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

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

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

Completed copies of the response form should be returned:

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

Via post to:

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

	Quoted company
	Other company
	Investor or investment manager
x	**Business representative organisation**
	Investor representative organisation
	Non governmental organisation (NGO)
	Trade Union
	Lawyer or accountant

☐ **Other (e.g. consultant or private individual)**

The Board of Directors

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

Comments
We believe that there are a number of issues to consider. Clearly the nature of the business involved will have an influence on the time horizon that a Board of directors may work to. So for example a company involved in scientific research may work to a timetable of several years for a new product to come to fruition whereas a retail company may focus on the outcome of one season's trading covering a matter of months. Notwithstanding this, boards should be planning for the long term continuity of a company to deliver returns for investors, and this will require the periodic reassessment of strategic objectives to take account of economic, social and technological changes. What appears to have happened in the last 30 years or so is a contraction in the time period demanded by investors for returns. This has in part been driven by over active trading in equities as a method of delivering income for third parties and the development of more frequent reviews of investment portfolios – particularly those of pension funds – resulting in a focus on increasingly short term returns. This has fed through to pressure on Boards to deliver results on an ever shorter time cycle which in itself militates against longer term investment decisions. This coupled with the desire to link directors' and shareholders interests has lead to directors' financial rewards being driven by artificially short term financial targets.

Question 2: Does the legal framework sufficiently allow the boards of listed companies to access full and up-to-date information on the beneficial ownership of company shares?

Comments

The current legal framework does not allow boards to interrogate investors who hold an economic interest in their companies via certain types of derivative positions, eg CfDs. The current "passive" disclosure regime forces investors to disclose positions over a given threshold (currently 3%) but companies do not have the right under Companies Act S793 to force disclosure of derivative or short positions as the Act only covers voting shares.

As increasing number of investors are using synthetic positions to hold a position in listed companies, the UK legal framework needs to be updated commensurately.

However, we should stress that the UK legal framework for interrogation of shareholders is far in advance of other European countries and we believe that any decrease in transparency would be pejorative to the efficient functioning of capital markets.

Shareholders and their role in equity markets

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

Comments

The growth in overseas investors and trading funds as holders of UK companies has had a significant impact on the governance of UK companies. Many overseas investors and sovereign wealth funds operate on a much more arms length basis with less direct involvement in the governance aspects of companies. Trading funds have even less involvement in governance. So it has been left to an increasingly small proportion of UK based fund managers to exercise fiduciary control over boards. And because such funds are usually in a minority position they have been unwilling or unable to exercise voting control either in M&A situations or in relation to corporate governance issues. The introduction of the UK stewardship code may help to reverse this trend and it is encouraging to see a number of overseas investors signing up to the code.

It is also worth mentioning the separation of voting and ownership. The role of outsourced voting (based on pre-agreed standards) is causing less direct involvement by investors. Also, the growth of remote ownership through derivatives such as CFD's does not encourage investors who have an economic

interest to engage.

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

Comments

Investor Relations is the two-way communication of information and insight between a company and the investment community. This process enables a full appreciation of the company's business activities, strategy and prospects and allows the market to make an informed judgement about the fair value and appropriate ownership of a company.

The Investor Relations Society has produced guidance which aims to help companies enhance the quality of their dialogue with those institutions who own their shares, and to help enhance a long term understanding of the companies' prospects and governance. The advantages stemming from good communications between Boards and the company's owners far outweigh the potential costs and risks of such a dialogue.

A key task of the IR team is the communication of the long term strategy of the company, in such a way that investors understand the context in which individual events can be seen.
IR teams should create proactive investor outreach programmes including site visits, road shows, as well as regular, financial-calendar linked conference calls. Where practical, events should be communicated to the market as a whole.
Companies should produce investor materials in line with current best practice with an open and inclusive approach to communication on governance issues.

