Association of British Insurers

BIS Call for Evidence – A Long-term focus for Corporate Britain

The ABI is the voice of the insurance and investment industry. Its members constitute over 90 per cent of the insurance market in the UK and 20 per cent across the EU. They control assets equivalent to a quarter of the UK's capital. They are the risk managers of the UK's economy and society. Through the ABI their voice is heard in Government and in public debate on insurance, savings, and investment matters. As a representative of major institutional investors we welcome the opportunity to respond to this call for evidence.

Introduction to the response

ABI members agree that successful companies and effective markets are vital for the health of the UK economy. Investment through the equity markets not only finances industry, creating jobs and wealth, but also allows ordinary people to invest and save for their retirement and other expenses. The interests of these individuals, our clients, should be respected and promoted. The primary purpose of the investment made by the members of the ABI is to make a return on the money entrusted to them by these savers and pensioners. The resulting economic activity, job creation, tax revenues generated etc are all valuable by-products of that.

We believe that the purpose of financial markets market primarily is to serve and promote the interests of the providers of capital –savers - and the recipients of capital - companies. The markets should not be there to serve the interests of the intermediaries.

We agree that the relationship between principal and agent, the shareholders and the directors, lies at the heart of the equity market and should continue to do so. Any reforms should not undermine the centrality of this relationship. It represents the cornerstone of an effective free market. The UK's current system of company regulation and corporate governance is effective in most cases. In looking for improvements, we should remember that the UK leads the world in this field.

We agree that there needs to be a sensible balance between regulation and best practice. It is also important that there is a proper understanding of the distinction between corporate governance and regulation. Corporate governance exists to help ensure that the company is run in the interests of its shareholders, and that it is successful in the long-term. Regulation and supervision exist to ensure market confidence and stability, and to protect the interests of consumers and the wider public. The Government naturally has an interest in both areas. There are clearly areas of overlap between them, and some of the tools and approaches can be applied to either purpose. However, we should be mindful of this distinction when determining the need and scope of any reforms. If this distinction is not made, or there is a move to far in one direction or another, there is a risk of unintended consequences that will damage the aims of one or both of them.

When looking at reforms in corporate governance it is important to be clear whose interests those reforms would serve. Corporate Governance is not an end itself. It is a means to an end, a tool that contributes to the ultimate aim of the company of generating wealth and serving the needs of society. For a long-term focus to develop, there also needs to be a stable regulatory environment and governance framework. We would therefore urge the Government to consider carefully the practical impact of changes to the current system before making those changes.

Further consideration needs to be given to some of the assumptions underlying the consultation. For example, we do not necessarily agree that a short-term approach is wrong in all circumstances. There are times when it is necessary for investors, boards and others to have a short-term focus. We believe that it is patience that we should be aiming for. Patience generates savings by households, which in turn finances investment by companies.[1] Patience by market participants, companies and investors, overall generates higher returns over the long-term. But as patience is a psychological attribute, it cannot be mandated or regulated. Therefore, we should seek to create a system that allows, encourages and rewards patience in the financial markets. Ultimately, this is the only way to create an effective long-term focus for Britain.

Further consideration should also be given to the effects of a longer-term focus by shareholders or boards. For example, this may lead in practice to greater risk, as a business with a longer-term focus inevitably takes on a greater degree of uncertainty. In addition, we do not necessarily agree that lower remuneration is desirable in all cases. The evidence in the consultation document of increasing levels of remuneration is of course a major concern to investors. However, lower remuneration could result in fewer companies operating in the UK, with a declining quality of management. The focus of efforts in relation to remuneration should be the creation of structures that reward long-term sustainable performance.

More thought should be given to the role of the mandates awarded by clients, and the investment consultants that advise them. These mandates are the primary drivers of fund managers' behaviour as they set out the aims and objectives of the fund and the fees payable to the managers. We believe that there could be advantage in a thorough review of whether the current mandates properly encourage and reward a long-term approach. This may be an issue that should be investigated by the UK Institutional Shareholders' Committee/Institutional Investor Council, which produced the recent Ferrans report on Rights Issues, given that it is made up of representatives of both clients and fund managers.

When looking at raising the bar in relation to takeovers, one potential result would be to entrench bad company management, leading to the inevitable slow decline of those companies. In terms of putting more responsibilities on fund managers, if this is done in the wrong way, it will blur their fiduciary duty, and increase costs for them and their clients. Further reflection on these assumptions embedded in the consultation, and on the consequences of pursuing a course of action based on those assumptions will provide us with a clearer vision of what we are collectively trying to achieve, and help to avoid unintended consequences.

[1] Patience & Finance, A G Haldane, 2010

Executive Summary

We consider the current legal framework to be adequate. Directors' Duties, as described in the Companies Act 2006, are framed in such a way as to allow directors to have a sufficiently long-term focus, and to take into account the interests of stakeholders. It is extremely important for companies to be able to identify their shareholders, and in our view the current framework[2] works sufficiently well. However, consideration should be given to how transparency could be improved when equity derivatives are involved, in order for companies to be able to identify those with the underlying economic interest. In relation to remuneration, the current legal framework adequately empowers shareholders in regard to the approval of remuneration schemes and allows them to hold directors to account. However, we do believe that improvements could be made to the reporting of remuneration. There should be more transparency in the link between pay and performance, with a greater focus on outcomes.

