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
✔	**Other (e.g. consultant or private individual)** **Professional Body**

The Board of Directors

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

Comments
There can be no complete answer to this question because it is too generalised. Regardless of the new strictures on long-term focus which are contained in the Companies Act 2006, boards of major companies will always claim that they are mindful of the all the factors that need to be taken into account in directing their companies, including those factors which impact on long-term and sustainable shareholder value. They will also claim that they pay due regard to the effective management of risk. Whether they do these things effectively is another question. In considering the extent to which companies have a long term focus, it must also be borne in mind that companies are to an extent driven by the investment motives of their shareholders. Boards are required to pursue 'success' for the benefit of their shareholders (as a whole). This inevitably means that companies must take into account what they perceive to be their shareholders' conception of what the benefits of investment are. While it is not possible to generalise about the motives of all shareholders, it is clear that many significant shareholders, including pension funds, seek short-term returns which exceed market benchmarks, and if they do not achieve this they will sell their investments and move to stocks which offer a better prospect of doing so. Increasingly also, investors are buying and selling shares on the market within very short times with little interest in doing anything with those shares other than making a short term profit. If substantial numbers of investors are motivated to act thus, and if this tendency has a material effect on companies' share price, it is inevitable that the behaviour of company boards will be influenced. Accordingly, the achievement of a generalised commitment to long termism on the part of companies will be in part dependent on how boards can be encouraged to effectively withstand short-termist pressures imposed on them by their investors and the markets. The issue could be said ultimately to revolve around incentives, since these drive behaviour. Anyone wanting to consider why many investors and boards find it difficult to take a long term view should weigh the incentives for short termism against the incentives for long termism. Incentives for short termism are many and arise from regulation, culture, custom and practice and apply to both companies and investors. Executives and others receive remuneration and/or bonuses based on short term measures. This rewards short term focus on present share value. Competitor pressures generally encourage a short term focus. For example, a competitor who cuts costs or takes on gearing to boost short term profits at the possible expense of long term success will be rewarded with a higher share price and its executives will be rewarded

accordingly. The company which does not do so may be better positioned for the longer term but risks a hostile bid and its executives will receive smaller remuneration. From the investment side, pension fund trustees will, as referred to above, appoint professional investment managers and assess their performance on the basis of quarterly movements in the value of the equity (and other) investments under their control.

Separately, tax rules encourage high gearing as interest is tax deductible. High gearing means a company has more pressure to deliver in the short term. In financial institutions, high geared transactions are not assets people want to hold for investment - they are more typically traders assets. Tax rules also discourage the payment of dividends.

A further factor to take into account in relation to the question posed is that our reporting system does not facilitate analysis of long term value-building activity. In fact reporting can be misleading as, for example, reducing expenditure on, say, training will mean an immediate profit but may reduce profit in the longer term. Companies and investors and boards and analysts would benefit from using more complete measures of value added.

<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
The law gives companies rights to request basic information from shareholders as to the beneficial owners. Often, such provisions will also be incorporated into companies' constitutions. We suspect though that, given the substantial and likely long-term increase in real-time share trading, the value of this right to companies is small.

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
There are significant implications for both governance and the markets. As mentioned in our response to Q1, the strong move towards real-time buying and selling poses real challenges to governance – if large parts of a company's capital are being bought and sold as commodities, with their owners showing no interest in owning or exercising ownership rights, this will have a bearing on how boards are expected to acknowledge those investors in the governance process: if there is no readily identifiable body of investors who are the 'owners' of the company and who act as such, how are boards to be expected to be guided and supervised within the process of governance? The growing involvement of non-UK investors also has the potential to present cultural challenges to companies and regulators. We are aware of cases where investors from certain parts of the world, having taken out large but not majority stakes in UK companies, have seemed to find it difficult to understand the parameters and limitations of their powers as minority shareholders. This latter experience suggests that boards, in engaging with their shareholders, may need to have to develop new skills to manage these expectations.

