ICGN
International Corporate Governance Network

By email: clgconsultations@bis.gsi.gov.uk

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

14 January 2011

Re: ICGN response on the UK Department for Business Innovation & Skills' consultation 'a long term focus for corporate Britain, a call for evidence'

Dear Madams and Sirs,

We are writing on behalf of the International Corporate Governance Network (ICGN) regarding the consultation being conducted on amendments to the Code of Corporate Governance by the German Corporate Governance Commission. The ICGN is a global membership organisation of over 500 institutional and private investors, corporations and advisors from 50 countries. Our investor members are responsible for global assets of US$12 trillion. The mission of the ICGN is to contribute meaningfully to the continuous improvement of corporate governance best practices through the exchange of ideas and information across borders. Information about the ICGN, its members, and its activities is available on our website: www.icgn.org.

The ICGN welcomes the UK Department for Business Innovation & Skills' consultation 'a long term focus for corporate Britain, a call for evidence' and is glad to provide you with our views.

We share the objective that efficient, effective and transparent allocation of capital should be ensured in order to safeguard the long-term sustainability of UK companies.

In the UK it is well recognised -through the recently introduced Stewardship Code as well as the revised UK Corporate Governance Code- that the quality of the relationship between company boards and shareholders is pivotal to the long-term success of companies. By seeking to live up to high quality corporate governance standards, companies will be better able to take the decisions which will protect and enhance value for their long-term shareholders. The ICGN also believes that dialogue between shareholders on the one hand and senior executives and board-members (executive and non-executive) on the other is a necessary part of effective corporate governance. Such a dialogue starts from a more productive base in case companies make public disclosures which are substantive and company-specific rather than boilerplate.

The objective of companies is to generate sustainable shareholder value over the long term. Companies will only succeed in achieving this in the long run if their focus on economic returns and their long-term strategic planning include the effective management of their relations with shareholders as well as other stakeholders. Other stakeholders include --amongst others- employees, suppliers, customers, local communities and the environment as a whole.

Shareholders on the other hand should act in a responsible way aligned with the company's objective of long-term value creation. Institutional investors should for example

recognise the responsibility to generate long term value on behalf of their beneficiaries, the savers and pensioners for whom they are ultimately working. Institutional investors should be ready, where practicable, to enter into a dialogue with companies in order to achieve a common understanding of objectives. Pension funds and those in a similar position of hiring fund managers should put sufficient resource into governance analysis and engagement which deliver long term value.

The ICGN recognises that both companies and their shareholders should contribute to the long-term success of UK companies. At the same time we would like to point out that while an investor might have a long term investment strategy, which does not necessarily mean that each individual stock is held for a longer period of time. It might for example be that an investor buys the shares of a company because of the belief that these are undervalued. As soon as the shares are again fairly priced in the investor's opinion, he might make a conscious decision to sell. The investor has duty towards his beneficiaries to realise an optimal investment return.

By answering the questions as outlined in the consultation document the ICGN hopes to contribute to the discussion about the long-term sustainability of the UK equity markets.

Consultation Questions

The Board of Directors

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

While there is no evidence to suggest that UK boards do not have a long-term focus and that their strategic decisions are driven by short term share price movements, we acknowledge concerns that short term thinking may influence decision-making processes. In general UK boards appear to recognise the importance of having a long-term focus when setting strategy and, following the introduction of the Companies Act 2006, understand that they now have a statutory duty to do so.

2. Does the legal framework sufficiently allow the boards of listed companies to access full and up-to-date information on the beneficial ownership of company shares?

The current legal framework in the Companies Act 2006 obliges the largest shareholders (above 3%) to disclose their holdings to the market and also where appropriate enables the boards of listed companies to require shareholders of below 3% to disclose their shareholding. Boards of listed companies therefore already have all of the requisite tools under the current legal framework to identify their beneficial owners.

Whilst acknowledging that the use of nominee accounts in the UK does make it quite complicated for the boards of listed companies to identify the beneficial owners of their shares, changing the legal framework to oblige all shareholders to routinely disclose their shareholding would be impractical.

In recent years many companies have made more of a concerted effort to identify their beneficial owners via their company secretarial departments, registrars and proxy solicitors. There appears to be no evidence to suggest that fund managers and institutional investors have refused to cooperate with companies in disclosing their shareholdings. Although there is scope for this communication to develop and improve, in our view it is a more practical solution than changing the legal framework.

Shareholders and their role in equity markets

3. What are the implications of the changing nature of UK share ownership for corporate governance and equity markets?

The most important trend since the mid 1990s has probably been the increased ownership of listed UK companies by overseas shareholders. This means that the boards of UK listed companies have to seek the views of a wider range of shareholders on strategy and corporate governance. This probably introduces greater challenges for boards when trying to garner different views and seek consensus. It is also possibly more difficult for overseas shareholders than domestic shareholders to engage effectively with the boards of UK listed companies given the logistical challenges.

