forum for the future
action for a sustainable world

Adam Gray
Long-term Focus Consultation
Corporate Law and Governance
Department for Business, Innovation & Skills
1 Victoria Street
London SW1H 0ET

By e-mail to: clgconsultations@bis.gsi.gov.uk 14 January 2011

Dear Mr. Gray

A Long-Term Focus for Corporate Britain

Thank you for the opportunity to respond to the BIS consultation on this topic.

Founded in 1996, Forum for the Future is an independent, non-profit organisation with a mission to promote sustainable development. We work with business and the public sector to explore how society can generate lasting wealth for current and future generations within the natural limits of one planet. Our partner organisations are some of the best-known brands in the world and the leading companies in the UK, including **PepsiCo, Vodafone, O2, AkzoNobel, Unilever, Sainsbury's** and **Kingfisher**. By working with us they commit to playing a leading role in achieving a sustainable future, to reengineering their operations, and to changing attitudes and behaviour among their customers, suppliers and staff.

Our 70 staff help them future-proof their strategy, innovate low-carbon products and services, and equip their top people with the skills they need to ensure their organisation is fit for the future.

In the finance sector, we work with specific financial institutions such as **Aviva, Barclays** and the **Co-operative Group** on innovative products and approaches and on cross-sector projects involving several organisations, such as our work on climate finance and on forest investment.

Forum for the Future is a charitable organisation, and everything we do ultimately benefits the public. We help companies and public sector bodies understand sustainable development, and we share the results of our work widely so that organisations all over the world can develop products and services which are environmentally sound, socially just and economically viable.

Our practical work with companies and investors over the last 15 years has provided us with a range of insights on how short-term thinking within corporate Britain often tends to prevent optimal outcomes for employees, shareholders and society as a whole. Our work has also helped us to formulate ideas on what could help to "nudge" behaviour in the right direction.

Below we outline our thoughts in response to the separate questions posed by the consultation. These comments are based on our research, our practical experience of working with companies and the findings of a round table of senior representatives from

companies and financial institutions that we convened in collaboration with the Aldersgate Group and UK Sustainable Investment and Finance (UKSIF).

In October 2010, Forum for the Future began a project looking at overcoming the barriers to long-term thinking. This was funded by Friends Provident Foundation, with a key focus on constructive solutions, particularly involving cultural or behaviour change. The project also aims to identify opportunities to pilot and scale up some of the solutions in the future. More detail on the project is available at:
http://www.forumforthefuture.org/projects/overcoming_barriers_long-term_thinking

While the project is ongoing, the initial research findings were particularly relevant to questions 1, 2, 7 and 8 of the consultation. Our main responses have therefore been focused around these questions, summarising:

- some of the trends and barriers to long-term thinking.
- actions that could address these barriers within the business or investor community.
- areas of government policy or support that would be needed to address these barriers.

We hope that our response is helpful to you, and we would be happy to talk further about any of the comments and recommendations.

Best regards

Alice Chapple
Director, Sustainable Financial Markets
Forum for the Future

We outline below Forum for the Future's responses to the specific questions raised by the BIS consultation.

The Board of Directors

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

1.1 In our experience, UK boards tend not to have a long-term focus, for a number of reasons. These include:-

- Company performance is almost invariably measured by reference to short-term indicators, particularly quarterly returns. This means that boards of quoted companies feel pressure from the market to announce increasing short-term profits – for example, an increase in the Earnings Per Share (EPS) year on year. Sometimes this is not compatible with a longer-term strategy towards research and development or a shift in business activities that may be better aligned to long-term trends and mitigating long-term risks.
- These short-term indicators are also frequently used as a measurement of individual performance and reputation, and executive remuneration. These remuneration practices can give a perverse incentive for risk-taking or short-term behaviour.
- Boards are often composed of like-minded individuals whose views are not challenged and / or who may feel pressure from their peers to behave in certain ways. Where the norm is to think short-term, this therefore continues.
- Evidence shows that CEO tenure has become shorter[1]. This means board members may not perceive their role as long-term, and they may not have a historical long-term perspective of the business.
- Long-term drivers of value (including social and environmental impacts and dependencies) are very difficult to predict with any accuracy and are therefore heavily discounted. This problem is compounded by the fact that individual companies or investment managers do not see their peers seeking to quantify many of these long-term drivers of value and they take comfort from this herd effect.

