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
	Business representative organisation
	Investor representative organisation
	Non governmental organisation (NGO)
	Trade Union
	Lawyer or accountant
X	**Other (e.g. consultant or private individual) – see overleaf**

Introduction -- who we are

This consultation response is submitted on behalf of the ICI Pension Fund, one of the oldest and largest defined benefit pension schemes in the UK with nearly 65,000 members and assets around £7.5 billion.

The Fund is unusual amongst UK pension schemes in a number of respects:

- Active members still employed by sponsoring companies represent barely 1% of the membership, the majority being pensioners (52,000; 81%) or deferred members (12,000; 18%)

- The Fund was an early mover in prioritising investment risk and covenant management, reducing equity risk to 20% of the Fund by 2001, successfully negotiating a £250million contingent asset in 2003 and a parent company guarantee in 2007 when ICI was taken over by AkzoNobel NV, a Netherlands chemical company

- The sponsoring employer ceded the right to appoint trustee directors to Law Debenture, the independent trustee of the Fund, in 1991 and the Fund has had its own independent executive Secretariat since 2008

We believe these features make the Trustee of the Fund particularly well placed to comment on government proposals from the perspective of ordinary pension fund members generally, since its ownership and governance structure creates an unusual degree of practical freedom to represent their interests even where these may diverge from those of the employer.

The Board of Directors

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

Comments
It is impossible to generalise on this question. In any one year, there will always be high-profile examples of short-termist conduct, which will tend to grab more headlines than examples of long-termist conduct in the same period. However, it is in general difficult to demonstrate objectively whether short-termism is more prevalent nowadays, or merely more prominent in our own short-term memory. We do think, however, that it is nevertheless possible to identify particular factors which are likely to make it more difficult for Boards to maintain a long-term, such as: • The priority which the UK has historically placed on openness to takeover – which, whilst emphasising accountability to shareholders, exposes UK company directors more directly to the differing time horizons of different classes of investors • The rising power of international hedge funds, whose business model generally thrives on volatility and on events not priced in by the market, rather than on stable, predictable growth • The substantial rise in the level of remuneration to senior specialists in some sectors of the financial services sector, which enables the greatest risk-takers to accumulate what others might regard as a lifetime's income within a small number of years • Extensive use of management share options as a remuneration tool, which tends to align management interests with those of option-holders rather than those of shareholders or long-term creditors • Unequal tax treatment between equity finance versus debt-finance, which encourages excess leverage in general and particularly encourages takeover activity using tax-relieved debt-finance to transfer taxable UK profits to low-tax foreign jurisdictions • Lack of an explicit duty (such as exists in German corporate law) for company directors to consider the interests of long-term creditors, including pension schemes which they have sponsored. (Most UK pension scheme members nowadays are no longer employees of the sponsoring company).

<u>Question 2:</u> 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
We have no view on the general legal framework. However, you will see that we argue in question 3 below that the openness of the UK to foreign takeovers creates new dangers in an economic era where most surplus wealth now resides in emerging markets, in which ownership and effective control often lack Western standards of transparency.

Shareholders and their role in equity markets

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

Comments
We believe this is an issue of enormous importance to government policy across many departments and one whose significance has, to date, been under-estimated. We note that Office of National Statistics (ONS) has reported that, as at end-2008, over 40% of UK listed equities were held by foreign investors. However, we believe the underlying foreign economic interest in listed UK equities is already well above this figure, since foreign investors have additional indirect economic exposure as shareholders of share-owning financial institutions (banks, insurance companies etc.) and as shareholders in companies which have underwritten defined benefit pension schemes that invest significantly in UK listed equities. These ONS figures also do not include foreign subsidiaries, nor nominally-UK-based companies in private equity ownership, where most of the operating profit may effectively be transferred via associated-company borrowings to low-tax foreign jurisdictions. We urge government to consider substantially extending the work of ONS in this area, in order to illuminate further the wider implications (including on corporate tax revenues and security of pension promises) of foreign ownership - in the widest sense - of UK industry.