This trend also has the potential to make stewardship less integrated with the investment decision making: increasingly overseas shareholders are employing in-house corporate governance teams or third parties who are responsible for voting and engagement rather than delegating the responsibility to their fund managers. This means that the fund manager who has decided to invest in a particular company may not actually be responsible for voting and engagement. This can lead to confusion amongst companies particularly where an institutional investor votes against management without informing them in advance of the general meeting.

4. What are the most effective forms of engagement?

For long-term investors and companies the most effective forms of engagement or 'stewardship' activities depend very much on the issue that has initiated the engagement and the extent to which this could impact long-term investment returns. For example, a change of company strategy (such as a merger or acquisition) would require quite different forms of engagement to the restructuring of an executive remuneration plan or a CEO's succession. A change of company strategy would require company executives to engage proactively with investors whereas the restructuring of an executive remuneration plan may only require a letter to investors in conjunction with a conference call with the Remuneration Committee Chairman where appropriate.

Importantly it is the responsibility of both boards and investors to communicate effectively in order to establish what forms of engagement are required and necessary particularly where concerns could potentially result, for example, in a significant level of opposition at a company's general meeting. The Stewardship Code, which requires fund managers to outline how they approach stewardship and escalate engagement in order to protect long-term shareholder value, should lead to increased transparency to their clients on how they fulfil their responsibilities.

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

How fund managers and institutional investors allocate and structure their corporate governance and investment responsibilities amongst internal and external personnel differs significantly. For example, some employ in-house corporate governance specialists who work alongside the investment teams whereas others may choose to outsource their stewardship, voting and engagement activities to third parties.

Some boards of UK listed companies have complained that within fund managers there can be a lack of communication between investment and corporate governance teams and that this can result in mixed messages to companies: for example, a corporate governance team deciding to vote against management at a general meeting when the

company was told that the investment teams were supportive. However, there appears to be little evidence that this actually happens in practice: according to the IMA, who surveyed 32 fund managers in 2008 (representing 68% of UK equities under management) on how they integrate engagement into their investment process, the vast majority said that voting and engagement activities and decisions involved both their corporate governance and investment teams.

Where institutional investors don't delegate voting and engagement activities to their fund managers, it is clearly important that they satisfy themselves that their policy and procedures protect long-term investment returns and where appropriate is suitably aligned with the wider investment process rather than being simply a box-ticking exercise.

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?

For long-term investors to exercise their voting rights effectively, particularly on contentious or material issues, engaging with companies before the general meeting is invaluable. Voting at general meetings is not an end in itself: it should actually be viewed as a form of stewardship which prompts engagement rather than a form of engagement itself. Voting against management without prior engagement essentially blunts voting as a stewardship tool and is likely to be counterproductive and less likely to result in companies making changes particularly where investors have concerns.

The obvious benefit to institutional investors and fund managers from disclosing their voting activities publicly is one of enhanced reputation: it creates the perception that by being transparent they are fulfilling their fiduciary responsibilities. However, public disclosure of voting activities can also be misleading: in the US, the rules requiring public voting disclosure by mutual funds has led some consultants to publish tables which 'name and shame' mutual funds with the fewest votes against management. Since voting is not an end in itself, these tables fail to capture the extent to which investors have engaged with companies prior to the vote and have encouraged changes. In addition since there is clear statistical evidence that the public have very little interest in voting data on investors' websites (increasingly UK fund managers are publishing their voting voluntarily on their websites). Despite these concerns, the ICGN expects from responsible investors to be transparent on their actual voting behaviour.

The 'comply or explain' Principles on disclosure to clients and members, and public disclosure, in the Stewardship Code are a more productive and practical way of increasing the quality of voting and engagement reporting and transparency than prescriptive disclosure rules.

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

The Bank of England report which is mentioned in the consultation "evidencing increased short-termism" refers to the significant decrease in holding periods and increases in turnover since the 1960s. However, we believe that it would be misleading to describe this as simply a 'short-termism problem'. There are a number of explanations for increases in turnover which have little to do with short-termism: changes in mandates, for example moving from segregated to pooled funds. Also the increasing importance of high frequency trading can be a reason for the decrease in holding periods and an increase in shareholding turnover. More analysis is required of changes in turnover and holding periods before drawing any definitive conclusions from the Bank of England report about equity markets generally.

Since the 1960s the growth of quant funds, which have higher turnover within their portfolios, has also reduced holding periods. However, to describe this as an unwelcome trend is misleading: having both long and short term investors in the equity markets helps to increase liquidity and lower the cost of capital.

8. What action, if any, should be taken to encourage a long-term focus in UK equity investment decisions? What are the benefits and costs of possible actions to encourage longer holding periods?

