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
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	Lawyer or accountant
X	**Other (e.g. consultant or private individual): Academic**

The Board of Directors

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

Comments
Research suggests that boards of UK-listed companies are acutely aware of the need to maintain the confidence of shareholders over both the short and long run. In some cases, boards may be swayed by pressure for immediate returns, or may take decisions with a view to maintaining investor confidence over a short-term time horizon, in such a way as to constrain long-term planning. There are examples in the recent past of divestments of corporate assets and the initiation of share buy-back programmes motivated by this type of consideration. On the other hand, there is also evidence that many listed companies have been able to make the case, to their shareholders, for taking a long-term view of their investments, and these shareholders, in turn, have supported far-sighted corporate planning. Thus it seems possible, within the constraints imposed by a shareholder-focused system, for some UK boards at least to take a long-term strategic view of the company's business. **It is not clear that amending company law would make any difference here. Company law already provides that the board should act with a view to promoting the success of the company, and must take into account a range of interests, not just those of shareholders, in doing so (section 172 Companies Act 2006). There is perhaps an argument for amending the law to make it easier for shareholders to take action to enforce the section 172 duty through litigation, but this change would not necessarily help to address the issue of long-termism; it could equally well make boards more vulnerable to short-term investor pressure.**

<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
There may be a case for tightening disclosure requirements in cases involving the lending of shares and the use of certain share-based derivatives such as contracts for differences. There are already some regulations on CFDs. Boards can be put in a difficult position, in particular in takeover bids, if they do not know who the holders of CFDs are.

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
This question appears to be related to the relative decline in the proportion of shares in UK listed companies held by UK-based institutional investors, including pension funds, and the rise of hedge funds and sovereign wealth funds, together with the increase in overseas ownership of UK shares. It is possible that the informal channels between institutional investors and the boards of listed companies, which research suggests existed in the period of stable institutional ownership of UK shares up the 1980s, have been weakened or attenuated by the decline in pension fund ownership. It is not clear that this is resulting in a more short-term emphasis in corporate governance. Where hedge funds act as short-term speculators or arbitrageurs, their growing presence in the market may be seen by some boards as destabilising. On the other hand, where hedge funds act as medium-term investors holding sizable stakes, which many of them increasingly do, they may be a source for stability of ownership and a medium- to long-term orientation in corporate decision making. Hedge funds taking large stakes in this way in UK-listed firms tend to be non-confrontational in their approach to dealings with boards, in contrast to the more activist approaches generally taken by such investors in the US, although there have been some exceptions to this. Little is known, by way of publicly available research, about the role that sovereign wealth funds play as investors in listed companies, but, as in the case of hedge funds, there is little evidence of them being engaged in public, confrontational engagement with investee companies.

<u>Question 4</u>: What are the most effective forms of engagement?

Comments
There is evidence that, in the recent past (the 1980s and 1990s), most engagement between institutional shareholders and their investee companies took place on an informal, 'behind the scenes' basis. This is probably still the case although more recent research on this type of engagement is limited. Public, confrontational engagement is still relatively rare in the UK. It is more common in the USA and there are also recent instances of it in Japan and some other countries. Evidence is mixed on the effectiveness of public engagement. In the US context, confrontational shareholder activism, involving public campaigns over issues such as dividends, share buy-backs and governance reforms, is associated with higher than normal returns to shareholders in the target company in the period immediately following the relevant event. However, there is also evidence that companies targeted by this kind of intervention suffer impaired operating performance or at least no clear improvement for some time following the intervention of an activist shareholder. On balance, the evidence suggests that confrontational engagement engenders short-term returns for shareholders but may disrupt corporate performance over the medium to long term. As stated above, this type of engagement is rare in the UK, where informal engagement is the norm and arguably works better. **Some steps could be taken to encourage supportive, non-confrontational engagement by larger shareholders. This type of engagement is sometimes costly and difficult in the light of capital market rules and practices designed to ensure equal treatment of shareholders. Clearly, larger shareholders should not be put at an advantage by being given a privileged position concerning the disclosure of corporate information. On the other hand, they are often in no better position than smaller shareholders to engage with their investee companies. This is an issue which is relevant to the aims of effective stewardship set out in the Stewardship Code. The legal issues are complex but they could be addressed by research examining, among other things, how the UK position on this issue compares to that in other countries.**

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

Comments

We have no direct knowledge of this.

