make a difference. These include:

Regulatory and tax changes to promote and reward long-term equity ownership

11. The CBI believes the best way of promoting a long-term approach to company ownership, and preventing takeovers being driven by investors with only short-term time horizons, is to promote and reward long-term equity ownership.

12. So our preferred reforms would be to explore various regulatory and tax changes that would provide more of an incentive, or at least tackle some current disincentives, for long-term equity ownership.

13. Regulatory changes that could make a difference would include revisiting accounting and solvency rules that currently discourage equity ownership at points in the economic cycle. And in its forthcoming "corporate tax roadmap" the government could look at how to ensure a level playing field for equity ownership and progressively reward long-term ownership of shares.

Building long-term relationships between boards and investors

14. The CBI believes that strong and high quality engagement between boards and shareholders is an important part of the equation in promoting a long-term approach to company ownership.

15. The "Investor Stewardship Code", drawn up by the Institutional Shareholders Committee and launched under the auspices of the Financial Reporting Council (FRC) is designed to promote better shareholder engagement with firms, and should be an important tool in delivering this objective. A key test for the new Code will be its ability to reach out to foreign investors and encourage them to be active and engaged investors.

16. Similarly, it is important that managers and boards are given a strong mandate to focus on the long-term. The recently updated UK Corporate Governance Code includes additional references to the board being collectively responsible for the long-term success of the company and the need to act in the interests of the company, both of which should be helpful to meet this objective.

17. It is also notable that the Companies Act clearly sets out broader Directors' Duties including to employees and other stakeholders. These tend to be adhered to in normal circumstances, but there is a much narrower focus on value in a bid situation.

18. One idea for further reform which might help in takeover situations would be to emphasise that boards are entitled to assess any offers against a medium to long-term time horizon, defined as perhaps three to five years. Current practice seems to restrict evaluating a bid price against a company's likely performance and value with a three year cut off.

Transparency and certainty around takeover rules

19. The CBI is cautious about making radical changes to the takeover rules, but we do support greater transparency and certainty around takeovers and bid situations.

20. Measures here include tightening the "put up or shut up" regime to reduce the period of uncertainty for firms in a potential bid situation, ensuring that advisory fees are structured so that they do not overtly bias the outcome of bids and introducing greater "truth in takeovers" to ensure sufficient disclosure and accountability around future intentions for the acquired business, many of which were addressed in the recent Takeover Panel consultation.

Providing greater clarity in the "public interest" test

21. The CBI believes that an economic emphasis based on competition tests is the right way to determine the outcome of takeover and merger situations.

22. There has been much talk of broadening the "public interest" so that a broader range of factors other than competition can be considered by regulators when takeovers are proposed. The CBI believes that we should strongly resist any politicisation of ownership decisions, but that greater clarity over where the existing national security test might be applied could be useful, for example in energy, communications and other critical infrastructure.

We set out below our further comments in response to the specific consultation questions.

RESPONSES TO SPECIFIC CONSULTATION QUESTIONS

THE BOARD OF DIRECTORS

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

Yes. It is impossible to manage and operate a business for the benefit of the company's shareholders, employees and other stakeholders without addressing and planning for the long-term.

The Companies Act 2006 (section 172) introduced a new statutory duty of the company's directors to have regard, amongst other matters, to the likely consequences of any decision in the long-term in promoting the success of the company. The revisions to the UK Corporate Governance Code and recommendations in the Walker Review put an emphasis on Boards having a long-term focus.

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?

Broadly yes. There are statutory powers for public companies to require any person it knows, or has reasonable cause to believe, to be interested in the company's shares to provide certain information about that interest. Under the Disclosure and Transparency Rules, listed companies are also notified about certain interests in their shares.

We note the suggestion that all shareholders might be put under an obligation to disclose the information about their interests in shares, rather than only requiring this when asked by a company. Under section 803 of the Companies Act the members of a company can require a company to exercise its powers to ask for information. We think it would impose an undue burden and cost on investors and the companies receiving information to require all investors to provide information about interests in shares. We think the current provisions strike the right balance between allowing companies to find out about those with interests in their shares where this is important, without imposing costs on investors and companies where this is not so important.

SHAREHOLDERS AND THEIR ROLE IN EQUITY MARKETS

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

   The increasing globalisation of investment opportunities has allowed companies to access a larger pool of capital and improved the liquidity of markets for investors.

   A liquid and vibrant market is good for investors, companies and the UK economy. For companies it lowers the cost of capital, helping to fund growth, investment and job creation.