1.2 Some actions that could address these challenges within the business community include:-

- Companies could present their sustainability performance in a way that is more relevant to mainstream investors and more closely integrated with financial reporting. One report recommends that "Leading companies can focus attention on the long term by embracing enhanced reporting that concentrates on cash flows and a broad range of operating metrics. These companies can take the lead in "changing the conversation" to a focus on the long-term growth prospects that are ultimately more important to continued success than pennies per share in a quarterly earnings forecast."[2] More work is needed in this area, to reduce the disconnection between sustainable investment and mainstream investment, and to help quantify the business risks and opportunities of sustainability. Recent work by Accounting for

[1] Karlsson et al (2008) and Favaro et al (2010) quoted in Patience and Finance, speech by Andrew Haldane, Oxford China Business Forum, Beijing, 9 September 2010.
[2] Breaking the Short-Term Cycle, Discussion and Recommendations on How Corporate Leaders, Asset Managers, Investors, and Analysts Can Refocus on Long-Term Value, CFA Institute, 2006

Sustainability is a good example of this approach. This may involve greater cooperation between companies, investors and other sectors to research and develop better ways of valuing natural and social capital, and better metrics to mention long-term business success.

- Companies could report annually or less often, rather than quarterly, and communicate better with investors about their long-term strategy and how it addresses sustainability. Our research showed support for companies increasing their level of communication with investors generally, providing proportionally less information on short-term measures and more communication and engagement on long-term strategy[3]. Unilever have shown strong leadership in this area, and have spoken about their long-term aims and their aims to attract investors with a long-term perspective.
- Companies could report to investors using "confidence accounting", where a range of possible future values is provided to allow for the fact that there is considerable uncertainty over future events. This approach would help companies relay to investors the uncertainties associated with the long term.
- Companies can ensure that executives and managers at all levels of the business are incentivised to focus on creating long-term value. This includes business objectives and the criteria used for remuneration decisions, and could involve linking performance criteria and executive pay to longer-term and more qualitative targets.
- Introduce greater diversity into boards and ensure that Non-Executive Directors are better able to challenge perceived wisdom.
- Companies need to have more resources for long-term thinking or have a platform to enable them to share future insights across markets so that there is more momentum around longer-term thinking.

1.3 However our research found that businesses face a number of systemic barriers in taking these actions. A comment in the Roundtable was that "the regulatory framework favours the laggards rather than the leaders". It is difficult for individual businesses to take the lead without peer action or demand from investors. Reducing these barriers for long-term thinking will therefore require government support, through actions such as:-

- Developing policies designed to support, encourage or mandate boards to communicate better with investors on their long-term strategy and how it addresses social and environmental sustainability, and place less emphasis on short-term measures of performance. Introducing mandatory carbon reporting would be a good example of this, helping to provide investors with clear and comparable information on corporate emissions, but it is also important for companies to undertake thorough analysis of their full exposure to future risks and opportunities. This could require clearer guidelines for consistent communication and reporting on sustainability risks, and it could also include accounting approaches such as confidence accounting (as mentioned above). These aspects should be considered in the context of the development of the requirements for corporate reporting and rethinking the Operating and Financial Review.
- Supporting companies in their efforts to identify and value their dependencies and impacts on people and the environment. Also ensuring that more effort is allocated

[3] Investment horizons: Do managers do what they say?, Mercer, 2010

to developing robust data in these areas, so that company performance can be assessed and benchmarked against peers and in relation to scientific information. This includes supporting research to understand, assess and assign a more realistic value to the natural capital (water, fertile soil, stable climate etc), human capital (skills and experience of employees) and social capital (customer loyalty and trust, support of various suppliers and local communities) that their operations depend on. This is not driven by woolly notions of corporate social responsibility. It relates to the long-term financial success of the business. Making this happen may require support for cross-sector initiatives to develop new measures of success for companies and to support financial analysts in the construction of new models.