The most effective way to promote a long-term focus, or patience, is to create a system that encourages it. The role of public policy and regulation should be to facilitate this by creating a regulatory and tax framework that encourages a long-term approach, and at the same time removes barriers that prevent market participants from focusing on the long-term. Barriers include those relating to prudential regulatory requirements, accounting and solvency rules. The current tax system does not incentivise a long-term approach or encourage long-term investment in the equity markets. Three examples of this are the repeal of the dividend tax credits, the presence of stamp duty and the different tax treatment of debt and equity. We consider it essential that there should be a level playing for equity

The current market structure does not in our view adequately protect and promote a long-term focus. Increased liquidity, lower transaction costs and more information are generally a force for good in the financial markets. However, we share the view of the Bank of England, as set out in the consultation, that the evidence suggests that increased liquidity and information availability has also led to an increase in the level of trading trading and share price volatility.[3] We are concerned that these developments may primarily benefit the market intermediaries, such as investment banks, and short-term traders, including those involved proprietary trading in the banks, rather than the long-term investor. These developments require further detailed study. We also believe that there should be a focus on the efficiency and competitiveness of the intermediary market. We would agree that 'efficient financial intermediation increases the returns to patience thereby encouraging thrift and promoting growth.'[4] However, inefficient intermediation, marked by excessive fees and a lack of competition, causes the exact opposite. The government should seek to ensure that under the new regulatory architecture the interests of the providers and recipients of capital are paramount.

In relation to many of the questions raised on the changing nature of share ownership, engagement and the agency gap between asset owner and manager, the answer lies within the FRC Stewardship Code. The Code should promote a clearer understanding by asset owners and companies of the investment managers' approach to stewardship issues. It

[2] Companies Act 2006, Section 793
[3] http://www.bankofengland.co.uk/publications/news/2010/067.htm

[4] A G Haldane, Patience & Finance, 2010

should also help to rebuild a critical mass of engaged shareholders and help to sustain the comply-or-explain framework. This ultimately will facilitate better engagement and a stronger relationship between long-term shareholders and companies. The Code has only been in place since September 2010 and we consider that it should be given time to bed in and become effective before any further radical changes are suggested in this area.

The primary factor driving the behavior of fund managers is the objectives of the providers of their mandates, the clients. As fund managers are acting as agents they are ultimately governed by the expectations and requirements of their clients. Although many clients are moving towards a long-term focus, there remains a tendency for the mandates to be awarded for a relatively short period and for performance to be measured over even shorter periods. This means that those fund managers whose judgement is right, but whose timing is wrong, stand a high chance of losing their mandates.[5] The causes of this short-term approach are various, including the development of accounting for liabilities for pension and solvency measurements on an increasingly short-term basis, and the role of investment consultants. Further consideration should be given of how we can correct rather than reinforce this development.

Consultation Questions

The Board of Directors

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

We believe that the current Directors' duties are sufficient to allow boards to have an appropriate focus on the success of the company for the benefit of its members as a whole, and have due regard to the likely consequence of the decision in the long-term and the interests of other stakeholders.[6]

The manner in which these duties are interpreted will vary according to the particular circumstances of the company. Some companies, for example in the natural resources industry, are more naturally long-term in their planning than others, their projects take longer to execute and the returns that are created are payable over a much longer time period. We also note that, as the Prime Minister pointed out in his speech to the CBI Conference this year, the life-span of companies on average seems to be declining. He noted that 'In 1950, the average life of a company in the S&P index was forty-seven years. By 2020, it will fall to just ten years.'[7]

It is therefore very difficult to create a general definition of what the long-term is, or to determine which behaviours are consistent with promoting a long-term approach. We believe that directors should seek to act in accordance with their duties, including in relation to the long-term view, taking into account the individual circumstances of the

[5] "Investors whose judgement is right, but whose timing is wrong, stand an increasingly high chance of exiting the game" A G Haldane
[6] UK Companies Act 2006, Section 172
[7] Prime Minister's speech to CBI Conference 2010, http://www.cbi.org.uk/pdf/20101025-cbi-pm-conference-speech.pdf

company. The owners of the company are then in a position to hold them accountable for such decisions.

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?

The current framework for the disclosure of shareholdings to companies (CA. 2006 s.793) is broadly adequate. Any more onerous requirement on investors during normal circumstances would create significant costs with very little benefit. However, there could be improvements made in the disclosure regime relating to equity derivatives such as Contracts for Difference. It is important for companies to understand who has the underlying economic interest, rather than just the legal entitlement. This is currently being considered at European level under the Transparency Directive framework, and we urge the Government to take an active part in this debate. We also believe that there would be significant value, for both companies and investors, for the equivalent of the s.793 regime to be introduced at a European level, and would again urge the Government to push for this.

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?

There has been substantial change in the nature of share ownership in the last 20 years. As noted in the consultation document, this has included a relative decline in the percentage of the market held by UK institutional investors, and a corresponding rise in overseas and other investors. There has also been a rise in the use of alternative equity instruments, such as Contracts for Difference. Such instruments allow market participants to hold an economic interest in the underlying share without the need to own it.

