BIS | Department for Business Innovation & Skills

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)

The Board of Directors

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

Comments
The UK Corporate Governance Code and Walker Report have instigated a cultural shift in UK corporate governance. The emphasis on training, external evaluation and the obligation on boards to maintain and monitor risk and the requirement to report on how the company generates or preserves value over the longer term (the business model), and the strategy for delivering the objectives of the company, ensure that UK Board teams maintain a long-term focus.

<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
Whilst the UK Companies Act (the Act) and related disclosure obligations do provide a useful mechanism by which to access share ownership information, the regime is not comprehensive enough and also creates inefficiencies and needless costs. For example, the widespread and growing use of pooled nominee accounts by custodial organisations requires a greater reliance on Section 793 of the Act in order to uncover share ownership which is a costly, time consuming and error-strewn process. Furthermore, the growth in the use of Contracts For Difference (CFD), intended to avoid stamp duty and provide a cloak of anonymity, makes it very difficult for companies to get a full picture of share ownership. On a related issue, the framework is also inadequate when it comes to discovery of short interest which, arguably, is even more important to understand and where disclosure is only made during very specific situations such as rights issues.

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

The issues around share ownership (as discussed in question 2 above) have made life more difficult for corporates and equity markets. The lower levels of visibility of share ownership and short interest means that companies have greater difficulty in understanding what their shareholders feel about specific issues and also how they vote at meetings.

The internationalisation of share ownership has brought many benefits, with one of the most obvious being the access to new pools of capital in North America, Continental Europe, the Middle East and Asia. That, of course, means that corporate management teams have to spend more time than they used to travelling to meet current and potential investors.

The proliferation of hedge funds and other types of boutique investors has made navigating the investor landscape more complicated for issuers. Many of these do not have a dedicated corporate governance resource and it is challenging for an issuer to establish any dialogue regarding corporate governance issues.

Also, the polarisation of investment strategies towards either index tracking (cheap beta) or focused stock-picking (expensive alpha) has made life more difficult. Index trackers do not always successfully integrate corporate governance in the overall investment decision process.

Moreover, the average holding period for any given share has fallen dramatically over the recent years, partly driven by the increased presence of short term trading strategies. High volume algorithmic trading makes it more difficult to understand who is trading in any given security and why.

We welcome the introduction of the Stewardship Code which encourages institutional investors to be more active and transparent in the governance of companies in which they invest. We believe that transparency, through public disclosure, is imperative in demonstrating and exercising accountability. We would encourage the FRC to continue to review this. In noting that foreign investors are invited to adhere to the Code on a voluntary basis, we firmly believe that it is critical that a level playing field is maintained between UK and foreign investors in terms of their disclosures and voting practices.

It needs also to be appreciated that, as the consultation paper outlines, foreign ownership is now as significant as domestic institutional investment and is matched by UK investment in non-UK assets. As the inward investment of capital is largely seen as a positive phenomenon, any proposed additional regulatory or policy measures should be tested in terms of their effect on the relative competitiveness of the UK as a place to invest.

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

Comments
There are many effective ways that issuers can engage with investors. Each serves a particular purpose. For simple dissemination of static information the corporate website and media channels are very effective. However, the most effective way for corporate management teams to build strong, long term relationships with current and potential shareholders is through direct personal contact by email, phone, and, most critically, in physical meetings. The corporate investor roadshow remains the mainstay of the investor relations programme though the trend is to use ever more efficient formats. Annual general meetings of shareholders are an effective form of engagement with shareholders since they give all holders, regardless of holding size (which is often the criterion which excludes some of them from ever meeting management on a roadshow), the opportunity to express themselves and seek justification for their management's decision making. We would further add that the increased requirements for transparency necessitated by the UK Corporate Governance Code and Walker Report will encourage greater shareholder involvement and companies should seek to utilise technology to ensure shareholders can easily access information through the company website. Separately, engagement with large institutional shareholders can be undertaken by way of meetings between the chairman, finance director, chief executive and the institutional investors, allowing the company to hear feedback on management, strategy business performance and corporate governance. The UK Stewardship Code introduced only six months ago provides a fair outline of the principal forms of institutional investor engagement. As the code acknowledges, the nature of information provided during direct engagement is usually governed by the need to avoid the investors being made insiders.