   However this diversification has placed UK equity in the hands of owners domiciled in many jurisdictions and with legal frameworks different from the UK. So it is important that the governance environment for shareholders in UK companies is based on best practice not regulation. Any move away from this approach would discourage overseas investors from investing in the UK, leading to an increase the cost of capital for UK business.

   Whilst the financial crisis was caused by the failure of some major financial institutions, there remains little evidence of governance failure amongst other companies, in particular the broad spectrum of UK listed companies subject to the UK Corporate Governance Code. We also continue to strongly uphold the UK model of corporate governance based on the "comply or explain" philosophy.

   Whatever might be proposed by the EU in its planned forthcoming Corporate Governance Green Paper, the Government must ensure that the UK model of corporate governance remains firmly in place.

4. **What are the most effective forms of engagement?**

   Engagement should be based on information, communication and dialogue and, where possible and practicable, personal contact.

   Through engagement shareholders seek to protect their interests and gain assurance that the stewardship of the company by its board meets their expectations, including the company's aims, objectives and business model, and that the business achieves performance levels which meets their expectations as owners and equity providers. Through engagement boards can learn how they are performing against these shareholder expectations. We would encourage greater non-executive participation in this dialogue, as advocated in the recent corporate governance reviews undertaken by the Financial Reporting Council.

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

   We believe that practice varies. In some instances, such a dialogue is seen as an integral part of the investment process. Going forward there needs to be a more consistent practice to allow the dialogue between managers with different functions to be more effective.

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 the prime legal mechanism by which shareholders exercise their rights, and is the means by which companies and their boards can formally be held accountable to their shareholders.

   Effective engagement is about all forms of information, communication and contact, not just shareholders' legal powers. We are also mindful of any unintended consequences, where disclosure of this nature could inhibit improved corporate governance if it leads to investors choosing not to exercise their vote or adopting a "follow the leader" approach.

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

Investors and other market participants inevitably have a mix of time horizons, risk appetites and desired rate of return on their investments.

Indeed, the only way that capital markets can sustain liquidity is through the participation of a mix of long and short term investors. It is also the case that there will always be short-term issues that affect a company or shareholders and it is right that these are dealt with in that time horizon.

The main determinants of a company's attractiveness to its shareholders and investors are not time horizons of individual shareholders, but expectations about future returns and perceptions of risk.

To encourage a stable investment environment, we advocate a regulatory and fiscal environment that is predictable and encourages diversity in terms of financial and investment products.

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?**

As we set out in our introductory comments, regulatory changes that could make a difference would include revisiting accounting and solvency rules that currently discourage equity ownership at points in the economic cycle. The government should also look to ensure a level playing field for equity ownership and progressively reward long-term ownership of shares.

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

Agency is a common feature in a market economy, including the investment processes associated with it. The most serious strains occur where the agency function distorts the risks being borne by market principals. For example, the way that the markets for securitisation in the US encouraged excessive risk taking by the originators of mortgages, which led to the "sub-prime" crisis and the major international financial crisis that ensued.

The remedy for this is carefully targeted regulation and the operation of caveat emptor.

In the UK the operation of good governance practice by agents within the investment chain has now been taken up in the new FRC Stewardship Code for institutional investors, which requires fund managers to disclose if and how they apply the principles of the Code.

Certain types of investment may also contribute to weaknesses in the chain of accountability, for example, collective investment schemes that track equity or other indices. These funds have no direct interest in the governance or performance of a particular company, because the only criterion for investment in a company is its weight or status within the relevant index.

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

The role and mandate of the fund manager is primarily a matter between the fund manager and their client. Market forces have caused or encouraged an increased level of transparency about the costs borne by owners that use fund managers, with the result that market participants are now much better informed about the impact of costs on investment returns.

DIRECTORS' REMUNERATION

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

Directors' remuneration, as with remuneration generally, is ultimately determined by market force in a free economy. The largest and most successful companies have to compete globally for talent, and competition for the best people is fierce.

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

Remuneration is a board responsibility, and should remain so. So it follows that the membership of the remuneration committee should remain a committee of the board, made up solely of board members.

The remuneration committee is free to take the views and advice of others, as it sees fit.

Shareholders do not seek or want management responsibilities for remuneration.

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?

It is matter for shareholders how they exercise their ownership rights. It is clearly in the interest of companies and boards that shareholders understanding and support the company's policies and objectives, and this includes policy on directors' remuneration. This is a key part of the engagement process between a board and its shareholders which the UK Corporate Governance Code and new Stewardship Code for investors seek to encourage.