The UK framework is based on comply-or-explain under the FRC's Corporate Governance Code. This principles based approach allows companies to comply with best practice guidance, or to explain why they do not. It is then for the shareholders to judge the quality of the explanation, and to engage as appropriate on issues of concern, or where they would like further clarity. The system relies on good quality explanations by companies and an engaged shareholder base.

The relative decline of traditional engaged institutional investors has created challenges for the comply-or-explain framework. If shareholders are not sufficiently engaged, they may not in all circumstances be able to challenge companies effectively, and take appropriate action, including voting. This runs the risk that, over time, companies will start to provide poor quality explanations, and will not seek to ensure the highest standards of governance in the long-term interests of the company. However, currently the traditional UK institutional investors are still in a position to set standards of corporate behaviour and others, such as overseas investors, are able to coalesce around these and benefit from them.

For this system to continue to be effective, we must consider ways to sustain and increase the UK traditional investor base and draw together new entrants with similar aims. This can be done most effectively in two ways. Firstly, by drawing together the existing

shareholders through a common set of values and secondly, by rebuilding the traditional UK shareholder base.

The UK's FRC Stewardship Code is the most effective way to draw together existing market participants, including overseas investors, around a common set of principles. Since it became effective on the 30th September 2010 the Stewardship Code has already had over 75 institutions and other organizations signing up or offering their support to the principles it espouses. This is an encouraging start, that shows the genuine commitment of investors, both in the UK and overseas, to a responsible long-term focus. The Stewardship Code should now be allowed to bed in, and best practice should be allowed to develop against a stable background.

Investors are also under pressure globally to vote their shares. Many investors, particularly in the US, have responded to this pressure by appointing proxy voting services, either to provide advice on resolutions tabled at the AGM or to vote on their behalf. This has given proxy voting agencies considerable power to influence and control a substantial portion of the market. Their voting recommendations are based on best practice, but cannot take sufficient account of individual circumstances. Therefore, this creates a box-ticking approach to corporate governance, both by companies who feel explanations are not listened to, and by investors who blindly follow advice. [8]

There has also been a change in the UK equity market composition through the rise of alternative equity instruments, such as Contracts for Difference. Such instruments allow market participants to hold an economic interest in the underlying share without the need to hold it. Whilst there is value in derivatives as a way to hedge risk, too often they are used as an instrument of short-termism, creating or benefitting from volatility. Derivatives can also provide a means to exposure to the benefits of equity ownership without the associated costs, including tax, and responsibilities, such as voting.

The relative decline of traditional UK institutional investors' holdings in the market is in part a function of globalization as recognized in the consultation. However, it is also a result of a trend in tax, regulatory, accounting and solvency requirements that has discouraged or forbidden the traditional institutional investors to hold equity.

Currently the tax regime is formulated in a way that discourages the ownership of equity by investors and the financing of business by equity. The existence of stamp duty on shares and the repeal of dividend credit are two examples of the tax system discouraging the ownership of shares. The different tax treatment of debt and equity, with debt interest repayments attracting tax relief, is an example of how companies have been encouraged to use debt rather than equity to finance their activities. This in part caused companies to leverage up their balance sheets, which had severely detrimental consequences for some during the financial crisis, as they found access to debt financing cut off, or were unable to meet interest repayments. We consider that it is essential that there should be a level playing for equity finance.

There is an understandable desire by governments and regulators to ensure that pension funds and insurance companies have sufficient means to meet their liabilities. This has led

[8] The ABI operates on behalf of its members and for their benefit the Institutional Voting Information Service ('IVIS'). IVIS does not offer voting advice.

to ever more stringent requirements regarding the forms of assets they are able to use to back their liabilities. This has resulted in a move away from equity as an asset class, as the regulatory, solvency and accounting requirements have considered it to be too volatile and uncertain. In effect an anti-equity bias has been created. These regulatory barriers have included prudential regulation that has driven insurers into short-dated government bonds in order to reduce risks. As a consequence traditional long-term investors have de-equitised and their overall level of holdings across the market reduced. This problem may be further exacerbated by over-stringent enforcement of forthcoming regulatory initiatives such as Solvency II, which may make it even harder for insurance companies across Europe to hold equities to back their liabilities.

4. What are the most effective forms of engagement?

The most effective form of engagement will be dependent on the aim, nature and subject of that engagement. It will also be affected by the investment style of the shareholder. For example, at times it is effective to engage directly with the management on a specific commercial issue. On other occasions it is best to engage with the non-executive directors of the company, for example on remuneration or audit issues, where the management may be conflicted. Similarly, on occasions it may be best to seek extensive dialogue, whilst at others it may be more appropriate or necessary to vote at the General Meeting, or indeed sell the shares. The nature of engagement may also be a result of the investment style or mandate of the manager. A passive manager that tracks an index and cannot sell may pursue extensive dialogue, whilst an active manager may decide to sell as it is in the best interest of their clients.

