A Long-Term Focus For Corporate Britain

Submission by the Association of Investment Companies (AIC)

Introduction

The Association of Investment Companies (AIC) welcomes the opportunity to respond to this consultation. The AIC represents some 350 closed-ended investment companies with assets under management of some £80 billion. The AIC's Members include UK investment trusts, Venture Capital Trusts (VCTs), and offshore investment companies mainly domiciled in the Channel Islands.

Investment companies are a type of collective investment fund. They are closed-ended funds meaning that they have a fixed share capital. Funds are raised through the issuance of a set number of shares which are subsequently traded on a stock exchange. Our Members' shares are traded on the London Stock Exchange, AIM, Euronext and the Channel Islands Stock Exchange.

Investment companies are governed by a board of directors. It is the duty of the board to oversee the company to secure the best possible returns for shareholders within the framework set out in the company's investment policy. The vast majority of investment companies are "evergreen". This means that they are trying to deliver their investment objectives for a sustained period of time. This focuses the board on the long-term interests of the company and its shareholders and feeds directly into the investment strategy used to deliver that policy.

Investment company directors meet several times a year and monitor the company's performance. The board is directly answerable to the shareholders. Most investment companies outsource day-to-day investment management. Where this is the case, the board is also responsible for selecting a fund manager and explaining its continued appointment to shareholders on an annual basis.

Our Members are therefore both investors in equity markets and listed companies operating under company law and their respective market regulations – including the UK Listing Rules.

Overview

In preparing this response the AIC has taken into account the following considerations:

- UK equity markets have an international reach and appeal. They are used by companies and investors around the world to raise capital and secure returns for clients. Where the Government is considering regulatory changes to the rules

- Shares of listed companies are not the only publicly traded securities. For instance debt can also be publicly traded, as can financial instruments such as Contracts for Difference. When considering the role of equity markets, the Government must take this broader context into account.

- Traditionally, shareholders in the same share class have the same rights. These are set out in a company's Articles of Association and in company law. These rights are secured by virtue of ownership of a particular security without any assumptions made as to the intent of that holding or the period of time which it will be held for.

- Fund managers need to be able to react to market circumstances to enable them to deliver returns to their clients and protect their interests. Considerations such as a change in circumstance (driven perhaps by movements in other asset prices and/or bank covenants) means that from time to time even long-term investors might need to quickly dispose of stock. A shareholder must always have the option to sell his holdings regardless of the length of time the product has been held.

- Successful equity markets are reliant upon deep and wide liquidity. One of the key contributors to the liquidity of markets is the diversity of market participants. A variety of different investors brings a diversity of investment objectives and strategies. This helps to ensure that there are always willing buyers and sellers of securities, avoiding stagnation and making equity markets attractive for companies and investors.

Q1. Do UK boards have a long-term focus – if not, why not?

Boards of investment companies have a long-term focus as one of their primary duties is to secure value for shareholders over long timeframes. Most investment companies are 'evergreen'. They have no set deadline for selling assets. Where realisations occur, the proceeds are reinvested for another period. The imperative is to focus on investment fundamentals (risk vs return) and the competing attractions of allocating capital to one or another investment opportunity. Given the timeframe of investment company strategies, they also want their investee companies to deliver in the long-term. If stable and growing returns can be achieved without churning the portfolio, this reduces transactional and other costs.

Some investment companies are limited-life, where the fund has a set lifespan of usually 7 to 12 years. In these circumstances boards have a responsibility to secure

value to a set maturity date. As they move toward the winding-down date investments may be disposed of. However, conducting a planned and agreed investment policy with a set maturity date is not the same as short-termism. Limited life investment companies are a legitimate and attractive investment opportunity for a variety of retail and institutional investors.

The AIC has not seen any evidence to suggest that boards of UK traded companies are taking any less of a long-term strategic view than in the past. Even in exceptional circumstances where a short-term view might be taken, it is tenuous to assert that equity markets are a cause of this.

If shareholders are concerned that the board is not taking a long-term view then they can act against the directors. This can include voting for their removal. Section 172 of the Companies Act 2006 sets out the duties of a director. These include having regard for "the likely consequences of any decision in the long term". These are impartial checks which tend to focus directors on the long-term prospects of their company.