- Encouraging collaboration between businesses, investors, and the insurance sector, to enhance understanding of long-term sustainability risks and opportunities. For example, Government could play a role in providing support for a platform for sharing insights across markets, with specific targets to ensure that it is more than a talking shop.

1.4 In addition to policy action, government communication could also influence the debate within the business and investor community, for example:-

- Creating expectations that successful companies and boards must focus on long-term issues. This could include a clearer narrative on the relevance of long-term thinking to our wealth and well-being, and clear messages to emphasise that liquidity must not come at the expense of long-term stability.
- This would be supported by clear long-term policy commitments that environmental and social externalities will be increasingly factored into costs. Our project research showed that it is important to create market certainty around the benefits for sustainable businesses, and one comment from the Roundtable was “There’s a paradox in asking businesses to take a longer term view when the fundamental ground rules change so rapidly”. The policy commitments needed will require a joined-up approach within government, and encouraging an international response to sustainability issues.
- Raising awareness of the existing best practice within the business and investor community on long-term thinking, and encouraging communication between businesses and investors on the mutual benefits of long-term value creation.
- Keeping long-term risks (such as climate change) at the forefront of the debate, and encouraging the development and application of research on future business risks and opportunities. Also supporting education and training that helps businesses to develop the skills needed to tackle these issues.

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?

Out of scope of research

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?

3.1 In our view, the key elements of the changing nature of UK share ownership that tend to drive more short-term behaviour in equity markets are:-

- A tendency towards shorter average holding periods[4]. This is made possible by lower transaction costs, largely as a result of information technology. The increasing speed of media and online data access also contributes to this, providing real-time information which can encourage more frequent transactions.
- Partly driven by technology advances, the increasingly international ownership of shares and the lengthening of the investment chain also adds to this separation between businesses and investors.
- Institutional investors also manage an increasing amount of investment. One report showed that between 1975 and 2009, institutional investor ownership in the US rose from 35% to 70%[5]. This raises the importance of how fiduciary duty is interpreted.
- These trends have also been linked to a cultural change in the perception of share ownership. For example, one paper[6] describes this trend: "Fuelled by an array of ancillary forces such as executive stock options and real-time media reporting of minute-by-minute stock performance, the market's speculative quality has led to a steady decline in the mentality of trusteeship, and steady upward trends in shifting and skimming wealth instead of creating it." Over time, this may have shifted the culture away from stewardship of shares to a more speculation-based approach. While guidance such as the UK Stewardship Code helps to address this, a wider change in culture may be difficult to achieve.
- Finally, one comment in the Roundtable was that "there seems to have been a move away from incentives for longer-term holding through differing rates of Capital Gains Tax in the recent past". This perception may further influence the shift to shorter-term share ownership.

3.2 Our research noted that short-term investment has an important role to play in a well-functioning market. But the increasingly short-term nature of mainstream investment has the effect of driving out "patient capital" and has a number of negative implications. We have summarised these implications, both for corporate governance and equity markets as a whole.

3.3 For corporate governance, these changes have the consequences that:-

- These shorter average holding periods have led to a reduced appetite / need for research into the long-term fundamental drivers affecting a company, and a greater focus on the short-term movements in market prices caused by more ad hoc information or events. This leads to short-term pressure on boards to stabilise returns for investors.

[4] Patience and Finance, speech by Andrew Haldane, Oxford China Business Forum, Beijing, 9 September 2010
[5] Why stewardship is proving elusive for institutional investors, Simon CY Wong, Butterworths Journal of International Banking and Financial Law, July 2010
[6] The Grasshoppers and the Ants: Why CSR Needs Patient Capital, Allen L. White, BSR, 2006

- Research has also shown that this short-term pressure may lead executives to sacrifice value creation in order to smooth earnings. One report cited a survey of over 400 financial executives[7]. "The majority of respondents indicated that Earnings Per Share (EPS) reported on a quarterly basis was the metric of most interest to outsiders, including analysts and investors. Equally important, over three-quarters of the executives indicated they would sacrifice activities with demonstrable economic value in order to smooth earnings and meet analysts' expectations".