In our experience, the most effective engagement takes place in private. Quality dialogue and engagement by its very nature involves careful negotiation and does not benefit from publicity. Therefore, it is important that the effectiveness of engagement is not measured by the publicity it generates or the outside attention it receives.

All these styles and methods are equally valid, dependent on the interests of the client. Therefore there should be no attempt to identify or prescribe one form of engagement as being better or more valid than another. There are significant dangers in doing this and potential unintended consequences. We would point to the experience in the US of the EIRSA Act ('Employee Retirement Income Security Act'), which resulted in pension funds being required to vote shares as part of their fiduciary duty. However, this did not improve the level of engagement, but merely caused them to outsource this activity, as it was seen as a compliance cost rather than a way to add value to investment.

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

Each individual fund management company will be organized according to their business model and investment style. In our experience, there is considerable internal dialogue across teams within institutions regarding the correct approach to investment issues, corporate governance, engagement and voting. The nature of this dialogue varies considerably and it would be wrong to assume that one approach is better another.

The two parties with an understandable interest in the nature of this dialogue are the clients of the investment manager and the companies that the manager invests in. We consider that there is benefit in a degree of transparency in relation to the investment manager's approach. This transparency is now provided by the disclosure requirements under the FRC Stewardship Code for Institutional Investors. Under the Code, Investment Managers should disclose their approach to "Stewardship Issues", including how this is integrated into the wider investment approach. Such disclosures will allow people to better understand how corporate governance is integrated into the investment process, and promote better dialogue.

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 an important part of engagement. However, in many ways it is the outcome of engagement rather than a part of the engagement itself. In our experience, ABI members and companies have extensive engagement before general meetings on relevant issues, which results in votes being cast according to the results of that engagement. Therefore, voting is in many cases a signal of the result of that engagement and can be used as a way to register shareholder discontent. Voting results in themselves are not a good indication of the quality or quantity of engagement.

The issue of the value of voting disclosure has long being discussed, and for a number of years major UK institutional investors have voluntarily disclosed information on how they have voted. Indeed, the FRC Stewardship Code requires that signatories disclose their voting. In addition, all ABI members report to their clients on their voting and engagement. We would therefore be opposed to mandatory requirement of voting for a number of reasons.

Firstly, a mandatory requirement would by its nature be prescriptive, and impose additional compliance costs on the managers above what they already incur under the voluntary regime. These resources would be better deployed in constructive engagement. Secondly, investment managers may find that they on occasions vote holdings differently according to the multiple funds with different investment aims or mandates that they operate. If disclosure is required in aggregate, this can lead to strange disclosures, whilst requiring individual mandates/fund disclosures would be immensely costly and time consuming and may not be in line with client wishes. Finally, in our experience there is little interest in the information already disclosed, and those with any interest have access already through the voluntary regime.

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

Many of the issues relating to short-termism are addressed in our response to question 3. However, a distinction should be made between short-term behaviour in boardrooms and in the equity markets. We therefore consider that there are a number of issues that deserve separate consideration. These include the structure of the market, the role of the intermediaries and advisors, and the role of clients and their advisors.

As noted in the consultation, the last decade has been characterised by increased financial liquidity, falling costs of trading and increased flows of corporate information. All of these

are generally seen as positive. However, we believe that detailed consideration should be given to their other consequences.

Liquidity is necessary and beneficial on the whole. However the massive increase in liquidity has been more to the benefit of the facilitators of liquidity, the banking intermediaries, than to investors and issuers. Regulatory reforms, such as MiFID, have to date worked primarily in the interests of these intermediaries rather than in the interests of the providers or recipients of capital. In relation to the cost of trading falling, and indeed the proliferation of equity type instruments such as CfDs, the prime beneficiaries have been the short-term market participants rather than the long-term investors. In relation to corporate information provision to the market, e.g. quarterly corporate reporting, this has perhaps caused companies to focus too much on quarter by quarter performance rather than the long-term, and led to increased volatility and uncertainty. It has done little to promote a long-term approach by either companies or investors and, as Haldane notes, has promoted the interest of the short-term investor.[9] These concerns are not in themselves new, in 1990 Nicholas Brady[10] stated that short-term trading strategies and similar practices "can't possibly contribute in an important way to performance, much less national goals....we need to create a climate where business leaders can concentrate on the long-term objectives rather than worrying about the next quarter's earnings....the Treasury is examining aspects of the corporate governance process which encourages both executives and institutional investors to think long-term."

Part of the explanation for the current market structure is that over the last twenty years or so the regulatory authorities have been too willing to listen to the views of the intermediaries and have not paid sufficient attention to the views of the users of the market, the companies and investors. We would therefore urge the Government to make sure that in the future, and in particular under the new regulatory architecture, the views and interests of the market users are properly heard and taken into account.

Intermediaries, such as investment banks, also provide advice to the market users, in particular companies. High quality professional advice can be highly valuable when dealing with complex issues such as mergers & acquisitions or corporate financing. However, consideration should be given to the extent to which the incentives of these advisors are properly aligned to the interests of their clients. Corporate activity, such as M&A, generates large fees for advisors and this in turn may cause them to be more eager to promote such moves even when it is not in the long-term interest of the client. Similarly, when a merger has been proposed, the advisors' fees may be contingent on the completion of the deal or its price. Such factors may cause the advisor a conflict of interest and affect the independence and impartiality of the advice.