The IR team should support the Board in its meetings and contacts with shareholders. To do so, the IR team should:

- Ensure that they can identify and obtain contact details for the investors in the majority of their shares[1].This should include shareholders who have recently sold or significantly reduced their shareholding, (where possible[2]) significant strategic short sellers, and any activist shareholders;

- Make themselves available as a 'first port of call' resource for institutional investors seeking information;

- Create a structured plan for regular IR contact with a representative group of shareholders, including through an investor survey;

- Give careful consideration to, and evaluation of any material investor

[1] UK law provides for both reactive disclosures under Disclosure Rule and Transparency Rule 5 (DTR 5) and proactive through Sections 793 of the Companies Act. Effective monitoring of disclosures under both of these provisions will enable companies to identify shareholders.
[2] Currently only disclosed for financial sector companies

concerns, and ensure that the Board is aware of them;

- Create a strategy for Board consideration on when and how proactive outreach to specific investors is appropriate, and on collective engagement with shareholders;

- Facilitate meetings with management if investors are expressing specific and material concerns;

- Facilitate attendance by the Chairman and other non-executive directors at roadshows / analyst meetings with management to understand shareholders' major issues;

- Ensure adequate contact with proxy advisors to gain insight into any investor concerns;

- Provide to the Board a regular analysis of internal and external earnings expectations, such that all members are aware of potential challenges.

Where investors choose to engage collectively, such as at times of significant corporate or wider economic stress, the IR team should:

- Keep channels of communication with all investors open so that concern can be addressed at an early stage;

- Keep the market updated of any material changes in the economic or corporate environment and how they impact on the company.

Boards should ensure that processes exist for the dissemination of information to their IR team on internal strategic decision making and processes and others in order than they can maximise their value to institutional investors.
The IR team should support the Chairman and Non Executive Directors in their meetings with investors, as well as supporting management in their day to day contacts. This may include:

- attending company roadshows;

- dialling in to analyst briefings, or attending a selection of analyst meetings;

- attending post-results meetings;

- Remuneration committee chairmen attending meetings with the major shareholders to seek views on the remuneration scheme.

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

Comments
Our members have certainly reported that in the past there has been a silo mentality in some investment institutions with the investment teams, governance teams and CSR specialists not talking to each other. We believe that this is now changing and the most pro-active institutions are developing better joined up thinking. However there is still a chasm between the 'front' and 'back' offices in many investment firms. So fund managers may be unaware if stock has been 'lent out' by the back office and they may not know if votes have been effectively lodged or even how many shares the institution is able to vote on. We would comment that the fragmented investor market – the agency problem - with its different roles of ultimate owner, custody, asset allocation, trading strategy, pooled accounts, prop desks, prime brokers etc is not conducive to a common investment management or voting strategy. Each plays a different role, but rarely communicate.

<u>Question 6</u>: How important is voting as a form of engagement? What are the benefits and costs of institutional shareholders and fund managers disclosing publically how they have voted?

Comments
Ultimately a shareholder can use his vote to express displeasure at the way in which a company is being run. However as a method of engagement it is a fairly blunt instrument. Whilst voting is to be encouraged, it should be the final part of the engagement process not the first indication of a problem. Issuing companies find it very frustrating when investors vote against resolutions when no previous warning or discussion has been given. Companies believe there is no true substitute for the 'fireside chat'.

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

Comments
It is dangerous to say that 'short-termism' per se is a problem. There are valid reasons why an investor may only hold an investment for a short period of time. From an issuer's perspective a balance of short and long term investors on the share register can be advantageous with short term investors providing liquidity and long term investors providing stability. However, as discussed in answer 1 above, if investors' focus becomes too much on delivering short term performance this can damage a board's ability to bring longer term strategic plans to fruition and ultimately reduce the return to shareholders. We believe that the introduction of the new UK Stewardship Code will go some way to encouraging investors to take a longer term interest in the development of their investee companies. We also believe that increased transparency between companies and their investors and the improvements in narrative reporting which are now happening through the implementation of the Companies Act and other peer group pressure to improve disclosure will enable companies to explain their strategies more fully and enable them to take a longer term view. However we do not support the introduction of wholesale rule changes: guidance towards lessening the gap between those companies who produce award winning reports and others, would be helpful.

<u>Question 8</u>: What action, if any, should be taken to encourage a long-term focus in UK equity investment decisions? What are the benefits and costs of possible actions to encourage longer holding periods?