The AIC is unconvinced that UK companies are overtly affected by short-termism.

Q2. 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 speaking, the current legal framework provides boards with sufficient access to information on the beneficial ownership of shares. However, the AIC acknowledges that the changing nature of equity markets does make this much harder to achieve. A fuller discussion on this topic can be found in answer to Q3 below.

Q3. What are the implications of the changing nature of UK share ownership for corporate governance and equity markets?

There are a number of implications arising from the changing nature of UK share ownership. These include:

- **Difficulties in securing access to information on the beneficial ownership of company shares**

Investors often use nominee arrangements to hold shares. In these circumstances, the nominee becomes the legal owner of the share and their name appears on the ownership register. This makes it more difficult for boards to identify the investor making the 'buy/sell' decision. Furthermore, the chain of ownership of a share can often be more complicated than simply a beneficial holder using a single nominee.

There can be a number of parties in an ownership chain. This system allows for custody and other arrangements to develop and has complicated the task of engagement between boards and shareholders.

On balance, the use of nominee arrangements is a positive and necessary aspect of modern equity markets.

While nominee arrangements mean that identifying the beneficial owner of a share is more complex, if the beneficial owner wants to contact a company and take up opportunities for dialogue they can do so relatively easily. The recent publication of the FRC's Stewardship Code has indicated that a culture of engagement is growing.

- **The growing number of passive investors**

The vast majority of investment companies are active investors. This means that the fund manager takes an active view on the prospects of portfolio companies. Passive investors purchase (or sell) shares without consideration of the company's performance. There are a number of factors in modern equity markets which have increased the number of passive investors. These include:

- **Innovation in financial instruments.** An example would be a shareholder who owns stock in a company as collateral for a financial instrument such as a Contract for Difference (CFD). These shareholders do not have a direct interest in the governance arrangements of the company in which they hold shares. CFDs, which give the holder exposure to shares, have various advantages over a direct holding including gaining the exposure without having to pay the full price. A CFD can also allow the investor to benefit if the share price falls and is an important tool for hedging strategies.

- **Tracker funds.** These have become more prevalent for a number of reasons, including innovations in information technology. Index tracker funds buy and sell shares in order to ensure that the whole investment portfolio tracks the general market trend. Share purchases and sales are often triggered automatically as constituents in indices change. As with innovation in financial instruments, the Government should not view the increase in tracker funds as necessarily having a negative influence on equity markets. For instance, tracker funds are a lower risk and long-term investment strategy used by, among others, pension and life assurance funds. The ability of funds to operate in this manner is essential for these investors and brings a tangible benefit to ordinary citizens.

- **The growth of collective investment funds**

Collective investment funds provide accessibility to equity markets for the ordinary investor. The introduction of tax-focussed schemes, such as ISAs and pensions, has stimulated demand and allowed the benefits of the stock market to be opened up to ordinary citizens rather than the very wealthy, as was historically the case. As a consequence of this, there has been a significant growth in the number and diversity of collective investment funds over the last 30 years. It is not practical for a manager of a collective investment fund to actively engage in all the companies in which his fund invests. A fund manager could have an interest in hundreds if not thousands of different companies on behalf of his clients.

Q4. What are the most effective forms of engagement?

Engagement is most effective when it provides an on-going relationship between shareholders and boards. This fosters co-operation between the parties and builds trust. True shareholder engagement requires more than just attending AGMs.

Ensuring that engagement takes place in private rather than through the news media is also an important factor. When engagement is made public in this manner it can have a detrimental effect by reducing turnout and entrenching positions.

Q5. Is there sufficient dialogue within investment firms between managers with different functions (i.e. corporate governance and investment teams)?

Not always. The current split between governance functions can hinder the ability of the fund manager to take a unified view of a company's prospects. The fund manager – looking at the fundamentals of performance – may have a different insight from a governance specialist with a different agenda. These separate functions may also have different levels of access or engagement with the portfolio company management.

A problem arises when governance specialists fail to engage with companies. This can be a particular problem for governance agencies which may not have the same engagement agenda as investors. This might arise, for example, because the agency represents a wide range of investors with differing attitudes to governance. They therefore may take a more 'standardised' approach rather than reviewing specific issues from the individual perspectives of different investors.