We would also point to the *Rights Issue Fee Inquiry*[11] that found underwriting fees have risen substantially even in the case of deeply discounted issues as evidence that intermediaries may not be sufficiently taking account of the interests of their clients. The conclusions of the Inquiry include that there should be more transparency regarding what fees are payable and for what activities, and that further consideration should given to how to increase the scope for competition in this area.

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[9] A G Haldane, Patience and Finance, p.11
[10] Nicholas Brady, US Treasury 1988 - 1993
[11] http://www.iicouncil.org.uk/docs/rifireport.pdf

Fund managers are provided with money by their clients to invest on their behalf. The fund manager is provided with a mandate by the client outlining the objectives they wish to achieve, the measurements of performance and the time periods involved. Although many clients state that they are interested in long-term performance, there remains a tendency for the mandates to measure performance over short-time periods, in some cases on a quarterly basis. This means that fund managers must focus on short-term performance in order to win and retain mandates. As Haldane notes,[12] information is a double edged sword. It supports the cause of the long-term investor, by allowing easier comparison of prices with the fundamentals. But it also tests the patience of the untested investor subject to regular performance evaluation. We would suggest that the average pension fund trustee is an untested investor that is forced to regularly review performance over the short-term.

There are multiple reasons for this approach. As noted previously, pension accounting and solvency rules require that valuations are based on short-term assumptions even when the liabilities may be extremely long-term. In addition, the ultimate providers of the mandates, such as pension trustees, may not fully understand the nature of the investment process and performance. Finally, their advisors, the investment consultants, may have an interest in encouraging a more short-term approach as this is more likely to drive change in fund managers and increase their own fees. The providers of mandates and their advisors engage in hyperbolic discounting. We consider that all these factors should be investigated further and clients should be incentivised and encouraged to take a more long-term approach.

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?

The best way to encourage a longer term focus in UK equity investment decisions is to consider the current regulatory and tax issues that may be discouraging this. The issues relating to this have been outlined above.

In addition, in a number of other jurisdictions there are systems in place that provide incentives or benefits for holding equities for longer periods. These can include additional voting rights, additional dividends for voting, or extra dividends for those holding shares for a set period. The theory of such systems is that longer term holders of equity are more likely to have a long-term focus, or such loyalty should be rewarded.

Such systems may be seen as desirable in terms of promoting a long-term approach. However, the operation and consequences are worth considering. These systems tend to operate in markets characterised by block holdings (either family or institutional). They often enable blockholders either to exercise corporate control in excess of their economic interest, or to reward them at the expense of other holders. This goes against the concept of one-share one-vote and the equal treatment of all holders. It entrenches bad management, leads to excessive rent extractions by one group or groups at the expense of others, and undermines the efficient allocation of capital. Equality in the treatment of shareholders is the key to a free and functioning equity market that provides capital at the

[12] A G Haldane, Patience & Finance, 2010

lowest cost alongside an efficient system of corporate control. Rather than seek to undermine the maxim that all shareholders are equal, we should look to public policy to encourage and reward patience.

Setting aside these issues, it is also worth noting that such systems are extremely difficult to operate in practice. Our members' experience in jurisdictions with such systems has shown that because of complications in the voting and ownership chains it is extremely difficult for shareholders or companies to determine who is entitled to extra dividends or votes. In effect, the only guaranteed recipients of them are the blockholders who benefit most from their existence. Given the dispersed ownership model in the UK such a system would be even more complicated to operate and provide few benefits to the ordinary shareholder.

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

The core function of good corporate governance is to address the agency problem, either by controlling the agent's actions or by holding them to account, and by seeking to ensure that the agents' interests are aligned with those of the principal. This is equally true in regard to the relationship between the client/principal (asset owner) and the agent (fund manager) in the investment chain.

Under the current regime, the client is free to choose the agent that it feels will best serve its interests and is also free to determine the method of reward that creates the best level of alignment. However, we recognize that there could be improvements made in relation to transparency, particularly in how fund managers discharge their stewardship responsibilities.

This issue is addressed in the UK's FRC's Stewardship Code. This requires that fund managers explain firstly if they apply the Code Principles[13] and if they do so, how this is achieved. Each fund manager that applies the Code is required to make a statement regarding its approach to Stewardship on a comply-or-explain basis. Those adhering to the Code are listed on the FRC website.[14] This transparency allows the asset owners to better understand the fund managers' approach, to make informed decisions when allocating mandates, and to hold fund managers to account for their actions and.

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

It may be useful to draw a distinction between transparency between fund manager and client, and public transparency, as different issues are raised. As far as client transparency is concerned, the main issue is to ensure that clients take decisions on the basis of adequate and accurate information. Fund managers act as agents of their clients and they have a clear duty to them. The manner in which this duty is discharged is determined by the mandate that the client awards them. The nature of this mandate is primarily determined by the client, who usually awards it after a competitive tendering process involving a number of fund managers. There is already a high degree of transparency to the client

[13] FSA Handbook Amendement, 10 November 2010 http://www.fsa.gov.uk/pubs/handbook/hb_notice104.pdf

[14] http://www.frc.org.uk/corporate/stewardshipstatements.cfm

regarding the charges, pricing, investment model, portfolio composition etc. Wider disclosure of these issues would raise serious difficulties with commercial confidentiality.

