SUBMISSION ON THE DISCUSSION PAPER:

A LONG-TERM FOCUS FOR CORPORATE BRITAIN: A CALL FOR EVIDENCE

FINANCIAL REPORTING COUNCIL

JANUARY 2011

Introduction

1. The FRC shares the Government's belief in the importance of open, efficient and transparent capital markets, which need to be underpinned by effective corporate governance and reporting. The FRC also shares the Government's concern that too often companies' strategic decisions and owners' investment decisions may be driven by short-term considerations.

2. The FRC therefore welcomes the Government's decision to initiate a debate on how to restore a more long-term focus to the markets. As noted in the FRC's response to the European Commission's Green Paper on corporate governance in financial institutions, this debate must not be confined to the UK, and the outcomes of the current consultation should also inform the UK position in the various negotiations that will be taking place in Europe during 2011.

3. As the discussion paper notes, the FRC took a number of actions during 2010 intended to increase the effectiveness of corporate governance and reporting.

4. A strengthened UK Corporate Governance Code came into effect in June, which included changes to encourage boards to think more carefully about the sustainability of their business model and the risks to delivering it, to make them more accountable to the owners, and to link their remuneration more explicitly to the long-term success of the company.

5. In July the FRC published the UK Stewardship Code, with the aim of fostering a critical mass of investors with a long-term focus and encouraging them to be more active in monitoring and engaging with the companies in which they invest, to act as a counterweight to short-term pressures on boards.

6. In August the FRC, through the Professional Oversight Board and Auditing Practices Board, published a discussion paper on what audit firms need to do to ensure that auditors are appropriately sceptical in practice, and how companies and others can facilitate this in the interests of investors and other company stakeholders.

7. More recently, the FRC published earlier this month "Effective Company Stewardship: Enhancing Corporate Reporting and Audit" as a contribution to the debate initiated by the Government. It contains a number of proposals to promote high quality reporting and auditing, particularly in relation to business strategy and risk management. They include proposals to place greater emphasis on the role of the audit committee, to expand the audit report and to encourage greater investor involvement in the appointment of the auditors.

General comments

8. The FRC believes that the actions outlined above can make an important contribution to addressing some of the concerns raised in the discussion paper about short-termism and the agency problem.

9. The Department's paper has rightly highlighted the relationship between fund managers, their clients and the companies in which they invest. However the FRC also believes that there are other significant drivers of short-termism that have not been identified in the paper. Unless these other drivers are recognised and, where possible, addressed, there is a danger that the actions already taken by the Government, FRC and FSA – and any further actions envisaged as a result of the current consultation – may have only a limited effect. Whilst they may alleviate aspects of short-termism, they would do so without tackling some of the fundamental causes.

10. Other potentially significant drivers of short-termism whose impact needs to be understood and further considered include, in no particular order:

    - The desire for deep liquid markets, which may have contributed to a culture that encouraged trading rather than ownership;

    - Long term savings being directed away from the UK equity market, as a result of Defined Benefit pension schemes adjusting their distribution of assets, and the extent to which solvency standards based on market values have contributed to this trend;

    - The influence of investment banks and other corporate advisers, who may be incentivised to push companies towards actions that generate fees, irrespective of whether they are in the long-term interest of the company;

    - The influence of leverage, as reflected in the behaviour of some hedge funds;

    - The lack of transparency about the objectives of the different parts of the investment chain, and their incentives, including remuneration;

    - The increased popularity of share buybacks, which contribute to short termism because they encourage management to seek to manipulate the share price for short term advantage, as opposed to dividends which require the ability to generate cash over the longer term; and

- The impact of other changes such as faster moving markets, the need for a quicker return on investment in R&D, and labour market flexibility that might have contributed to a shorter term perspective.

Detailed comments

11. The remainder of the paper comments on the four subjects highlighted in the discussion paper: the role of boards; the role of shareholders; directors' remuneration and takeovers. The FRC has not sought to comment on all the issues raised in the discussion paper, but our response indicates where the remarks relate to a specific question.

The Board of Directors

12. As paragraph 3.4 of the discussion paper notes, effective boards draw on broad pools of talent with varied and complementary skills, experience and perspectives, and the updated UK Corporate Governance Code issued in June 2010 incorporates changes to emphasise the need for the board to be fit for purpose and capable of delivering the company's long-term strategy.