<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
Voting can be an important form of engagement in contexts where shareholders want to register their disapproval of corporate malpractice or of a failure to follow corporate governance guidelines. It can also be used to raise issues of wider public concern over corporate behaviour. Legal reforms to encourage institutional shareholders to vote and record their votes may be useful in this context. This is a matter already addressed to some degree by the FRC's Stewardship Code.

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

Comments
Short-termism, in the sense of speculative trading, is an inherent feature of equity markets. The regular 'churning' of shares by institutional investors and asset managers acting on their behalf is also a feature of UK and other equity markets. It is often defended by reference to portfolio theory and related theories of investment practice. Most institutional investors value the liquidity which comes from the possibility they have of trading shares in individual companies on a regular basis, even if they also recognise that they have a long-term interest in the performance of the listed company sector as a whole, and cannot exit the market altogether. Speculation and churning are not necessarily problems for the operation of equity markets; some would

defend them on the grounds that they add to the informational efficiency of the markets. They may be a problem for corporate governance, in the sense of making it harder for companies to plan for the long-term, but as noted earlier (see answer to question 1), there is evidence that some UK-listed companies are able to persuade their shareholders to take a long-term view of their holdings.

Short-termism may be a problem for the efficiency of equity markets, in circumstances where bubbles arise. This can occur in the case of individual stocks, but it can also affect the market as a whole. Bubbles, leading to overvalued equity, have had an extremely harmful and destabilising effect on stock markets in some countries, most notably the US and UK, at various points in the recent past. In the late 1990s and early 2000s, over-valuation of new economy stocks led, by widespread agreement (see for example the view of shareholder advocates such as Michael Jensen), to hostile takeovers being mounted in circumstances where the sums offered by bidders were excessive. This later resulted in the destruction of corporate value as deals had to be unscrambled. The same phenomenon is visible in the context of the global financial crisis which began in 2007- 2008, most notably in the takeover of ABN Amro by the consortium consisting of RBS, Fortis and Santander. This takeover reportedly went ahead without the board of RBS exercising due diligence. The costs of the deal to shareholders in RBS and Fortis, employees in RBS, Fortis and the former ABN Amro, and taxpayers in the several countries affected by the various mergers and subsequent de-mergers associated with the deal, have been enormous.

This issue would best be addressed by reforms to takeover regulation (the Takeover Code and relevant aspects of the Listing Rules and companies legislation). In particular, steps should be taken to discourage some forms of short-term arbitrage activity which have harmful consequences for the integrity and efficiency of the market. Weighted voting, granting increased rights to shareholders with long term holdings (and reducing the rights of short-term speculators) is one option here, but would be complex to administer (see answer to question 8, below). Consideration should also be given to providing employees, who generally have a long-term orientation, with a greater say in takeovers and other change of control transactions, and in enhancing the role of public interest tests for takeovers through competition policy. These would be ways of dealing with the externality (or market inefficiency) that arises from excessive short-termism in equity markets.

<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
In some other countries, shareholders who hold their shares for a certain period of time are given enhanced voting rights, or tax benefits, as an inducement for doing so. There is a specific case for weighted voting in the context of takeover bids (see answer to question 7, above). These are options which could be considered for the UK. However, there is relatively little experience of weighted voting or enhanced voting rights in the UK context. Institutional investors have, in the past, strongly supported the practice of 'one share, one vote', and would probably continue do so. Most UK-listed companies observe this practice. Thus whatever the arguments in principle might be for introducing weighted voting for long-term holdings, there must be some uncertainty as to exactly how it would play out in the UK context. This is an area that should be researched, to see how weighting of votes works in other countries. Alternatives to vote-weighting to deal with problems of short-termism should also be considered. These include giving employees (who generally have the longest-term view of all the firm's stakeholders) a greater say in corporate decision-making and in particular in change of control transactions (including takeovers). There should also be a greater role for a public-interest test in the regulation of large takeovers through competition policy (see answer to question 17 below).

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

Comments
Agency relationships in the investment chain are certainly complex. In the case of pension funds, the control of investment decisions is in effect shared between the trustees of the fund, the asset managers they employ or appoint to work on their behalf, and the ultimate beneficiaries of the fund, who include active contributors, those in receipt of benefits and, in some cases, the sponsoring companies. Some delegation of responsibility for investment decisions from the beneficiaries of the fund to the trustees and then to the specialist fund managers who take day to day decisions on the shape of the fund's portfolio is unavoidable. An issue that could be addressed concerns the shaping of investment

policy by trustees. Board of trustees arguably could do more to set investment parameters which encourage a long-term approach to investment strategy, and also take account of issues of social and environmental sustainability. However, pension funds already have disclosure duties with regard to the inclusion of social, environmental and ethical ('SEE') considerations in investment mandates, and the Stewardship Code also sets standards in this regard. Where legislation could make a difference is in clarifying the extent of trustees' duties to take SEE matters into account, as opposed to merely reporting on how far they do so. This would be consistent with the emerging view (set out in the Freshfields report to UNEP) that trustees' fiduciary duties do not simply enable them to take SEE factors into account, but may also require them to do so under certain conditions.