Transparency in the public interest requires a careful balancing of the public interest in wide understanding of the relations between fund manager and client, and the need to retain commercial confidence. This is the purpose currently served by the Stewardship Code, which requires that fund managers now publicly disclose their approach to relevant issues, allowing clients to make an informed choice from the outset. We believe that the Stewardship Code should be allowed time to bed down before further changes are introduced.

There may be value in consideration being given to the issue of the form of the mandates given to the fund managers and the role of investment consultants. It is the nature and objective of these mandates that primarily drives fund managers' behavior, and ultimately remuneration. Although it is the case that more clients are including in their tendering process, or RFPs (Request for Proposals) for information on the manager's approach to Stewardship, this interest rarely extends beyond the first stage of the tendering and is not something that receives a high degree of consideration when reviewing an existing manager's performance by either clients or their advisors, the investment consultants. If a long-term approach is to be encouraged it is essential that this is an important feature of mandates. We therefore suggest that further work should be done on the role and structure of mandates. The UK's Institutional Shareholders' Committee/Institutional Investor Council, representing both fund managers and clients[i 15], may be best placed to consider these issues.

In relation to remuneration, it is important to understand how the system currently operates. Fund management firms receive remuneration in the form of fees from their clients, the level and structure of which is agreed when the mandate is awarded. The fees therefore are clearly disclosed at the outset and, in the case of active mandates involve a performance related element. In the case of retail funds, the fees payable must be clearly set out in accordance with strict regulatory requirements. In addition, fund managers are required to disclose their total expense ratio so that it is clearly understood what the total costs are. The remuneration of individual fund managers is determined by the firm they work for. This remuneration often relates to performance, tied to the long-term, and can involve an element of deferment. We would also note the growing use of co-investment in funds by managers and clients as an example of how further alignment is being encouraged. In these ways, fund managers are rewarded based on performance and their interests are ultimately aligned with the clients of the firm.

We do not believe that there is a need for in-depth disclosure in relation to individual fund managers' remuneration. However, there may be some benefit in fund managers making public statements in relation to their overall approach to remuneration and how it is tied to the long-term and the interests of the clients. Any requirement for such disclosure needs to be carefully considered so that it does not become too onerous or leads to mere box-ticking compliance. We therefore consider that the issue needs more careful consideration

[15] ISC/IIC membership consists of representatives from the membership of the Association of British Insurers, Association of Investment Companies, Investment Management Association and the National Association of Pension Funds.

and may be best addressed within the context of the disclosures required under the FRC's Stewardship Code.

Directors' Remuneration

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

There has been much debate regarding the causes of the increases in executives' remuneration over the last 10 years or more. There is no simple answer, but rather there appear to be various contributing factors.

The role of globalization has undoubtedly played a role in the increases. Highly talented individuals can now move much more freely around companies and the world. This has led to a highly competitive environment for talent, which in turn may have led to an increase in remuneration. For example, in the FTSE-20 over half of the companies have a chief executive who is not British by birth. In addition, the listed market itself has internationalized, with an ever growing number of companies on the market being multi or trans-national in nature. The consultation paper also notes that the major determinate of pay is the size of the business rather than performance. To a degree this is true, and it is therefore worth noting that one trend in the UK listed market is for it to be dominated by larger and larger firms. For example, according to the latest FTSE-100 figures[16] the top five companies represent over 33% of the index weighting[17], with the FTSE-100 constituting over 80 per cent of the total All-Share capitalization.

Since the Directors' Remuneration Report Regulation came into force, a view has developed that transparency has contributed to the "arms race in remuneration". A propensity to benchmark against peers leads to an ever spiralling upwards in quantum seem to be the main results of this greater transparency. We would agree that this is true to a degree and that there needs to be stricter adherence to the key principle in the UK Corporate Governance Code of paying "no more than is necessary"[18] by both remuneration committees and investors. However, we do not believe that transparency on its own is responsible for increases in pay. Other jurisdictions that do not have transparency or have introduced transparency later, such as Switzerland and Spain, have also seen substantial increases in remuneration.

Remuneration committee chairman must deal with three primary, if perhaps too simplistic, aims – to attract, retain and motivate. The psychological drivers that motivate individuals vary and, when combined with the fact that these must be balanced with the needs of the business, a remuneration committee chairman's requirement to motivate people is a difficult one. However, what retains and attracts individuals in terms of remuneration can be analysed more simply. Therefore, when seeking to retain or attract an individual, it is much easier to raise the quantum rather than try to manipulate the other drivers of behaviour.