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

Comments
In our experience, investors are being much more active in their engagement activities. In particular they are being pro-active in calling for one-to-one meetings with company boards. We believe that such engagement practices are very positive and trust that all major investors will go down this route in the wake of the new stewardship code. We would like to believe that investors who take a keen interest in engagement will be less likely to sell their shares quickly, so engagement plays a part in countering short-termism. More generally, a tick box mentality continues to cloud the way institutional investors look at corporate governance. This often frustrates the spirit of the requirements. Repeated attempts by governance code reformers from Lord Hampel onwards have not succeeded in addressing this problem. Although the Companies Act 2006 and the 2010 UK Corporate Governance Code attempt to instil a longer term focus, there is no sign yet of a change. The UK Stewardship Code seems to reinforce an emphasis on the Code provisions at

the expense of the principles.

<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 question is best answered by those in the investment community.

<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 in itself is a very important indictor of engagement as is disclosure of voting behaviour. It is particularly important for the major investors to disclose their behaviour so as to ensure that any concerted behaviour is apparent.

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

Comments

As with the first question, this is in our view too generic to produce a conclusive answer. It will always be the case that investors will own shares for a variety of reasons, some will look for a short-term profit while others will hold their shares for motives of capital appreciation or because they actually do want to exert a governance influence – venture capital firms, for example, will follow this latter path.

Institutional investors make up the largest group of investors who naturally should think longer term. Institutional investors, however, are professional investors who invest other people's money. Paul Myners noted this means that large listed companies are effectively ownerless. It also means that managerial capitalism has taken over from owner based capitalism. The focus on shareholder value since the 1980s, and attempts to align executive and shareholder interests through performance based remuneration, provided motive and opportunity for executives to make short term personal returns for achieving short term business objectives. This focus also encouraged executives to retain profits and buy back equity rather than pay dividends.

There is nothing wrong with this diverse ownership profile. But short-termism in itself can be damaging if it results in irresistible pressure on boards to govern and incentivise their businesses to pursue short-term outcomes which are counter-productive to the goal of more sustainable corporate 'success'. There are steps that can be taken to encourage investors to adopt a more long-term approach, and by doing so reduce the short-termist pressures on boards, but ultimately it is likely that boards will need to be encouraged or empowered to set the long-term as being the primary measurement time frame of corporate success. We would also like to see more emphasis place on the longer term picture in company reporting, especially in narrative reports.

<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
Controlling short termism by regulation, such as a requirement to retain holdings for a given minimum term, would be unworkable and massively harmful to the attractiveness of the UK equity market as a home for investment. Any action which encourages longer term investment decisions at the expense of shorter term decisions will inevitably reduce the attractiveness of the UK investment market to those seeking a short term return. There a two main difficulties with imposing any such financial disincentive.

The first is that if other markets offer the returns that investors have been seeking in the UK, the funds will simply divert to those markets. The second and more practical point is that framing a financial incentive to encourage long term holding of equities is difficult.

The obvious route to consider is through the taxation of the gains arising on investments. Models such as the taper relief extended to non-business personal investors seek to encourage long term investment by linking tax rates to length of holding term. However, overseas investors may avoid UK taxation altogether. UK corporate investors are (under current rules) subject to a totally different regime to individuals. Neither regime encourages long term holding, and indeed the removal of indexation and taper relief for individuals positively mitigates against long term holding of any capital assets. Revising the system to reintroduce differential taxation of gains for individuals would involve a major policy shift. Taxation of corporate equity holdings can fall to be taxed as income, chargeable gain or even be exempt from corporation tax altogether. To overcome the fragmentation of taxation regimes for shareholdings, a financial incentive to long term holding would need to be linked to the shares, rather than the holders tax status.

Ultimately however, even if the tax regime were to be revised to encourage long term holding of investments, there would most likely be a reticence on the part of investors to rely on the new rules. Despite repeated calls for stability in the taxation of long term investments, be they pensions or capital assets, successive governments have imposed ever greater and more rapid rates of change on the tax system in relation to these long term investments (and as noted above, these changes have mostly been to reduce the incentive for long term investment relative to short term). The new government has, by definition, not had a chance to demonstrate whether the changes it has made since acceding to power will be enduring or simply the first of many. However, it now faces a dilemma, whether to retain the existing system (which does little or nothing to incentivise long term investment over short term) or change the system to encourage long term investment, a course which would in itself indicate a return to short term shifts in tax policy.