3.4 For equity markets, these changes have the consequences that:-

- The changes have led to a system in which many investors increasingly take small stakes in a huge range of companies, therefore separating the investor from the activities of the underlying companies, and the asset manager from the investor. In most cases, the asset manager aims for short-term profit maximisation by default rather than being able to take on board the preferences of investors.
- Linked to this, the "increasing use of intermediaries – investment consultants, 'funds of funds', external asset managers, and others – in investment management has lengthened the ownership chain of companies"[8]. The average lengthening of the value chain means that performance metrics are typically employed at each link in the chain. This can lead to misaligned time horizons and a trader mentality (this is discussed further in response to Q9).
- These two factors have "lessened the sense of accountability between ultimate investor and investee company". As investor preferences for sustainability and long-term approaches are not clearly transferred into drivers for individual businesses, this restricts their ability of business as a whole to tackle these long-term challenges.
- There is also an increased risk of instability – more investors responding to short-term information increases the 'herding' effect and means that crashes are more likely.

4) What are the most effective forms of engagement?

Out of scope of research

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

Out of scope of research

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

Out of scope of research

[7] John R. Graham, Campbell R. Harvey and Shiva Rajgopal, "The Economic Implications of Corporate Financial Reporting,"
National Bureau of Economic Research Working Paper No. 10550, Jan. 11, 2005. (cited in The Grasshoppers and the Ants: Why CSR Needs Patient Capital, Allen L. White, BSR, 2006)
[8] Why stewardship is proving elusive for institutional investors, Simon CY Wong, Butterworths Journal of International Banking and Financial Law, July 2010

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

7.1 From Forum for the Future's perspective, we see two main sources of evidence for the hypothesis that short-termism in equity markets is a problem. The first piece of evidence comes from the messages from the scientific community on the impacts of our current systems for allocation of capital on a global basis. The second is from our hands-on experience of working with companies on their approach to sustainability initiatives.

7.2 Taking a broad view of how capital is currently allocated to economic activities through the equity markets, it is hard to argue that short-termism in equity markets is not a problem. As a global society, we are allocating capital to activities that are using up our natural assets at a rate that cannot be replaced[9] and we are contributing to climate change which could reach a dangerous tipping point[10].

7.3 Short-termism in markets ensures that the risks associated with this behaviour are not factored in to the price of shares. There are several reasons for this -:

- Many of these issues have historically been labelled as "ethical" or "SRI" issues and as such are dismissed by many analysts as irrelevant to a hard-nosed vision of how value is created in companies. The view tends to be that until regulation is put in place it is in an individual company's best interest to exploit the 'externalities'. This may tend to underplay the fact that there are real financial risks and opportunities for companies in engaging more proactively with 'ESG' issues.
- Future risks are discounted very heavily either because they are seen to be low probability or they are expected to occur far into the future. They are also perceived as difficult to quantify and to report.
- Investors may take the view that information emerging on long-term trends on the regulatory or physical risks that might affect the value of a company is often slow-burn (and in any case is discounted heavily, as noted above), giving ample opportunity to sell shares before any significant price adjustment. Sudden shocks such as the price collapse caused by the BP Deepwater Horizon explosion and oil leak are arguably evidence that this approach may not always be the correct one.

7.4 The second source of evidence on the problems caused by short-termism in equity markets comes simply from the CEOs and senior managers of the companies we work with. Paul Polman at Unilever and Ian Cheshire at Kingfisher are just two of the leaders who have made high-profile statements about how the tyranny of the equity markets in its quest for short-term returns stifles innovation and longer-term strategic positioning.