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[16] http://www.ftse.com/Indices/UK_Indices/Downloads/FTSE_100_Index_Factsheet.pdf

[17] HSBC Hldgs, Royal Dutch Shell (A and B Shares), BP, Vodafone, GlaxoSmithKline

[18] FRC's UK Corporate Governance Code

When considering remuneration, one should not merely look at the face value quantum, but also the structure of the package overall. There has been a move over the years towards a package that is based more on performance, with an ever greater proportion "at risk". This has been coupled with a significant relative decline in the value of the most long-term element of the package, the pension. Thirty years ago, by far the largest amount of long-term remuneration an executive or senior manager would receive would be the pension he would receive at the end of employment. This naturally tied them to the company for the long-term. However, for a variety of reasons there has been a major decline in the value of pensions and the importance they play in the total package. The means that to create a comfortable retirement and build up personal wealth the focus now is on bonuses and LTIPs rather than pensions, with employee performance being measured over 1 – 3 years, rather than 30.

We would further note that we do not in the UK have a peculiar problem in relation to the rest of the world. The issue of executive pay is the subject of discussion, regulation and other initiatives in many other jurisdictions. We should therefore be mindful that in some areas we already have adopted best practice and that over the last ten years or more there have been substantial successes.

Examples of success include that in the 1990s it was still common for executives in the UK to have three year rolling contracts and receive compensation for loss of office ("golden parachutes"). This was considered to be unacceptable by shareholders, the authorities and the public at large. The ABI and the NAPF issued its first Joint Statement on Contracts and Severance, stating that one year contracts were the lowest acceptable apart from in exceptional circumstances.[19] As a result one-year contracts are now the norm and directors' severance payments do not include compensation for loss of office. Similarly, when share options were first introduced they routinely included retesting provisions of performance conditions for up to 7 years after the performance period ended. This did not adequately align pay and performance and as result of shareholder pressure retesting is no longer a common feature of UK executive share plans.

In relation to the question regarding the appropriateness of the level of pay, it is important that we are cognisant of the interests at play here. For shareholders, the questions around pay focus on how it relates to their interests. In this respect there are two prime considerations: - does the level of remuneration represent excessive economic rent extraction (in effect is too much being paid for the activity and performance), and do the remuneration structures in place incentivise behaviour which is in the interests of the company and its shareholders. In this sense then, remuneration represents a sub-set of corporate governance. It is a means to ensure that the interests of the shareholder and agent are aligned (thereby seeking to close the agency gap), and that the agent is properly incentivised to act in ways that are in the interests of the company. If the question on the appropriateness of levels of pay is related to a perceived social or moral good, then this is properly the role of regulatory and tax regimes. If there is a wish to act according to these imperatives then the authorities should behave accordingly, and not seek to use corporate governance and mechanisms designed to close the agency gap to achieve these different objectives

[19] http://www.ivis.co.uk/ExecutiveContractsAndSeverance.aspx

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

The Corporate Governance Code requires that the board and its committees should have the appropriate balance of skills, experience, independence and knowledge of the company to enable them to discharge their respective duties and responsibilities effectively. We consider that there is significant benefit in a board and its committees being constituted of individuals from a wide variety of backgrounds, with a diverse range of skills and experience. Further, we believe that, in accordance with the Corporate Governance Code requirements, the Remuneration Committee should be made up of independent directors and that they should have due regard to pay and conditions elsewhere in the company. As with many areas of Corporate Governance, the effectiveness of the Remuneration Committee will be determined by the individuals involved in the decision making, and therefore will vary from company to company. The best way to ensure the effectiveness of boards is through an active and engaged shareholder base and through boards engaging in high quality board evaluations.

We do not believe that there is a case for expanding the membership of the committee to include shareholder, employee or special interest representation. Shareholders appoint directors as their agents, and are able to hold them to account if they do not act in their interests. The directors' responsibilities, as defined in the Companies Act, require them to take into account the interests of employees and other stakeholders, and to act in the long-term interest of the company. We therefore cannot see any benefit in widening the membership of the remuneration committee or the board in general. We believe that this would undermine the core tenet of corporate governance and law regarding the central roles and responsibilities of directors and shareholders, and the ultimate aim of companies to create sustainable long-term value.

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?

Shareholders have various mechanisms to hold companies to account and we consider that these are generally adequate. Shareholders elect and re-elect directors to act as their agents and in their interests. Part of this role includes determining levels of remuneration of management. In the UK, to solve the problem of those directors involved in the management of the business setting their own remuneration, there exists the concept of the non-executive or independent director. It is these directors who staff the remuneration committee which determines executives pay. If shareholders believe that the independent directors were not fulfilling their role or acting contrary to their interests, they are able to refuse to re-elect them at a general meeting. Under the revised UK Corporate Governance Code issued in 2010, best practice is that directors of FTSE-350 companies must seek annual re-election, thereby increasing this accountability mechanism.

Shareholders also have further mechanisms of accountability and control in relation to remuneration. Since 2002, every listed company has been required to submit a remuneration report to their annual general meeting on an advisory basis. This resolution allows shareholders to express their views on the company's remuneration policy and

practices. It provides a locus for dialogue and engagement, and allows shareholders to express their views and hold the directors to account for their actions at the AGM.

Shareholders have one further mechanism in this area under the UK Listing Rules. Any share based incentive schemes that affect or dilute their holdings must be approved at a General Meeting. This in effect means that shareholders approve every share based incentive scheme before they are implemented. Investors often are involved in dialogue before the schemes are submitted for approval at the AGM to ensure that they are aligned with their interests.