Comments
The answer is that no direct action should be taken. It is a slippery slope towards direction of investment which will ultimately distort the market and introduce inefficiencies. We would also comment that tinkering with the structure risks lessening the quality of the UK market as a whole. Despite the undoubted shortcomings of the present system good companies have prospered and by and large those companies with sound business models have been able to raise finance in the London market. As a Society we believe that proactive, universal, prompt and clear investor communications is fundamental to a proper understanding of a company's strategy and we support proportionate regulation that promotes equity and fairness. Clearly,

it is essential for investors to understand the costs and benefits of particular investment strategies and we would support the work done by independent researchers to reveal the shortcomings of so called 'active portfolio management'. We do not support the idea that there should be differential voting rights for shareholders which flies in the face of one share, one vote democracy and could be impossibly complicated and costly to administer. We do however think that the tax system (CGT) could be used to encourage longer term shareholding.

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

Comments
There is clearly a potential conflict between the interests of fund managers and investors. The partial answer to the problem must be through education and awareness of fund managers and trustees together with transparency of charging. As stated in 8 above, clearly, it is essential for investors to understand the costs and benefits of particular investment strategies and we would support the work done by independent researchers to reveal the shortcomings of so called 'active portfolio management'

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

Comments

Transparency in charging must be positive in the long term, although in the short term in might result in a reduction in the income and employment of some fund managers if it becomes clear that they are not generating real returns for investors.

Directors' Remuneration

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

Comments
We believe that the use of a small number of remuneration consultants who promote the concept that directors should normally expect to be in the upper end of earnings bands goes a long way to creating a self perpetuating upward pressure on directors' remuneration. Directors also have a tendency to get out of touch with the real world in terms of the absolute levels of remuneration, partly because it is not in the interests of their advisors or other colleagues in the organisation to say that they are overpaid. Investors often complain privately about excessive levels of Board remuneration but provided the company is delivering returns to shareholders they rarely vote against the Board solely in respect of this issue. Creating an overt, meaningful connection in annual reports between strategy, KPI's, risks and performance is rare among UK Plc, but would address much of the problem.

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

Comments

The effect of widening the membership would depend on who was included and the proportion of non-board members. Clearly the effect could be pretty radical if the committee included a majority of 'independent' non-board members and incorporated representatives from employees and investors.
One might expect to see Board remuneration levels behaving more in line with employees' remuneration. However,it is a slippery slope towards creating a German-style Aufsichtsrat, with the consequences for governance.

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

Comments
As highlighted in the call for evidence, as most payments to directors are made under contractual entitlements, it is difficult for shareholders to overturn these. It would therefore be necessary to make directors' employment contracts (or the remuneration elements of them) subject to shareholder approval. As to effectiveness, we have seen votes against the remuneration committee report at some AGM's. In these instances, it is arguable that investors have been effective, but these occasions are rare. As in our previous answer, communicating the basis on which pay awards are made, and taking soundings on those criteria is beneficial.

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

- **linkage between pay and meeting corporate objectives**
- **performance criteria for annual bonus schemes**

- **relationship between directors' pay and employees' pay?**

Comments
The UK's statutory disclosure requirements on directors' remuneration are amongst the most extensive in the world. We believe that presentation of this information is however of variable quality. In the best companies we have seen good linkage between performance and pay, but in others there is room for improvement. We do not believe however that this is a case for more disclosure, rather better disclosure, and that this will be driven by peer group pressure and guidance rather than additional regulation.

Takeovers

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

Comments
Good communication should not just start in a bid situation. We believe that companies that have developed a pro-active investor relations programme, which has consistently communicated strategy and generated a dialogue between management and investors, are far more likely to be able to garner the support of their shareholders. However, as noted in the call for evidence there is pressure in takeover situations for undue focus on short term issues. To a large extent Boards react to the pressures placed on them by shareholders in these circumstances. In many takeover situations fund managers give primacy to short term gains which will help to boost their portfolio performance rather than looking at the long term prospects for growth.

<u>Question 16</u>: Should the shareholders of an acquiring company in all cases be invited to vote on takeover bids, and what would be the benefits and costs of this?

Comments
Large transactions (class 1) already require approval by shareholders of acquiring companies. We are not convinced that approval of less material transactions would serve a worthwhile purpose and would add to the cost and time needed to complete an acquisition.

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

Comments