7.5 Our research suggests that an excessive focus on Earnings Per Share "leads to management decisions that engineer earnings and drain resources from profitable, longer-term uses of the firm's capital in order to artificially smooth and steadily increase performance"[11]. Research has shown that 80% of Chief Financial Officers would sacrifice future economic value to satisfy short-term return expectations from investors[12]. This is

[9] There are many relevant sources here, including the Millennium ecosystem assessment and the TEEB project.
[10] There are many relevant sources here, including the Intergovernmental Panel on Climate Change assessments.
[11] The Grasshoppers and the Ants: Why CSR Needs Patient Capital, Allen L. White, BSR, 2006
[12] Research cited in Network for Sustainable Financial Markets paper

borne out by our daily conversations with individuals within companies, trying to position the company to respond to sustainability challenges and generate economic value into the future.

7.6 Given this diagnosis, the following steps would help to address the problem (in addition to actions discussed in response to Q1) -:

- Encouraging a cultural shift towards 'stewardship' rather than speculation. This would tackle the psychological problem in that investors feel they are expected to make deals and behave "as gamblers" and there is a cultural bias against longer-term strategies. Our research will continue to explore possible solutions for this, which may include challenging the language that reinforces a culture of speculation, building a greater evidence base for the financial benefits of stewardship, or promoting greater understanding of the forces that promote short-termism. It may also involve the restructuring of objectives or incentives, for example, linking a portion of an investment manager's fees to the quality of their stewardship activities.
- Reviewing mandates and performance appraisal to encourage long-term thinking. A Roundtable comment was that it is difficult for asset managers to make investments in long-term propositions showing lower short term returns than the alternatives, because they are reporting to clients on a quarterly basis. Moving towards less frequent reporting, based on longer-term metrics, could help to realign incentives for asset-managers.
- Developing better metrics to measure sustainability performance, and the risks and opportunities associated with long-term action. As discussed in response to Q1, this may involve cross-sector collaboration and research.

7.7 Government interventions to support this could include -:

- Giving more clarity about fiduciary duties. One report proposes that "Policymakers should clarify to asset owners and asset managers that discharging fiduciary obligations requires thorough examination of both short and long-term considerations. It is also important to stress that – when making investment and other important decisions – qualitative assessments could be as vital as quantitative data, especially when precise calculations cannot be made easily, such as regarding the value of a vote."[13]
- Incentivising longer holding periods through the taxation system. Some form of tax levied on trade in financial products such as stocks, bonds, futures and options would add to the cost of these trades and could therefore shift the balance in favour of longer-term share ownership. In principle, we think that this could be positive, since losses in liquidity and efficiency could be outweighed by the potential benefits from greater stability. However, practical concerns were raised about this during the Roundtable. These included the risk that a UK tax could lead to a flow of capital out of the market, and the technical challenges of tracking shareholders. Another approach would be to incentivise loyalty and long-term shareholding. While it was mentioned that companies have had legal problems when trying to introduce loyalty dividends, this would be possible to overcome with government support.

[13] Why stewardship is proving elusive for institutional investors, Simon CY Wong, Butterworths Journal of International Banking and Financial Law, July 2010

- Requiring greater disclosure by pension funds on how they are engaged on long-term thinking. Thoughts from the Roundtable included the need for ratings or metrics to assess the performance of pension funds in this area.

7.8 As discussed in response to Q1, there are also a range of approaches in which government could help to shift the culture towards longer-term investment. -:

- Creating clearer policy direction (as discussed in question 1). This would give investors confidence to invest in key areas, and would reduce the "enormous separation between sustainability risk and financial risk".
- Government support for research and better assessment of long-term and systemic risks (as discussed in question 1)
- Government could also send a clear message through its own sustainable procurement. This would help build investor confidence, and drive more investment in sustainable companies.
- Government could also send some clear signals about how pension funds can be managed for the long-term, through the way it requires its own pension funds to be managed.

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?

8.1 Assuming alignment of interest between investor and asset manager, the best way to encourage a long-term focus in UK equity investment decisions is to demonstrate that longer holding periods result in better financial performance for investors over time. This might be through the provision of better information so that ESG risks and opportunities are better understood or it might be through government intervention changing the nature of the market to correct market failures.