13. These include a new requirement to have due regard to diversity when making new appointments to the board. In its response to the Davies review, the FRC has supported further disclosure, recommending that boards should state in their annual report whether, in conducting their board evaluation, they have considered diversity, what their approach is to this issue, and how they have sought to give effect to it in their nominations processes and instructions to head hunters.

14. The FRC believes that the current directors' duties, as summarised in paragraph 3.5, remain valid and are an appropriate framework for acting in the interests of, and reporting to, shareholders and stakeholders. Rather than considering changes to these duties, the focus should be on improving the application of the current framework, particularly in how longer term issues such as sustainability are addressed.

15. The role of narrative reporting and the OFR should be considered in this context. The FRC's views on the future of narrative reporting were set out in its response to the Department's consultation on that issue. Suffice to say, the FRC shares the concerns about the quality of communication between companies and their owners raised in paragraphs 3.9 to 3.12 of the paper, and would support properly targeted reforms to improve the usefulness of narrative reporting. As noted in paragraph 7 above, the FRC's own discussion paper, "Effective Company Stewardship: Enhancing Corporate Reporting and Audit", proposes a number of such reforms.

16. The FRC agrees that consideration should be given to the appropriate level of assurance to be attached to the annual report (paragraph 3.12). There is a good case for it to be subject to external review. However, a narrative report that incorporates forward-looking information cannot be audited in the same way as historical accounts and it would be misleading to leave investors with the impression that such a report would be as securely assessed as the accounts are by the "true and fair" opinion. In addition, we must avoid the risk of directors not reporting openly and auditors not giving and valuable assurance because of the fear of exposing themselves to litigation.

Shareholders and their role in equity markets

17. The FRC agrees with much of the analysis in this section of the discussion paper. The changing nature of the investor base over the last twenty years or so has had significant implications for UK listed companies and for the operation of the market as a whole.

18. As well as the perceived overall impact on market behaviour, this trend has significant implications for the UK approach to corporate governance, which assumes that shareholders and boards have a common interest in delivering long-term success, and that the shareholders will hold boards to account if they fail to act in those interests.

19. The declining share of the market held by those owners traditionally characterised as "long term", combined with regulatory and market pressures on those owners to adopt a more short-term approach, widely spread investment portfolios and the growth of alternative investment models has contributed to concerns that shareholders are failing to monitor boards properly or that they are encouraging them to pursue short-term gains at the expense of sustainable returns.

20. It is necessary to rebuild the critical mass of investors seeking long-term returns who have the willingness and capacity to hold boards to account. It was for that reason that the FRC agreed to take responsibility for the UK Stewardship Code, as recommended by Sir David Walker.

21. As of the end of December, 125 organisations had committed to apply the Code, including 25 of the thirty largest investors in terms of their holdings on the UK Main Market. The overwhelming majority of these organisations are investment managers. This is an extremely encouraging response, but it is still early days and it will take time before the real impact of the Code can be felt. And, as noted in our general comments, that impact will be limited unless other drivers for short-termism are addressed.

22. The discussion paper rightly focuses on the role of the investment manager. While not disagreeing with the basic analysis in the paper, the FRC considers that it understates the role of the asset owners. Investment management firms are commercial operations. If their clients begin to demand sustainable returns and increased monitoring of and engagement with companies in which managers invest on their behalf, and if they begin to award mandates on this basis, investment managers will have to respond.

23. That demand is not currently as widespread as one would wish, although the FRC believes that awareness is increasing. Some asset owners have already signed up to the Stewardship Code and the National Association of Pension Funds has issued guidance to its members on the subject. But any strategy to address short-termism must include engaging with asset owners and investment consultants and addressing any pressures on the owners themselves to adopt a short-term approach, as identified in paragraph 10 above.

24. Where owners do have longer-term objectives there are often barriers that make it difficult for them to make sure they are being met, such as lack of resource. The paper rightly identifies the lack of transparency within the investment chain as a significant barrier. The disclosures made against the Stewardship Code will begin to address this, but the FRC agrees that consideration needs to be given to more transparency (Question 10), including on the remuneration and performance incentives of investment managers. If appropriate, additional disclosure requirements could be incorporated into future iterations of the Stewardship Code, which the FRC will keep under regular review; regulation might be an option for some disclosures.

25. Many investors already disclose their voting policies and records, and they are encouraged to do so by the Stewardship Code (Question 6). If mandatory disclosure of voting records were considered desirable, it would be necessary to take great care in determining the format for any such disclosures, and to allow a degree of flexibility where possible. A blanket requirement to disclose all votes could be costly to fulfil, particularly for institutions running multiple funds, and too detailed to be of much value to clients and other interested parties.