A lack of engagement by governance agencies is something which would bear further investigation. The AIC **recommends** considering more clearly including governance agencies in the UK Stewardship Code or even the development of a separate code of practice for the bodies.

Q6. 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?

The importance of voting as a form of engagement. Voting is an important method through which shareholders exercise their rights and entitlements. Nevertheless, the full value of voting is only realised when it is done "intelligently" – that is where the shareholder properly inspects and considers the question at hand prior to casting a vote.

Voting will also be more effective where it represents the views of as many shareholders as possible. It may be helpful to establish what can be done to increase participation levels. One approach would be to give more information on voting levels to encourage non-voters to have their say.

With this in mind, the AIC **recommends** additional disclosure requirements on the details of shareholder votes. Alongside publishing the number of votes cast for or against a resolution, the company should also be required to disclose the total shares eligible to vote. The outcome of votes should then be disclosed as a percentage of total eligible votes. This will allow shareholders to see the proportion of the total shareholding that voted either way on a resolution, highlighting instances where a minority of shareholders won a resolution by virtue of inactive shareholders.

The table below demonstrates how this would be helpful where company X seeks to pass a resolution at an AGM. In the second table, it is clear that the resolution has been passed without a majority and by a very small margin due to the high proportion of non-voters. This information is not clear in the first example.

Table I: Voting disclosure

Shareholders voting in favour	Shareholders voting against	Outcome
3.5 million	2.8 million	PASSED

Table II: Voting disclosure including a proportionality requirement

Total eligible voting shares	Voting in favour of resolution	Voting against resolution	Abstentions	Vote not cast	Outcome
10 million	3.3 million **33%**	2.8 million **28%**	0.7 million **7%**	3.2 million **32%**	PASSED

Public disclosure of voting. There is no benefit to institutional shareholders disclosing publically how they have voted. Furthermore, this question has no bearing on short-termism in equity markets. No case has been made as to how this measure would contribute toward stable corporate governance. The only outcome would be to create additional cost in the system which would invariably be passed to investors. If anything, this requirement would simply encourage management companies to automatically cast votes with the board without giving the issue at hand full consideration. This would be detrimental to good corporate governance.

The Government consulted on this matter as part of the Company Law Reform Bill in 2005. While the Government's own cost-benefit analysis estimated the cost of implementation of this measure at £6 – £9 million per annum (the AIC predicts this cost would be higher for investment companies), it failed to provide a convincing account of the benefits which would accrue from it. The AIC does not believe that disclosure of voting practices will enhance the performance of issuers in any way. It is not legitimate to claim enhanced company performance as a benefit of disclosure as no causal link has been demonstrated.

Requiring full disclosure by institutional investors is not targeted on a specific problem. Demand for this information is negligible and there is no evidence of market failure in this regard. Consequently, the AIC believes that a requirement of this kind would not be proportionate to the cost of its implementation.

Q7. Is short-termism in equity markets a problem and, if so, how should it be addressed?

Alleged focus on short-term returns. The AIC does not believe that there has been an increase in investors and managers focussing on short-term returns at the expense of long-term performance.

Investment companies have a board of directors whose primary duty it is to govern the company to secure the best possible returns for shareholders within the framework set out in the company's investment policy. As with any listed company, the board is accountable to the shareholders under the UK Listing Rules and company law.

Most investment companies are externally managed. This means that the day-to-day investment decisions are outsourced to a fund manager. The board is independent of the fund manager and also counts among its duties the appointment of the manager. The board is obliged to justify its choice of fund manager to shareholders on an annual basis.

This structure mitigates against short-termism. As shareholders have an interest in long-term returns, it is the role of the board to also take a long-term focus.

Consequently the manager will be assessed by its ability to deliver long-term goals rather than short-term returns.

Many other non-investment company funds, such as pension funds, take a similarly long-term view. However, they may also need the flexibility to sell stock at short notice to respond to specific market circumstances (see opening comments).