8.2 Longer holding periods for individual companies are important because they give a company the opportunity to factor in emerging long-term risks and reconfigure its activities towards more long-term opportunities for example through research and development. However, the ultimate aim is to redirect the economy to invest in key areas that are likely to be sustainable in the long-term and position UK corporate sector well to be competitive in the long term. So other government interventions that provide regulatory certainty, or international pricing mechanisms (for example for carbon and other externalities) will give companies the confidence to make those investments, and investors more reason to support them.

8.3 Government actions to encourage longer holding periods are discussed in the answers to questions 1 and 7.

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

9.1 Our research identified a number of agency problems in the investment chain, particularly in relation to stewardship for institutional investors[14]. These challenges were discussed in more detail in section 7, and include -:

- The separation of ownership from responsibility, with lengthening share ownership chains that weaken the 'owner mindset'
- Portfolio diversification, with institutional investors increasingly taking small stakes in a huge range of companies on a global basis. While this helps investors to benefit from diversified risk across the portfolio, it can also reduce their level of engagement with boards of directors and therefore their understanding of specific company drivers.
- Expectation that pursuit of short-term returns is the overriding fiduciary duty, so that pension fund trustees feel that they are acting beyond their remit if they try to bring in a consideration of longer-term social and environmental risks.
- Inadequate performance metrics, based on short-term relative performance.

9.2 Proposed solutions to this include -:

- Reforming performance metrics to encourage long-term thinking and active ownership by investment managers. This could include lengthening the performance review time period, and supplementing market index comparisons with other metrics. It could also involve linking a portion of an investment manager's fees to the quality of stewardship activities.
- Clarifying the interpretation of fiduciary duties, and helping to educate institutional investors and their advisors on the issue of short-termism. One report suggests that "Trustees who understand the market forces that produce short-termism will be better equipped to do their part to stop it"[15]. Also supporting education initiatives for individual investors to encourage a focus on long-term value creation.

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

At the recent round table organised by Forum for the Future, the Aldersgate Group and UKSIF (summary notes attached at Annex), the following points were made -:

- We need longer-term mandates with strong get-out clauses benchmarked against growth in GDP and fundamentals rather than an index.
- The way pension funds have been regulated has contributed to short-termism in the market. The minimum funding requirement for pension schemes introduced in the 1995 Pensions Act was well-intentioned but had a completely perverse effect.
- There is too much emphasis on the form and not enough on the substance – for example, pension funds ask fund managers for detailed disclosure on how they are

[14] Why stewardship is proving elusive for institutional investors, Simon CY Wong, Butterworths Journal of International Banking and Financial Law, July 2010
[15] Breaking the Short-Term Cycle, Discussion and Recommendations on How Corporate Leaders, Asset Managers, Investors, and Analysts Can Refocus on Long-Term Value, CFA Institute, 2006

approaching sustainability and claim to support that approach, but may behave very differently in their practical decisions about mandates.

- Pension funds need to be much more robust about their questions on transaction costs, and fund managers need to report on these. Asset managers are not incentivised to control transaction costs because they don't bear them, so they nibble away at performance.
- Some important progress resulted from the amendment to the UK Pensions Act in 2000 [that resulted in a requirement for fund managers to disclose the extent (if at all) to which social, ethical or environmental considerations are taken into account in the selection, realisation or retention of investments], particularly in raising awareness. But it has not yet driven real change in approaches.

Directors' remuneration

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

11.1 Directors' remuneration is assessed largely in relative, rather than absolute terms. It is compared with peers and with previous years' payouts. Everyone expects to be in the top quartile. This leads to remuneration inflation.

11.2 In part, this is driven by an insufficient recognition – both culturally and in terms of how remuneration packages are structured - of the status and intrinsic satisfaction that is conferred by creating great products, great service, or a great place to work, so money is the denominator by default. It is conceivable that more reporting on these elements of a company's performance, and greater public recognition of the role of the directors in achieving these objectives might reduce the tendency towards remuneration inflation.