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

Comments
Pension funds must already disclose how far they take ethical etc. considerations into account when setting their investment mandates. Extending this disclosure requirement to cover fund managers may catch some cases which do not come under the pension fund regulations. It is not clear that disclosure of pay will have the effect of lowering pay and benefits, if that is the intention; it has not had this effect in the case of corporate executive remuneration.

Directors' Remuneration

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

Comments
There are a number of reasons for this. There has been a systematic effort since the early 1990s to link pay to performance, with performance being defined as returns to shareholders. Gains from share options, rather than from salaries, account for most of the relative rise in top executives' pay. The resulting increases in top pay have been problematic, for several reasons. A major problem is the linking of managerial remuneration to absolute measures of performance. There

are many factors that affect a company's performance beyond the contribution of its top management. Bonuses and incentive plans should be based on performance relative to peer groups, not to absolute performance measures. A further problem is the tendency to link incentives to current or short-term performance. A greater segment of pay and pension entitlements should be linked to long-term performance to reduce executives' incentives to take a short-term view. The problem of short-termism is exacerbated by the relatively limited tenure of most CEOs. Limited tenure is sometimes taken to provide a justification for very high levels of pay and for the inclusion of 'golden parachutes' in executive employment contracts. In general, there is a case for longer-term tenure, lower overall pay, and the elimination of golden parachutes. The latter can distort managerial priorities, as, for example, in the case of takeover bids, which the managers of target companies may be less likely to oppose where the success of the bid will trigger large pay-offs for them.

Another factor in the increase in pay has been regulation. The combined effect of increased legal disclosure, making pay levels more public, and the growing role of remuneration committees, which mostly consist of other senior managers and act on the advice of remuneration consultants both of whom have an interest in seeing pay levels rise, has been to ratchet up pay still further.

Notwithstanding the attempt to link pay and performance, executive pay remains weakly connected to both shareholder and profit performance, and is still associated with huge pay-offs for contract termination which give rise to shareholder and public concern. Shareholder voting on remuneration packages appears to have had little impact here. If the purpose of disclosure requirements has been to dampen down executive pay by naming and shaming top earners, it has clearly failed. Other mechanisms should be considered. The most effective means of dealing with golden parachutes and share options with a short vesting period is through tax law. This can also be used to penalise corporate pension arrangements which do not link entitlements to long-term performance targets.

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

Comments

Remuneration committees of listed companies mostly already have independent members. If the aim is to have a more diverse membership of remuneration committees, this should be addressed by encouraging greater diversity in the selection of independent directors. Appointing employees below senior management level to sit on remuneration committees would also make a difference. Employee directors nominated by the workforce are likely to be more critical of unduly high pay than outside directors who are still mostly nominated by the CEO or through the board.

<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

No, they have not been effective. If the aim of greater shareholder involvement has been to dampen down pay or to restrict takeovers which still typically destroy shareholder wealth, it has failed. Granting shareholders additional rights over the approval of remuneration packages will not address the most serious problems, which relate to the link between remuneration structures and short-termism in managerial decision-making, and the negative impact of highly unequal earnings on employee morale and on corporate reputation. A focus on shareholder approval ignores the potential role of employees and other corporate constituencies. It is not realistic to expect shareholders, who are principally concerned with the returns from their investments, to entirely internalise these wider issues of concern. They should be addressed by giving employees a greater say in top executive remuneration and by changes to tax law (see answers to questions 11 and 12 above).

<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

As noted above (see answer to question 11), disclosure has been associated with a widening of the gap in pay between top executives and the rest, not a narrowing of it. Thus a strengthening of disclosure requirements may simply be associated with a further widening of the gap. In any event, if objective is taken to be the maximisation of shareholder returns, the link between these trends in pay and changed performance is weak.