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

Comments
Our experience is that communication between managers with different functions has improved significantly in recent years. For example, those responsible for Environmental, Social and Governance (ESG) issues within institutions are now much more integrated within the mainstream investment decision-making process than they ever used to be and are much more likely to attend meetings with management teams alongside the portfolio managers and analysts. In large part this trend was accelerated by the financial crisis,

which in many ways was driven by failures in corporate governance. Practice however is still likely to vary considerably. In some instances such a dialogue will be seen as an integral part of the investment process whereas in others it may viewed as a box ticking exercise. Going forward there needs to be a more consistent practice to allow the dialogue between managers with different functions to become more effective.

Question 6: 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

A distinction can be drawn between voting and engagement, with the latter involving more active participation by the shareholder. When considering the long term future of corporate governance it is important that companies seek to foster an environment of engagement through dialogue between shareholders and the board. The disclosure of voting practices would potentially inhibit improved corporate governance with many investors choosing simply to not exercise their vote or to 'follow the leader'. Indeed disclosure of voting practices could be counter productive diminishing voter response. The existence of the Stewardship Code which will become an increasingly integral part of best practice for institutional shareholders, provides sufficient guidance to ensure greater consideration and responsibility in voting, it does not seem necessary to go further and to ask how such votes were cast.

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

Comments

We do not consider short-termism in equity markets to be a problem, however companies do need to spell out their plans more clearly and quantify their risks. The decline of long-term long only funds such as Life funds is a concern, and these funds have not yet been replaced by other long-term managers.

Our only other comment would be that we would advocate the UK authorities guarding against regulatory initiative which add to pressures for short-termism. This includes perennial demands for the introduction of quarterly reporting and, in the case of regulated financial institutions, proposals for the publication of regulatory data on shorter timeframes.

<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
We see the focus being placed by the FRC on institutional investment as a positive step and support continued measures aimed at making the UK Stewardship Code a success. Increasing incentives to hold securities for longer periods would be sensible in encouraging a long term focus in equity markets. Such incentives could be effected through more shareholder rights for time-weighted voting or taxation law, but clearly the latter would have state budgetary implications. So too, increased regulation to curtail short term investment strategies may encourage the UK's large asset management industry to move some of its operations abroad with the obvious impact on employment and wealth creation.

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

Comments
While there are limitations on the information which a company's directors can share with investors, it is in their interests to set out in the clearest terms possible their strategic plan for the direction in which they wish to take the company. This can then be supported by objective benchmarks against which investors can place current performance into a longer-term context. There are a number of agency problems in the investment chain given the number of agents involved and the difficulty in aligning interests within a regulatory framework. Firstly, the main agency issue is aligning the interests and actions of institutional investors with the interests of their underlying investment clients. A more robust and transparent framework that allows investors and corporates to understand how institutional investors operate, what they own (and what they have a short interest in), how they vote on specific issues, how they manage potential conflicts of interest, and how they ensure sound and independent governance of corporate issuers would be helpful to address some of the agency issues. Secondly, an agency issue may arise if interests of sell-side analysts and the investment banks they represent are not fully aligned with those of the buy-side who are the recipients of the research they publish. Chinese Walls between research and investment banking as well as close monitoring of all published research against the market activity by an independent party could help detect and/or eliminate some of the agency issues.

Thirdly, an agency issue may arise on a corporate side, when there is a misalignment of interests between the board of directors of the issuer and the underlying shareholders. This is best prevented through robust corporate governance structures and effective shareholder voting mechanisms.

Fourthly, the use of proxy voting agencies can create issues in terms of the transparency on how the institutions use agencies to log their votes or use them to obtain guidance on how to vote. We consider that it does not matter how good the chairman and the investor relations team may have been in communicating adequately with investors, if the decisions on voting shares are taken by proxy voting agencies then such discussions are arguably wasted.

In referring to the Stewardship Code, there is an argument that the voting service agencies (e.g. Manifest) should have been asked to commit to the spirit of the Code, and that it may have been useful to have included an appendix providing 'best practice' guide for these agencies. This may include guidance on their minimum service level, commitment to avoiding 'lost votes', transparency on their processes, and disclosure of the institutions they vote for.

Furthermore, we would also like to see more disclosure from the proxy voting advisory companies (e.g. ABI, PIRC, NAPF) including disclosure on how they assess companies resolutions and the basis that 'abstain' or 'against' votes are recommended. They should also disclose their policy on engaging investee companies before they issue their voting report especially in regards to 'abstain' or 'against' votes. We would also like to see a list of institutions they represent and disclosures on the steps that they take to ensure that they are correctly representing their members' views.

<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
While it is important for fund managers to report on their engagement policies and engagement activity, (as addressed in Q9 above) we do not consider that there is a need for increased transparency in the role of fund managers.