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

Out of scope of research

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?

Out of scope of research

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?

During research, one view was that increasing the transparency of remuneration may have a perverse effect of increasing the rate of inflation. As executive salaries have become more

widely known, people have become increasingly aware of the earnings of their peers, and this has created an upward pressure on remuneration. One alternative might be to provide greater transparency about the structure of remuneration, for example the proportion linked to short or long-term criteria, rather than the amount.

Takeovers

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

We have noted with interest the recent research by McKinsey in this area – A return to deal making in 2010 – McKinsey Quarterly January 2011 - which shows that on average over the 13 years since 2010, 60% of investors thought that M&A deals destroyed value. Yet substantial premiums continue to be paid, which seems to indicate either a lack of alignment between investor and deal-doer, or a false confidence in the value generated by any particular deal.

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?

Out of scope of research

ANNEX

Key themes emerging from the round table for the BIS consultation on "A Long-term Focus for Corporate Britain" on what interventions the UK Govt could make.

On 12th January 2011, Forum for the Future, UKSIF and the Aldersgate Group co-convened a round table with senior-level representatives from investment institutions and large (mainly FTSE 100) businesses to debate the BIS consultation "A Long-term focus for corporate Britain".
The points expressed in this document reflect the individual views of round table participants and are not necessarily shared by any of the organisations attending or hosting.

(1) Strengthen tax incentives for long-term holding

- There seems to have been a move away from incentives for longer-term holding through differing rates of Capital Gains Tax in the recent past and we should understand why.
- Where the investment is through a fund, we need to distinguish properly between incentivising an individual investor to invest for the long-term, and incentivising the fund manager to make longer-term investments in the underlying assets. Incentivising the former won't change the investment strategy.
- Loyalty dividends would be interesting but have created legal problems when some companies have tried to introduce them.
- We are not necessarily trying to make people hold for longer. We are trying to redirect the economy to invest in key areas. This could be incentivised in other ways.
- You need a crude financial incentive so that the short-term disbenefit of not playing the market on a day-to-day basis is rewarded in the longer-term.
- It may be difficult in practice for a company to track exactly who its shareholders are.
- Equity finance is disadvantaged in tax and this has created a move towards other assets.

(2) Take care on interventions to slow down the number or frequency of transactions

- Given that UK institutional investors are not the majority of the investors in the UK, a significant transactions tax could risk sending capital elsewhere.
- You need to include externalities in trades so that the incentives to trade are different. Trading's not a bad thing if you've taken into account all the relevant factors.
- In some emerging markets, policies to introduce transactions taxes have resulted in a flow of capital out of the market.
- Incentives for long-term holding may be a better route.

(3) Undertake a wholesale review of structure of, and performance appraisal in, mandates

- It is difficult for asset managers to make investments in long-term propositions showing lower short term returns than the alternatives, because they are reporting to clients on a quarterly basis.
- We need longer-term mandates with strong get-out clauses benchmarked against growth in GDP and fundamentals rather than an index.

- The way pension funds have been regulated has contributed to short-termism in the market. The minimum funding requirement for pension schemes introduced in the 1995 Pensions Act was well-intentioned but had a completely perverse effect.
- There is too much emphasis on the form and not enough on the substance – for example, pension funds ask fund managers for detailed disclosure on how they are approaching sustainability and claim to support that approach, but behave very differently in their practical decisions about mandates.
- Asset managers are not incentivised to control transaction costs because they don't bear them, so they nibble away at performance. Pension funds need to be much more robust about their questions on transaction costs.

(4) Require greater disclosure by pension funds on how they are engaged on long-term thinking

- Support the development of ratings / metrics to assess the performance of pension funds in this area.
- The way the investment chain works, and the relationship and reporting between asset owner and asset manager creates a focus on returns not strategy. The amendment to the Pension Act in 2000 [to require disclosure on management of social and environmental issues] was a good start but more is needed.
- It would help to have better information on the age profile of pension funds – working with future beneficiaries on long-term issues will be more effective in pension funds with younger members than for those already in pay-out mode.