As noted in the Consultation, "golden parachutes" or compensation for loss of office are not a feature of the UK market. Indeed, the ABI's Remuneration Guidelines and Joint Statement on Contracts and Severance have long stated our members' opposition to such practices. As a result they ceased to be common practice some time ago. The statement also makes clear that any payments in excess of the basic contractual entitlement should be kept to a minimum, and that the duty of mitigation should be enforced. We believe it is of the highest importance to minimise payment for failure.

We recognise however, that sometimes additional payments are made, for example in respect of bonus entitlement. However, this is an area where corporate governance and company law interact with employment law. The relationship between these factors is further complicated by the existence of precedent. In Mallone v BPB Industries plc [2002] the courts recognized that, if an employee had a reasonable expectation of even a discretionary bonus, and this was not paid, the employer was in breach of contract. Although the Court of Appeal said that the appropriate test should related to what could be expected of a 'reasonable employer', this created uncertainty regarding how this would be applied on a case by case basis. In Horkulak v Cantor Fitzgerald [2004], the Court of Appeal further stated that the employer must not exercise their discretion in relationship to the amount payable 'capriciously or irrationally'. This further adds to the difficulty relating to the amount that should be paid. Finally although in Keen v Commerzbank AG: [2006] it was decided that, in fields where there was a high degree of discretion in relation to bonus levels, such as Investment Banking, the employer should retain the discretion to award lower amounts, it is difficult to see how this would be applied at executive level in listed companies where bonuses are generally paid against clearly defined objective targets.

Given the above, it may be difficult to introduce binding votes on such payments. As the Failure to pay may conflict with employment law and rights, and as such leave the company open to further legal challenge. Therefore this issue needs further consideration and investigation.

14. 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?***

A more outcomes based approach to remuneration disclosure is desirable. Currently, investors receive a great deal of information regarding the policy and design of remuneration packages. However, there is very little clear disclosure on how these policies and schemes work in practice. It is the outcomes of the remuneration structures that ultimately show how successful the link between pay and performance has been. This disclosure could take the form of clearly setting out what level of performance was achieved during the period for all schemes, and what was paid out as a result. We believe that this is achievable for both short-term and long-term incentive schemes and, that issues of commercial sensitivity can be managed.

We believe that caution should be exercised when considering disclosure of the relationship between directors' and employees' remuneration. Remuneration disclosure is for the benefit of the shareholders, to help them understand how their agents are being incentivised and to ensure that there is no excessive rent extraction. It is not clear to us how a simple ratio or description of the relationship would help shareholders understanding. The nature and business of companies vary immensely. Some have thousands or hundreds of thousands of staff paid different levels of remuneration from very low to very high, whilst others have relatively few staff all of whom receive high levels of remuneration. Given this lack of comparability it is difficult to see what investors would gain.

Takeovers

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

Takeovers represent perhaps the greatest challenge to boards in considering both the long- and the short-term implications of whether their decisions are most likely to promote the success of the company. Inevitably judgements as to long-term implications are subject to a degree of uncertainty. This contrasts starkly with the prospect of short-term value being crystallised through a takeover. This point is relevant to the boards of both the bidding and the target company.

We believe that boards generally do give proper consideration to long-term implications and they will undoubtedly be reminded of their obligations under the law by their legal advisers. We think that the formulation of directors' duties under the law is well specified but the law has been in operation in its present codified form only for a relatively short period of time. How it works in practice is a legitimate object of study.

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?

We start from the position that the current arrangements in the UK in this regard are well-specified and achieve the right balance between giving corporate boards the powers to run companies while ensuring proper accountability to shareholders. The Listing Rules of the UK Listing Authority, currently a part of the Financial Services Authority, impose an obligation to obtain prior shareholder approval for transactions that exceed a 25% materiality threshold as measured by any of a number of 'Class Tests'. This is an important element of investor protection for shareholders of (premium) UK-listed companies.

The 25% threshold for categorising transactions as 'Class 1', and therefore subject to the shareholder authorisation requirement, is well-embedded under the Listing Rules. Although detailed operation of the Class Tests has changed a little over time, the principle and the threshold have applied for many years. We suspect that the benefits of significantly extending the scope of Class Test requirements would be outweighed by the costs. However there may be greater merit in considering now whether a lower threshold, such as 20 percent, which would improve accountability to shareholders, would generate a benefit in excess of the consequent incremental cost.

Offerors that come from overseas jurisdictions and, indeed, unlisted companies in the UK are not subject to the UKLA's Class Tests. As investors in overseas companies UK institutional investors would wish to enjoy shareholder rights equivalent to those in the UK but this is not something that UK Government or regulatory authorities have proper jurisdiction over. We do not believe it would be right for the UK to seek to impose extra-territorial jurisdiction. Nor do we think it would be easy to devise an obligation that could not be circumvented, such as by putting in place a corporate structure where an intermediate company is the offeror and, by definition, is legally owned merely by a higher-placed company in the group structure where all such companies are by definition under common control. By contrast, the Listing Rules approach, almost by definition, applies to the top company within a group structure where economic ownership really resides.

Other

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

No