We note that the proportion of UK listed shares held by one particular category of long-term investor -- namely pension funds -- has declined from over 30% to less than 13% over the last 20 years. We agree with the outgoing Chairman of the Pensions Regulator that defined benefit pension schemes needs nowadays to be considered as a legacy "endgame" for corporate UK and so we do not regard it as an achievable policy objective to seek to reverse this trend -- particularly given the continuing emphasis among pension fund investment advisors in favour of wider diversification, both geographically and by asset-type. A more achievable objective is to improve levels of contributions into defined contribution pension arrangements for the next generation of pension savers and to make it easier for employers to engage in employee financial education and/or to combine with others to offer larger, more cost effective defined contribution pension arrangements.

On the other hand, we believe that – if the UK remains as open as in the past to foreign takeovers - then UK should prepare for a substantial increase in takeovers from emerging markets. There are many reasons why UK companies may in future present attractive targets to emerging market owners of surplus capital, which may not necessarily align with the UK's own economic interests, such as:

- To acquire UK companies with strong growth positions in emerging markets at a developed-market price

- To protect UK outlets for emerging market products as their local costs rise in sterling terms

- To capture UK brand names prior to moving manufacturing capacity and/or royalty income from the UK to low-cost/low-tax countries

- To reduce holdings of UK government debt (or other £sterling monetary assets) ahead of anticipated currency realignments

- To exploit the weakness of the UK pensions regulatory regime in enforcing debts outside the EU, in order to force reductions in pensions that EU-controlled employers would otherwise have had to fund

We believe that, in the past, UK government policy on takeovers has been excessively influenced by the financial services sector, so as to prioritise openness over all other considerations -- this despite a welter of international studies demonstrating that the typical corporate takeover destroys value even for those whom it is intended mainly to benefit (i.e. acquirer shareholders).

We believe that, in future, UK government should be prepared to set a framework for takeovers and other corporate reorganisations which takes a holistic view of all the economic issues, including:

- Protection of UK technology base and UK brands of global value
- Protection of UK corporate tax revenues
- Protection of long-term creditors (including pension schemes which help to reduce future government expenditure on the elderly)

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

Comments

In the vast majority of instances, shareholders do not have the expertise themselves to run companies. Given the emphasis in modern investment theory on diversification, it is also increasingly unlikely that any individual investor will have sufficient voting power to command management attention on their own.

So in practice, investors have to work through investment managers or others sufficiently large to command management attention and who are able and willing to allocate sufficient resources to their in-house corporate governance team. For example, we have adopted this as a specific selection criterion in the choice of our UK passively-managed equity manager.

Based on our discussions with leading investment managers, we believe that -- whilst the threat of voting against management is at times a necessary weapon to hold in reserve -- engagement is usually most effective when it is conducted informally, in a confidential setting where neither side risks losing face by considering the other's point of view.

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

Comments
This is not our area of expertise, but our perception is that investment firms are generally better nowadays than in the past in coordinating between their different functions -- not least because technological advances encourage more systematic capturing and sharing of analysis. We are not aware of any evidence that the level of dialogue within investment firms is the limiting factor in improving corporate governance.

<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
As explained in question 4 above, we do not generally see voting as the most effective form of engagement, but we do see value in systematically exercising voting rights in order to remind management as to whose interests they have been appointed to serve. We have no strong view on public disclosure of votes, so long as there is a sensible de minimis threshold to avoid disproportionate cost for holdings too small to affect the outcome.

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

Comments
See our answer to questions 1 and 3 above.

<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
For the reasons set out in question 3 above, we believe that, in future, UK government should be prepared to set a framework for takeovers and corporate reorganisations which takes a holistic view of all the economic issues, including: • Protection of UK technology base and UK brands of global value • Protection of UK corporate tax revenues • Protection of long-term creditors (including pension schemes which help reduce future government expenditure on the elderly) In addition, we believe it is important to recognize that, in areas such as Financial Services, shareholders have neither the expertise nor (for valid competitive reasons) the detailed information necessary to understand all the risks run by any particular financial institution. Consequently, a strong general regime for UK corporate governance is no substitute for a coherent and well-resourced regulatory regime for the financial sector. Finally, we support the recommendations of Lord Myners on the importance of pension fund investors setting - and sticking to – long-term objectives and periods of measurement in their own decisions on selection and de-selection of investment managers (see Myners Report 1 and 2, Myners principles). We hope that the government will build on the work of the previous administration in this area, rather than seeking to "reinvent the wheel."