(5) Create policy certainty

- The regulatory framework favours the laggards rather than the leaders. In all areas, investors need credible long-term policy frameworks including, for example, on carbon, on planning requirements.
- There has to be a much clearer policy direction so that companies and investment managers have confidence to invest in key areas. We have an enormous separation between sustainability risk and financial risk and this is compounded by a host of poor decisions by government that make regulatory risk huge.
- Corporate Britain has to work in a highly political environment and the political horizon is very short, so politics is always changing the ground rules. There's a paradox in asking businesses to take a longer term view when the fundamental ground rules change so rapidly.
- Coal India recently floated quite successfully and this caused a hubbub, and there was less appetite for Enel's Green Power flotation. But this is not surprising given the regulatory signals. Markets take into account the factors that are there.
- Further policies on pricing externalities are needed. The government started the process on carbon and the floor price for carbon will help. But it's really only just started and if you look at other resources we've only just scratched the surface so more research is needed.
- The UK Government will need to encourage an international response to addressing these issues.

(6) Walk the talk on procurement and public sector pensions

- Government has to procure sustainably so that this drives more investment in sustainable companies.
- Government could send some clear signals about how pension funds can be managed for the long-term, through the way it requires its own pension funds to be managed.

(7) Require more strategic and longer-term thinking in company reporting

- The primary focus for company reporting should be on strategy, not on returns.
- At the moment there is very little focus on how a company is investing for long-term sustainability and investors tend to give very little credit for it.
- There should be greater disclosure on how 5-year plans fit into a sustainable future.
- The current culture is such that even in the context of a discussion on long-term trends, the focus reverts to the present.
- There is work going on in the House of Lords about the role of audit, and this could be an important area of focus.
- Companies need to have more resources for long-term thinking or have a platform to enable them to share future insights across markets so that there is more momentum around longer-term thinking.
- There's still a disconnect between sustainable investment and mainstream investment. Some companies are beginning to present their sustainability information in a way that interests mainstream investors and more work is needed in that area.
- It would be valuable to assess how investors would rethink their fiduciary duty if companies were being held in perpetuity. This long-term strategic view from investors would then be reflected in their approach to returns and company engagement.
- Long-term, sustainability-related KPIs need to be included in the remuneration of directors.

(8) Consider institutional decision-making structures in Government

- The UK Government could review and learn from the structure of ministerial responsibilities within other governments that have successfully adopted a more long-term approach. For example, in Australia the links between pensions and business are closer as pensions, company law and Treasury all sit within one Govt department.
- Need to make sure that responses on the many government consultations (e.g. environmental taxation, disclosure) are tied together and coherent, both in submissions and in Government's response.
- Need to review past and future policies for their impact on long-termism. Several drivers of the current short-termism are the unintended consequences of otherwise desirable past policies - for example on pensions. Policies like these should be reviewed to identify where this has occurred and what could be done to address this.

(9) Contribute to a better narrative / cultural shift

- Tell a better story about the relevance of longer-term to our wealth and well-being.
- Tell a better story about the relative importance of liquidity and stability, and the trade-offs between them.

- We have a psychological problem in that investors feel they are expected to make deals and behave “as gamblers” and there is a cultural bias against longer-term strategies.

(10) Provide support for collaboration on measuring and managing long-term risks

- It’s becoming harder and harder for people to think in the long term because they know that black swans can happen from anywhere at any time. They focus on the short term because it is easier to predict and control.
- One powerful way to incentivise people for longer-term holding is to demonstrate that this does generate more robust and stable returns for investors, and this can only be done through more focus on fundamental long-term systemic risks. Government could help with research.
- There are unforeseen risks with the management of issues like climate change but also water, biodiversity and other resources, and more research is needed.
- Better assessment of long-term risks, and research into different ways of valuing them, would help in the integration of financial and sustainability agendas, so merits government support.