Takeovers

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

Comments

This is probably not the right question to ask. The issue is not whether boards understand the possible long-run consequences of takeovers and can communicate them, but whether they are permitted to take them into account when, in the case of the board of a target company, they determine how to respond to a takeover bid. Currently, the Takeover Code requires the board of a listed company to have regard, above all, to the financial interests of its shareholders when advising on the merits of a bid. The board is not permitted to recommend rejection of a bid on the basis of the negative impact it would have on employees or communities, if the overall result would still be favourable to the shareholders. Nor can the board straightforwardly reject a bid on the basis that the long-term gains to shareholders from keeping the company together will most likely outweigh their short-term gains from accepting the bidder's offer.

The position of shareholders also needs to be borne in mind here. Many institutional shareholders will say that they take a long-term view of their holdings, but very few will refuse the opportunity of a short-term gain arising from a takeover bid or merger which gives them a substantial premium over the pre-bid price. In practice, as the Cadbury-Kraft bid shows, once a hostile bid is announced, the institutions will generally be prepared to sell to hedge funds and other short-term arbitrageurs, taking profits even before the outcome of a bid is known. When institutional shareholders sell out to arbitrageurs in this way, a tipping point can quite quickly be reached when the sale of the company becomes unavoidable. In the US context, this situation is generally avoided by the inclusion of 'poison pills' in company bylaws (the equivalent of articles of association). These deter opportunistic bids and dampen speculative activity. In large part because of resistance

from institutional shareholders, very few UK-listed companies have US-style rights plans which could act as a genuine deterrent to opportunistic bids. This largely explains why it is much straightforward for a US company to mount a hostile bid for a British one than vice versa.

Because there is no recent tradition of rights plans and similar poison pills in the UK, encouraging their use here is probably not a feasible option. However, other steps can be taken to address the issue of the long-term implications of takeover bids. As it is currently drafted, the Takeover Code gives too much emphasis to shareholders' short term financial concerns. It is out of line with section 172 of the Companies Act 2006 which allows boards more leeway in balancing the interests of the different corporate constituencies. Thus some realignment of the Code with section 172, whether by amendment of the Code or through legislation, is needed. A longer-term perspective on bids could also be encouraged by mandating employee representation on corporate boards. Employees are, in the context of takeover bids, the corporate constituency with the longest-term view, and the best way of incorporating long-termism into the operation of the market for corporate control is to give them a more decisive say in change of control decisions. A third reform would be the strengthening of public-interest tests in the regulation of large takeovers through competition policy. This would again help to ensure that long-term considerations played a greater role in takeovers. (See also the answer to question 17).

Question 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?

Comments

Shareholders of the acquiring company already have certain rights to vote on transactions of the kind which would arise in connection with a takeover bid, under general company law and under the Listing Rules, so it is not clear that this is a real problem. The much more serious problem arising from takeover bids concerns the position of the board of the target company (see answer to question 15, above).

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

Comments

Some of the questions set out above assume that a longer-term orientation in corporate governance can be achieved through the more effective assertion of shareholder interests. This is unlikely. Shareholders have a mix of short-term and long-term interests, but with the former often predominating. Even those with long-term time horizons, such as pension funds, or those holding for the medium term, such as hedge funds or focus funds with large stakes in companies, will be content to take profits from short-term speculation or from takeover bids when they are available. Institutional shareholders of all varieties will prefer to churn their shares in order to maintain liquidity, than to take stable long-term stakes in listed companies. This is unlikely to change in the near future. The increasing short-term orientation of corporate management in Britain is the consequence of the growing emphasis since the 1980s on the paramount position of shareholders within corporate governance, and the related view that shareholders should be the principal beneficiaries of corporate activity. To reverse these trends would require a weakening of shareholder rights, and a strengthening of the position of other corporate constituencies, in particular employees. It also requires a return to the inclusion of wide public interest issues in the competition policy assessment of the impact of large takeovers.

In this context a number of specific reforms should be considered: opening up board membership to employees below senior level; tightening rules on corporate restructuring, by increasing the costs to employers of collective redundancies; removing the advantageous tax treatment of corporate debt, which currently acts as a subsidy for certain types of restructuring which transfer wealth from taxpayers and employees to shareholders; and reforming competition policy as it is applied to takeovers.

Consideration should also be given, in this context, to models of corporate governance in other countries. The system of codetermination as it is practised in Germany and some other continental European countries should be the focus for comparative research of this kind. Codetermination involves, among other things, substantial employee representation on boards (at least a significant minority), coupled with extensive voice rights for employee representatives. This model has served the German economy well and has provided a basis both for industrial peace and economic competitiveness. The last time there was a serious debate about codetermination in this country was at the time of the Bullock Report in the late 1970s. A fresh look at this issue is overdue.