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

Comments
We agree with the analysis and recommendations of Lord Myners on this subject (see Myners Report 1 and 2, Myners principles). We hope that the government will build on the work of the previous administration in this area, rather than seeking to "reinvent the wheel."

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

Comments
We are generally well satisfied with the level of transparency in agreements between investment managers and our pension fund. However, we believe that it would substantially impair our ability to negotiate mandates and fees in the best interests of our members (and of the employer who bears the balance of cost in our defined-benefit pension scheme) if we were not permitted to preserve the confidentiality of those arrangements.

Directors' Remuneration

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

Comments
This is not our area of expertise, but we refer to our answer to question 1 above in relation to the practical consequences of particular remuneration structures for likely time horizons of senior management.

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

Comments
This is not our area of expertise.

<u>Question 13</u>: 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
Most shareholdings are managed by professional investors who (like pension fund trustees) have a duty to manage primarily in the financial interests of their clients. This means that – whatever their own views may be about management remuneration – they can only justify intervention where: • There is a clear economic case for restraining a particular practice • The benefits of intervention outweigh the likely harm from undermining or de-motivating incumbent management • Engagement is a better option than selling the shares • They have an economically-influential shareholding It is therefore difficult in practice for individual shareholders to restrain company remuneration practices, except indirectly by supporting investment managers or investor-representative bodies who can command significant critical mass of votes. So, although this is not our area of expertise, we think there is general merit in widening the range of measures which require a positive shareholder vote prior to implementation.

<u>Question 14</u>: 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
This is not our area of expertise, but we think there is general merit in widening the range of measures which require a positive shareholder vote prior to implementation.

Takeovers

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

Comments
We have no reason to criticise the understanding of boards on the implications of takeovers. The uncomfortable truth is that most takeovers are pitched (eventually) at a sufficient premium to current market price to make it difficult for Directors -- who owe their primary duty to shareholders -- to resist purely on grounds of long-term consequences which fall largely on others. See also our answer to the question 3 above. If government agrees that foreign takeovers and/or highly-leveraged takeovers pose wider risks to the UK economy, they will need to consider changing the regime itself in which Directors currently have to take that decision, rather than hoping that communication or "greater understanding" will somehow change economically-motivated behaviour.

<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
Given the substantial academic evidence that takeover bids often enrich acquirer management and advisors at the expense of acquirer shareholders, we see a good case for lowering the threshold at which the acquirer management needs to seek shareholder approval. However, even where shareholders dislike the terms of a particular acquisition, they may often dislike even more the alternative of voting against management once a fully-fledged takeover proposal is tabled, for fear of leaving their investment effectively leaderless. Consequently, legislative change in this area should not be seen as a substitute for addressing more fundamental problems such as those highlighted in question 3 above.

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

Comments
We believe there has been insufficient coordination in the past between pensions protection policy (DWP), corporate tax revenue protection policy (Treasury) and industrial policy (BIS). We hope that this consultation will prove to be part of a wider process for developing a more holistic approach. In particular, we would encourage government to consider the merits of applying Section 75 of the Pensions Act (employer debt crystallisation) to any takeover affecting companies sponsoring UK defined benefit pension schemes -- perhaps in exchange for making Section 75 itself less onerous in cases where equivalent protection for pension fund members can be achieved without an immediate additional cash payment (e.g. via bank guarantees enforceable within the EU.) We would also encourage government to consider extending the provisions of the Takeover Code, so as to require consequences for scheme-specific funding of pension funds arising from any deterioration in covenant triggered by a proposed takeover to be addressed within the 60-day offer period and to give the Pensions Regulator powers (analogous to those of OFT) to delay completion of a takeover if its concerns are not addressed within the original allotted time. The existing Takeover Code requirement for a bidder's advisors to publish a "cash confirmation letter" (which assures shareholders that the bidder has sufficient cash or financial facilities to complete the offer) should be extended to require assurance also to creditors (e.g. trade suppliers, banks, pension schemes etc.) that sufficient financial resources will be available post-acquisition to meet any obligations to them, including any additional financial support triggered by the takeover by virtue of a revised Pensions Act Section 75. We believe that some of the most problematic recent takeovers affecting UK companies could have been deterred or substantially modified if such provisions had been in place sooner; and, for the reasons set out in question 3 above, we see early reform in this area as particularly important in relation to the risk of a substantial increase in the future level of emerging-market-based takeovers of UK companies