In addition UK company law provides for shareholders to have an advisory vote on the board's remuneration report at the AGM, and requires shareholders to approve all equity related share incentive schemes.

The shareholders' power to de-select directors by a vote at a General Meeting, or when a director comes up for re-election reinforces the chain of accountability.

The CBI does not support making any changes in the current legal position, which is that payments made to directors for loss of office or employment with the company for terminating a director's contract are not subject to shareholder approval.

It is not practical to impose any such requirement because the payments need to be agreed with the director at the time of the negotiations for the director's departure, and before it will be possible to convene a special meeting of shareholders. In addition a requirement to convene a special shareholders' meeting for them to approve the payment will also be very expensive for a listed company.

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

i. linkage between pay and meeting corporate objectives
ii. performance criteria for annual bonus schemes
iii. relationship between directors' pay and employees' pay?

The CBI strongly supports transparency around directors' remuneration, including the composition of pay and the link between pay and performance.

This is already reflected in Companies legislation which requires very comprehensive disclosure of all elements of directors' remuneration, and the Board's Remuneration Report is also subject to a shareholder advisory vote at the AGM. Shareholders are also required to specifically approve all equity related share schemes.

In addition, remuneration policy is also one of the key areas for effective engagement between a listed company and its major shareholders, as provided for in the UK Corporate Governance Code and new Stewardship Code for institutional investors.

Following the Companies Act 2006, new Regulations also included a requirement for listed companies to make a statement in the board's remuneration report on how pay and employment conditions of the workforce were taken into account when determining directors' remuneration for the relevant financial year.

However, following the recent publication of the Hutton Interim Report on Fair Pay, we would be strongly opposed to regulatory adoption in the private sector of any proposal to link or limit link CEO or other executive director remuneration to a multiple or ratio of the pay levels in the workforce below senior management.

The existing Companies Act Regulations are more than sufficient in terms of setting prescriptive requirements, and it would not be appropriate to apply the Hutton recommendations to listed or any other company or business. A one size fits all is not the way to manage or determine director or executive remuneration.

We would also caution against a "league table" approach to disclosure, which would have the unintended consequence of putting upward pressure on pay as individuals compete to be in the upper echelons of pay reward.

Companies must be free to set and apply remuneration policy sufficient to attract and retain key staff if the business is to be successful and grow for the benefit of all employees, shareholders and broader stakeholders.

It is vital that the UK should not set remuneration or taxation requirements that would place UK business both collectively and individually, and the UK's position in the global economy, at a competitive disadvantage. This also extends to anything that might cause talent to leave the UK, or make it harder to attract global talent to the UK with the skills necessary to support UK growth.

In summary, we believe that the existing regulations on Remuneration are sufficient and very comprehensive in achieving the Government's disclosure objectives.

TAKEOVERS

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

The Board has to act in the best interests of its shareholders.

If a bidder is willing to pay a substantial premium to the share price, and a premium to the company's short term prospects, the board has to weigh this up in its recommendation, but ultimately the outcome of a bid is a matter for the company's owners, the shareholders.

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 existing Takeover Code is and has always existed to protect the interests of the target company's shareholders. There are separate rules requiring the approval of the offeror company shareholders in respect of Class 1 Transactions. These arrangements operate satisfactorily.

Whilst at face value there might be some merit in this additional check and balance, we do not think it would be workable in the case of foreign acquisitions. If offeror companies had to submit all their bids to their shareholders for approval, this could place UK bidders at a competitive disadvantage to any competing foreign bidder not subject to such a requirement. Without a clear proposal for how this would be enforceable in overseas jurisdictions, we do not support this measure.

OTHER

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

As we set out in our introductory remarks, the CBI believes the objective for this review should be to ensure that the framework for investors and companies is consistent with promoting UK competitiveness and long-term growth in the economy.

Significant capital investment is required to drive forward private sector growth and employment, so it is important that the UK is attractive to all forms of investment, both domestic and international.

It is the underlying business environment that ultimately makes a difference to the ownership and investment location decisions of global businesses, and the government should focus its efforts on these fundamental building blocks for UK competitiveness.

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- *The CBI is the UK's leading business organisation speaking for some 240,000 businesses - together employing around a third of the private sector workforce. Our membership includes the majority of the FTSE 100, over 200,000 smaller businesses and leading trade associations.*

- *We are the premier lobbying organisation for UK business on national and international issues. We work with the UK government, international legislators and policymakers to help UK businesses compete effectively.*

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