26. Further consideration should be given to awarding extra rights to long term shareholders (Question 8), although the FRC would not support extra voting rights as these could encourage entrenchment and protection. An alternative approach could be to give long term shareholders additional scope to initiate action.

27. Approaches adopted in other markets are worthy of consideration. For example, the arrangement in Brazil under which a qualified shareholder can solicit proxy votes from other shareholders might be useful in cases where the board had not responded to representations; while the Swedish principle of shareholder-led nomination committees might be adapted to give qualified shareholders a more proactive role in certain circumstances, for example in the process of appointing new non-executive directors or the external auditor.

Directors' Remuneration

28. In June 2010 the FRC introduced a number of changes to the sections of the UK Corporate Governance Code dealing with remuneration policy and procedures. These include a new principle stating that the performance-related elements should be designed to promote the long-term success of the company, and provisions stating that payouts under incentive schemes should be subject to non-financial performance criteria where appropriate and compatible with the company's risk policies and systems, and that companies should consider provisions that enable them to reclaim variable components in cases of misstatement or misconduct. The recommendation that the directors of FTSE 350 companies should be subject to annual election should also make remuneration committees more accountable.

29. It is too early to say to what extent these changes, and other regulatory changes introduced since the financial crisis, will affect companies' behaviour and the remuneration levels of executive directors, but the FRC believes these measures should be given time to have an impact before additional regulatory requirements are introduced.

30. While there is some truth in the comments referred to in paragraph 5.11 of the paper about the performance of remuneration committees, the FRC is not persuaded that changing the structure of the committee is the most appropriate way to address these concerns (Question 12). Nor does the FRC agree with the argument in paragraph 5.12 that broadening the membership of the committee would necessarily reduce the influence of remuneration consultants.

31. Concerns might be better addressed by ensuring that the pool of non-executive directors on the board, from whom the committee will be selected, collectively have the independence, expertise and sensitivity to wider factors necessary to carry out their role properly. Attention needs to be paid to board composition, selection, development and evaluation, all topics on which the UK Corporate Governance Code has recently been strengthened.

32. As regards remuneration consultants, the FRC supported Sir David Walker's recommendation that consultants should develop a code of conduct addressing potential conflicts of interest and establish a professional body to oversee this code. It would be appropriate to review progress to date and what might be done to increase the impact of the code.

33. The FRC agrees with the comment in paragraph 5.13 that it is often difficult to see the wood for the trees when looking at remuneration reports. While companies must bear much of the responsibility for this, the patchwork nature of the requirements on them - remuneration reporting is prescribed by five different sources in the UK[1] – does not help matters. If additional reporting requirements are to be considered (Question 14), existing requirements should be rationalised as part of that exercise.

34. The FRC is not persuaded that creating requirements for additional specific votes on individual issues such as one-off payments or the Business Review, as suggested in the Department's discussion paper on the future of narrative reporting, is a desirable trend (Question 13). As noted above, the FRC considers that the introduction of annual elections for directors of FTSE 350 companies will increase the ability of shareholders to hold boards and remuneration committees to account, and might be expected to be a more effective discipline that a proliferation of subject-specific resolutions. That said, it would be appropriate to consider the arguments for and against replacing the existing advisory vote on the remuneration report with a binding vote on the remuneration policy.

Takeovers

35. The FRC supports the changes to the Takeover Code proposed by the Takeover Panel in its October report. In its response to the Panel's earlier consultation, the FRC expressed concern that, in attempting to protect good boards from unwanted bids driven by short-term considerations, measures should not be taken which served to entrench bad boards.

36. For this reason, the FRC was opposed to the proposal to raise the acceptance threshold for takeovers to 60 per cent, which it considers would weaken shareholder rights and make it more difficult for minority shareholders to exercise their stewardship responsibilities effectively.

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[1] The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008; the Listing Rules; the UK Corporate Governance Code; IFRS 2 (Share Based Payments) and IAS24 (Related Party Disclosures). There are additional requirements in the financial services sector.

37. The FRC also opposed the proposal to remove voting rights from shares acquired during the voting period. As well as the practical considerations, it was sceptical that such a change would reduce the incentive for long-term holders to "top-slice" their holdings; the incentive could increase as the absence of pressure from short-term shareholders for an increase in the bid price limited any potential market upside.

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