Some commentators in the UK have suggested that long-term share ownership could be encouraged by giving long-term shareholders additional voting rights and/or increased dividends. Double voting rights to long-term shareholders (for example, 10 years) are applied by many French companies and are essentially a reward to those investors that have been loyal to the company.

The ICGN Corporate Governance Principles clearly state that "corporations' ordinary shares should feature one vote for each share" and that "divergence from a 'one-share, one-vote' standard which gives certain shareholders power disproportionate to their equity ownership should be both disclosed and justified". We also believe that there are many practical difficulties in differentiating classes of short- and long-term shares.

As we highlighted in our response to question 7 above, since both short- and long-term investors are required to create market liquidity and lower the cost of capital, we believe that rewarding long-term investors and penalising short-term investors could have a detrimental effect on equity markets.

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

We are not aware of any agency problems in the investment chain and question the comments in the consultation that fund managers are incentivised to increase portfolio turnover because it generates higher management fees. Since fees are either performance related and/or based on a percentage of funds under management, the costs associated with portfolio turnover would actually reduce rather than increase fees.

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

We believe that fund managers are already fully transparent with their clients. The terms and objectives of mandates, reporting requirements, and fees are discussed fully with institutional clients prior to the fund managers' appointment. Fund managers have a fiduciary duty to both their retail and institutional clients to adhere to the terms of the mandates and be transparent.

One of the key objectives of the Stewardship Code is for fund managers to increase transparency to their clients on how they exercise their stewardship responsibilities on clients' behalf, particularly where this could enhance long-term investment returns. Since the Code was only recently introduced, and there has been insufficient time to assess its impact, we believe that it would be counterproductive to introduce new rules.

Directors' Remuneration

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

Companies increasingly benchmark their executive directors' remuneration against global peer groups which comprise inter alia competitors and similar sized companies. In recent years global regulations requiring companies to provide fuller disclosure on executive remuneration may have actually increased the ratcheting effect because it is easier for executives to see what their peers are earning. In addition, a greater proportion of executive remuneration is now via long-term performance share awards and is aligned with performance conditions. This is a positive trend since it means that there is now more focus on long-term performance metrics, however it also means that potential awards for executives are higher particularly if they achieve their maximum performance targets.

Importantly however global companies need to pay competitive remuneration in order to retain and recruit the right calibre of executives. Whilst quantum is a consideration, long-term investors are probably more interested in how remuneration structures align executive and shareholder interests.

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

It is very difficult to say what the effect would be, although it would not necessarily result in lower levels of remuneration given the need to pay competitive levels to recruit high calibre executives. We believe that remuneration committees should comprise independent non-executive directors who are elected by and accountable to shareholders.

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?

Shareholders in UK listed companies have an advisory vote on the remuneration report and also get to approve new long-term incentive plans. There have been several instances in recent years where a significant proportion of shareholders have opposed companies' remuneration structures. For example: GSK, RD Shell and Tesco. This level of opposition has encouraged remuneration committees to engage with shareholders and has led to positive changes on several occasions.

We believe that requiring UK listed companies to put individual elements of the remuneration package, such as golden parachutes, to the shareholder vote could potentially be very complicated when recruiting new executives. In our opinion, shareholders already have sufficient rights to hold companies accountable over pay.

14. What would be the impact of greater transparency of directors' pay in respect of:

- *linkage between pay and meeting corporate objectives?*
- *performance criteria for annual bonus schemes?*
- *relationship between directors' pay and employees' pay?*

We believe that in the UK there is already sufficient transparency on the linkage between pay and meeting corporate objectives. Importantly the advisory vote on the remuneration report has encouraged UK companies to engage more with their shareholders particularly when they are making changes to their long-term remuneration structures. This increased dialogue has helped shareholders to develop a greater understanding of how pay and corporate strategy are aligned.

The performance criteria for annual bonus schemes are often not disclosed by UK companies because of concerns about commercial sensitivity. Whilst we understand the concerns that many companies have, we would welcome additional retrospective disclosure

of performance targets once annual bonuses have been paid. This would allow shareholders to assess the linkage between pay and performance.

Re the relationship between director and employee pay, we believe that the new regulations which will require UK companies to make a statement in their remuneration report on how employee pay was taken into account when setting executive director pay is welcome and will provide greater transparency.

Takeovers

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

We agree with the IMA's suggestion that boards could communicate the long-term implications of bids more effectively by disclosing in the offer document on how the directors believe the offer fulfils their duties under the Companies Act to promote the success of the company and to consider the long-term effects on all stakeholders.

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?

We understand the logic and rationale for suggesting that shareholders of an acquiring company be allowed to vote on takeover bids. However, there may be practical and competitive implications for UK bidders versus foreign bidders, particularly where the latter is not subject to such regulation, which might actually prove detrimental to long-term shareholder value.

Other

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

We have no further comments.

We welcome dialogue on the issues noted in this letter or regarding our activities.

Yours sincerely,

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