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

Comments

Investors who operate via professional fund managers will reward those who have recently beaten the market. This introduces two distortions. Firstly, the shares owned by successful managers will become more popular, and even the managers themselves will invest more in their favoured stocks as investors reward them with more funds forcing the market price still higher. Secondly, the requirement to persistently "beat the market" on a quarterly basis imposes on fund managers a need to change their investments regularly. From the fund managers' point of view, the "long term" is simply made up of a number of successive "short terms"; their long term results will be better if they string together a series of short term investments that individually outperform the market.

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

Comments
We agree that investment and fund managers play an important part in the process, since their behaviour, in aggregate, results in significant pressures on companies. There should be more disclosure of investment managers' remuneration and incentive packages, as well as their mandates. In this context it should not be forgotten that companies themselves have an interest in the short term performance of their occupational pension schemes since the current market valuation of their net assets will be reported on their balance sheets.

Directors' Remuneration

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

Comments

The increase in Directors' remuneration seems to be linked to the ability and willingness of boards to sanction the rises, and the failure of other stakeholders to prevent them. It is not clear whether the lack of restraints imposed by stakeholders results from a lack of desire to do so (acquiescence), a failure to take advantage of available mechanisms to restrict directors' pay (apathy) or a structural inability to restrict pay (impotence).

In the case of shareholders, mechanisms are ostensibly in place to allow owners to influence remuneration policies and packages. The concentration of voting power in the hands of institutional investors means, however, that a significant proportion of the vote will be influenced purely by considerations of the performance of the investment. Fund managers tend to regard their job as profit maximisation rather than shareholder activism. In absolute terms, the marginal difference to profit levels of halving or doubling executive pay will be minimal, and less (whether upwards or downwards) than the effect of replacing the existing board or changing investments. Provided directors continue to generate profits, fund managers will invest in their companies. If the directors fail to generate profits, fund managers are more likely to switch investments to companies which are performing than spend time trying to influence the internal governance of what by their standards is a failed investment.

Other stakeholders currently have little influence over executive pay. Employees have no direct statutory method to affect remuneration of directors in their employer, and there is a concern that their judgement may be clouded by envy and resentment rather than taking into account the going rate for executive talent in an international market place. Suppliers to big business, and customers of big business, have no real influence over directors' remuneration. In the case of suppliers, many of whom are themselves small or micro businesses, they have no incentive to challenge their customers, as the contracts they hold may be essential to their own continued commercial survival. Customers can impose the ultimate sanction of boycotting a given business, but it seems that such actions are rare.

As a result, the sole effective restricting factor on executive pay has been the ability of executives to command pay packages at "the market rate". The market at this level of course includes international competitors and unlisted enterprises. While remuneration information may not be publicly available for unlisted businesses, it is available to recruitment agents. For many executives the unlisted route to personal enrichment may be preferable to the more onerous world of the publicly listed company, and to attract the best talent, listed companies must be able to compete. Statistical evidence indicates too that the gap between US and UK executive remuneration has narrowed in recent years, adding further weight to the argument that the efficiency of the

market is increasing.

While we encourage transparency as a driver of behaviour, it must be pointed out that numerous academic surveys around the world have found that, far from controlling executive remuneration levels, increased transparency of pay levels shows a strong correlation with wage inflation for directors. Whether this is as simple as directors “holding the boards to ransom” over highly publicised remuneration packages available from competitors is of course open to debate, but it seems clear that simply publishing details of executives’ remuneration packages, without any integral correlation with company performance, does not in itself act as a check on them. One conclusion which may follow from this is that more may need to be done to ensure that members of remuneration committees, when setting pay packages and incentives structures, are not influenced by indirect self-interest.

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

Comments
The current model of peer review is perceived in some quarters to be wanting. Expanding the scope of the remuneration committee to include employee or union representatives would almost inevitably result in downward pressure on remuneration levels. Regardless of the arguments over the relative efficacy of informed peer review or objective external scrutiny, revising the composition of the remuneration committee in one way or another could be interpreted as a conscious effort to influence the level of pay.