Directors' Remuneration

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

Comments
This coincides with the recognition of the benefits of diversity on company boards and the breadth of UK companies competing on the World stage. One reason for the increase therefore would be the need to compete in the global market place for the best candidates available. This for instance would explain the narrowing of differentials with the US. The economy is a big factor in deciding the increase in directors' remuneration. As companies grow larger and make more profit, leading executive roles have become more complex. Global competition for talent has also contributed to increase of pay. The increasing proximity between companies and the financial markets in the last few decades is also a consideration. That last factor is fairly complex and includes for example, that the performance of senior management on the financial performance of the company and the impact on its stock has increased. Market competition has also caused an increase. Even during bad economic times, individuals with the ability and experience to run a company (and turn around a company) are few and far between. Companies need to entice or retain them with appropriately high compensation packages. Whether or not the increase is appropriate as a general rule is hard to say. In some cases no doubt pay levels were not justified, whilst in others they were linked to exceptional performance benefiting employees, shareholders and indeed the wider economy It is also important to take into account the internationalisation of the FTSE 100 composition. There is now a global talent base from which senior employees are sourced. The nature of companies and where they carry out their business has also become increasingly international.

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

Comments
The consultation paper suggests there may be a case for widening membership of the remuneration committee but does not say to whom. Without a clearer understanding of what may be in mind it is difficult to say whether what is proposed may simply result in one set of issues being replaced with another. We consider that in order for the remuneration committee to work effectively each member needs to understand their role and time commitment, have a

thorough knowledge of the business and undertake an appropriate induction to make appropriate decisions. A well managed and independent remuneration committee is key rather than its size.

The remuneration committee already has the remit to seek external advice from an array of other stakeholders including other specialist areas of the business (e.g. risk and control), external advisors and government groups.

Ultimately, the remuneration committee is accountable to the owners of the business as determined by re-election and the "say on pay" vote that they are able to exercise at the Annual General Meeting (AGM).

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

Comments

We maintain that golden parachutes are a valuable tool in the remuneration armoury and appropriately used can be in a company's longer term interests. Abuse relating to poor decision-making in respect of discretionary payments should not be confused with the benefits of permitting these payments, nor should the importance of maintaining contractual entitlement be confused with ensuring that employment contracts are drawn up on appropriate terms in the first place.

We are not aware of any evidence that investors are calling for a greater level of involvement. Shareholders are already using negative votes in increasing numbers to make their points heard, including rejections of the remuneration report at AGMs.

There are already an increasing number of guidelines and provisions which give both prescriptive and informative detail on how pay is managed, determining how remuneration is structured. This is particularly true in the financial industry.

We would also argue that most organisations already have due regard for appropriate governance and consideration to the important factors.

<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
Transparency is not always served by the provision of <u>more</u> information and the need therefore is to ensure that additional disclosures can be provided in a clear and readily digestible format. From a banking industry perspective, it is also important that any new requirements dovetail neatly into the extensive regulatory requirements which will apply in respect of the 2010 reporting year.

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 believe that boards do understand the long-term implications of takeovers and will always seek to communicate the long-term implications of bids effectively. Any communication would include the compelling rationale for the takeover as well as an indication of the long term value it would create for investors. Consistent with the Act, UK boards will also have regard to other stakeholders, such as employees and the local community.

<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
The UK Listing Rules already required UK-listed companies to seek shareholder approval for major transactions and we consider that the threshold level at which shareholder approval is required remains appropriate at this time. If companies were required to seek shareholder approval in all cases, the cost and timescale of preparing shareholder documentation may outweigh the benefit of the acquisition. We would highlight that UK-listed companies could potentially be at a disadvantage if they were required to obtain shareholder approval for an acquisition where a non-UK competitor bidder was not. We believe that it is critical that a level playing field is maintained and that, if any new legislation must be introduced, it is done so equivalently on an international basis.

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

Comments
We would reiterate our support for the UK Stewardship Code and its promotion. In noting that some of the questions in this consultation overlap with those addressed elsewhere in other consultations, we believe that a more integrated and co-ordinated approach would be helpful going forward. Ultimately, there is a need for one comprehensive and consistent framework of 'comply or explain' principles that can be applied on an international basis, are clear and easy to follow and which provide incentives for those who apply them in an exemplary manner and consequences for those who do not. This however may be easier said than done. Overall, we believe the UK economy to be well served by its capital markets and their ability to attract inward investment. We therefore cannot recommend highly enough the need to consider global competitiveness factors in determining whether or not additional regulatory measures are needed whether in respect of the issues raised in the paper or company law and corporate governance generally.

British Bankers' Association
14th January 2011