Short-term holding of shares. The consultation contends that a growth in short-term holding of shares produces a danger of herd behaviour which creates asset bubbles. This cannot be a product of current holding periods, whether longer or shorter than in previous years, as asset bubbles have been a problem for equity markets for centuries. The South Sea Company bubble in the 18th Century is a commonly cited example. The consultation also asserts that short-termism may result in the inefficient allocation of capital, where those companies with potential for sustained growth do not receive the financing they require. The AIC has seen no evidence to support this case. Indeed, the ability to dispose of stock at any time – alongside practices such as "short selling" – are crucial mechanisms for ensuring that investors are attracted to primary capital markets, that capital is effectively distributed, and that capital is allocated in the right place so that stocks do not carry an artificially high price.

Equity markets serve both investors and listed companies. In the case of a collective investment fund, the fiduciary duty of the fund manager must be to his clients rather than the investee company. From time to time, meeting these duties requires that shares are sold after a short holding period.

The AIC does not support any measures that could artificially restrain investors who want to dispose of shares. The AIC strongly rejects any suggestion of a minimum holding period for shares and securities. This would be deeply detrimental to the attractiveness of equity markets, cause unjustified damage to legitimate investment strategies (such as passive investment), and breach the traditional principles upon which equity markets and share ownership operate.

Q8. 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?

See Q7 above

Q9. Are there agency problems in the investment chain and, if so, how should they be addressed?

The investment company structure protects against the kind of agency problems outlined in the consultation. The board is able to test the manager on their approach

on a regular basis and then must formerly report to shareholders on their continued appointment on an annual basis. Boards are concerned with the long-term benefit of shareholders and, as such, assess managers on issues such as the reasoning for investments made, the anticipated long-term performance of investments, and the balance of risk in the wider portfolio. Managers are assessed according to their ability to deliver the investment strategy over the long term, not the individual performance of each share in which they have invested in each year or in each quarter.

The AIC is unconvinced by the analysis included in the consultation document at paragraph 4.25. The LSE report to which it refers does not provide any detailed evidence to back its assertion. Further detail would be helpful to understand this claim.

Over the last ten years, investment companies have replaced their manager on 66 occasions; an average of just under 7 contract changes per year in a sector which currently includes over 400 companies. This small but not insignificant figure is what one would expect from an industry which has the ability to remove underperforming managers yet also takes a long-term view of success. If directors assessed the manager based on quarterly performance, the number of replacements would be far higher. Furthermore, the ability of boards to remove a manager which is underperforming makes the likelihood of frequent trading in order to incur additional transaction costs (as discussed at paragraph 4.25) unlikely. Fund managers in the investment company sector operate in a highly competitive market with each firm battling for market share over their competitors. This has had the result of pushing up standards. A fund manager's long term performance is a key contributing factor to its corporate reputation.

Q10. What would be the benefits and costs of more transparency in the role of fund managers, their mandates and their pay?

The investment company structure already provides for a high level of transparency between the investor and the manager through the requirement for annual reviews and the publication of audited accounts by each investment company. These include details of performance fees.

Additional transparency requirements for investment companies are unnecessary.

Q11. What are the main reasons for the increase in directors' remuneration? Are these appropriate?

Directors of investment companies are usually paid relatively modest fees on a non-executive basis. Research conducted by the AIC in 2008 found that board chairmen of investment companies were paid an average of £24,700 per annum.

The AIC does not have a specific comment to make on director pay in the wider corporate sector.

Q12. What would be the effect of widening the membership of the remuneration committee on directors' remuneration?

See answer to Q11 above.

Q13. 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?

See answer to Q11 above.

Q14. 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?**

See answer to Q11 above.

Q15. Do boards understand the long-term implications of takeovers, and communicate the long-term implications of bids effectively?

The AIC does not have a specific comment on this matter.

Q16. 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 UK Listing Rules already require the shareholders of an acquiring company to vote on takeover bids when the transaction is of a certain size. Where a takeover bid is made for a company worth more than 25% of the acquirer's share capital, a shareholder vote is required. A deal of this size can be considered 'transformational' and could present some of the issues for the shareholders of the acquiring company noted at paragraph 6.5 of the consultation. A vote is appropriate in these circumstances. However, in cases where large companies make strategic acquisition of other companies which are much smaller, the AIC does not believe that a requirement for a shareholder vote would justify its cost.

Q17. Do you have any further comments on issues related to this consultation?

No

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For more information on the issues raised in this paper contact:

Guy Rainbird, Public Affairs Director, Association of Investment Companies

Daniel Rosenstone, Public Affairs Executive, Association of Investment Companies