<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
While there have been isolated instances of shareholder revolts, the statistics suggest that shareholders have not held companies to account over board level pay. Given the failure of current mechanisms to exert any noticeable restraint on UK executive pay it seems doubtful that increasing the administrative burden on companies would have any greater impact, as the issue rests not so much on the requirement for shareholders to approve pay as their willingness to do so – or, as the case appears to be, reluctance (for whatever reason) to engage in voting against the proposed packages.

<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
Any further increase in transparency for UK listed companies would need to have the purpose and effect of ensuring that remuneration levels are commensurate with individual and corporate performance, as well as to satisfy investors and the markets that the packages paid are reasonable in the circumstances. Greater disclosure needs to be careful to avoid adding to the potential for wage inflation, mentioned earlier.

More disclosure would most likely be opposed on grounds that, certainly in terms of the first two bullets above, the disclosure of details relating to corporate performance criteria would breach commercial confidentiality and give an unfair advantage to overseas or unlisted rivals. Any new requirements should therefore be careful not to impinge on legitimate commercial confidentiality.

But ultimately disclosure requirements need to be accompanied by mechanisms which allow those who are concerned about directors' and executives' employees' pay to respond to the information. If these are not available it seems unlikely that greater transparency would serve any concrete purpose.

Takeovers

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

Comments
Again, it is difficult to give a simple response to this question since it is too generic. But we would make the point in this context that the Take Over Code is extremely extensive and detailed, we suspect excessively so. We understand that boards very often find it difficult to understand, which may have a bearing on whether they, as the question puts it, understand the full implications of take-over bids and communicate effectively with their shareholders. We suggest therefore that part of the solution is to review the wording of the code – we consider it would be preferable to re-present it on a principle basis which conveyed the intended outcomes of the process more clearly than the code does at present.

<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
We agree there would be benefits in inviting shareholders in the acquiring company being asked to vote, though there would also be costs. The benefit would be that the shareholders would be involved in a decision which might have very material economic consequences for their investments. The experience of RBS and AMRO suggests, albeit with the benefit of hindsight, that that was a decision which should not reasonably have been left entirely to the directors to make.

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

Comments
Adam Smith divided incomes into profit, wage, and rent. In profit-seeking behaviour, entities create value in a competitive environment by engaging in mutually beneficial transactions. In this way an 'invisible hand' means that profit seeking generally benefits society. In rent-seeking, wealth is transferred from one party to another through the latter being able to benefit from special privileges conferred by favourable regulation. Such privilege might include benefits from monopoly or oligopoly, quota, licence, regulation and state support. Long term value is not created through rent seeking behaviour. These days, because legislation and regulation are entwined with business, it is not always possible to distinguish between the two types of income. The fact remains, though, that rent seeking is likely to feature wherever 'profits' are made that are higher than can be explained by competitive forces alone. This clearly applies to the profitability of the banking sector compared with other sectors. A shortcoming of our present reporting framework is that it does not distinguish profits which are earned from value creating behaviour in a competitive environment and transfers of wealth through rent seeking behaviour. Creating value is for the longer term whereas rent seeking confers immediate transfers of wealth. As a concluding point, we very much welcome the Government's interest in inculcating a more long-term focus in business. The recent financial crisis has shown that any business which aspires to being successful over the longer term must consciously adopt strategies to bring this about and recognise that practices which appear attractive in the short-term must be made subservient to the goal of longer-term prosperity. To bring this about requires not only action by companies but supportive behaviour by investors and wider society.

Unfortunately, our culture seems increasingly to be characterised by an expectation of immediate results. We prefer ‘jam today’ to ‘jam tomorrow’ and do not like waiting. People often discount the future. So naturally there are political pressures to sustain a level of economic growth in line with these tendencies. This explains why people do not save enough for pensions, why people buy houses in flood or earthquake zones and why not enough is being done about climate change. This is the reality which faces government in the (worthwhile) task of encouraging a more long-term focus in business.