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
X	**Other (e.g. consultant or private individual)**

The Board of Directors

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

Comments

We set out below and in other boxes our responses to the Department for Business Innovation & Skills consultation, 'A long-term focus for Corporate Britain' of October 2010 (the '**Consultation**'). We welcome this opportunity to provide comment.

EIRIS Ltd is a leading international research organisation within the responsible investment field. The EIRIS Foundation (Charity registration 1020068), its parent company, and EIRIS, were established to undertake research into corporate social, environmental and other ethical performance. As part of this process we interact with companies and investors and have seen changes in this field over the last twenty-eight years.

The extent to which UK boards have a long-term focus varies from company to company; however, on the whole there could be a greater long-term focus across UK boards. Short-term reporting requirements, the lack of incentives and remuneration for directors based on long-term objectives, and often the lack of clearly expressed shareholder interest in long-term risks and opportunities, have led to a predominantly short-term focus by boards.

However, not all boards are the same and some do have a more long-term focus than others. For example, some boards, due to the nature of their business and shareholders' interests, are attempting to have a more long-term perspective e.g. resources companies for whom capital must be committed over the long term due to the lead time on major projects and the need to secure access to resources.

From our work, it is evident that there is a substantial body of UK companies that increasingly take a long-term view on the importance of environmental, social and governance matters and a growing body of investors for whom this is important. The danger remains that mainstream investors' demands for quarterly returns and short-term trends can mitigate against this movement.

Auditing and Reporting
Arguably too many boards currently work on a quarterly reporting schedule as they are expected by investors to give regular updates on short-term financial returns rather than establishing a longer-term perspective. These also require reporting primarily on purely financial matters, not on wider risks that could have a financial impact in the long term, such as environmental, social and governance issues. Including the latter issues in reporting can provide a more accurate picture of the all-round risks facing a company over the long term.

It is stated in paragraph 3.12 of the Consultation that '*There have however been questions about the role of audit, including suggestions that audits do not address*

the issues of most concern to investors and are therefore little read.' Audits are primarily backward-looking. There is a need for forward-looking reporting which might take greater account of long-term risks to a company, and as the NGO FairPensions argues, forward-looking reporting that is also independently audited.

The inclusion of environmental and social matters into a company's Operating and Financial Review would be helpful here. Similarly, the initiative for integrated reporting on environmental, social and governance matters with the annual report, led by the International Integrated Reporting Committee, aims to address a number of the same issues.

These moves towards integrated reporting provide an important opportunity to encourage companies to report on longer-term plans, costs and opportunities where relevant. Given the focus that will be necessary by many parties to make a success of the integrated reporting initiative, it would make a lot of sense to look at how best to influence and develop that stream of work in this direction, rather than to launch any closely related ventures independently. Gathering and publishing this information will better inform boards for the long-term life and development of a company, as well as providing information that will assist the market in better reflecting long-term value in share prices.

Remuneration
In many cases the remuneration structure for board members does not reflect long-term incentives. There is a need for 'appropriate remuneration frameworks for sustainable success'.[1] Shareholders need to engage with companies to actively vote against unacceptable remuneration; perhaps ask for disclosure / explanation behind packages and the integration of environmental, social and governance issues into both short and long-term variable pay. Regulators may need to similarly underpin the requirement for long-term focus in remuneration practices through legislation.

Roles on the Board
It may be worth considering that not all board members may be required to think about or prioritise long-term issues to the same extent. There may be differentiated ways that long-termism could be integrated into their roles. Finance directors, for example, might be in a position to organise information about long-term issues in a way that encouraged the board to consider them in a constructive way - and their professional associations should be encouraged to develop this role within companies. Those directors with specific responsibilities in relation to risk-management systems might be given explicit responsibility to ensure that long as well as short-term risks are given proper consideration within their work.

[1] EIRIS and EUROSIF, 'Remuneration', Theme Report – 3rd in a series, January 2010

<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

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 Consultation suggests that between 1963 and 2008 the composition of UK share ownership has become more institutional (as opposed to individual) and comprised of more non-UK owners (as opposed to domestic). It is worth noting that whilst there may have been an increase in the number of institutional investors during this time, the ultimate owner of pension funds is the pension policy holder, the individual. It is necessary therefore to find ways to empower the individual to articulate their long-term interests and thereby bring the individual back into the equation. It could be argued that the general public, individuals, are also interested in environmental, social and governance issues and enquiring about these risks with regards to their investments. These issues can and do affect the long-term financial sustainability of companies; having due regard of them can thereby preserve and enhance long-term value. A positive aspect of the trends mentioned above in terms of progress towards longtermism is that large asset owners, such as sovereign pension funds and their equivalent, tend to act as universal owners. They own a large proportion of the global economy (including the UK) and they increasingly realise that they cannot externalise risk and costs without that externalisation affecting their other investments, because they invest in them all. Therefore, longtermism may be better served by those sorts of investors. However, one would expect them to only be a small proportion of UK plc shareholders.

Question 4: What are the most effective forms of engagement?

Comments

Engagement by shareholders can take many different forms. It can be by voting on a shareholder resolution or taking part in wider ongoing conversations with the board. To be effective, engagement needs to be addressed to the decision makers in a company and focus on issues that are placed in a business context i.e. the long-term risk and opportunity for environmental, social, governance and political issues to affect the ability of a company to survive and thrive. The more investors ask these types of questions and bring these challenges to boards' attention, the more companies are likely to respond, thereby encouraging a culture of, and creating an expectation of, the adoption of a long-term perspective.

Effective engagement also requires active ownership by the shareholder and those involved in the investment chain.

Engagement is not just between the investor and the company board, but between all those in the investment chain; between asset owners and asset managers and between asset managers and consultants, proxy voting agencies and brokers. The recent UK Stewardship Code by the Financial Reporting Council (2010) and the National Association of Pension Funds' 'UK Stewardship Code: Guidance for Investors' (November 2010) support this. We welcome both as providing direction in this area. It is imperative that asset owners, as long-term responsible owners give clear guidance and instruction to their (often many) asset managers regarding their mandate (which should require fund managers to report back to them on how they are ensuring that the companies in which they invest are properly tackling long-term sustainability).

Where voting is the vehicle for engagement and an investor votes against or abstains, the process will be more effective if investors explain their vote to the company concerned and if companies take the opportunity to enter into dialogue with their shareholders on the points raised. Both parties should be encouraged to play their part here (including in any reporting obligations on investors or by clarifying who is responsible for such dialogue at the company end).

To develop this a little further: if an investor summarises for their clients (if an asset manager) or stakeholders (if an asset owner) and for the other companies in which they hold shares, details of the categories under which they have withheld their support (and their general reasons for doing so), and some analysis of the responses they received from companies as a result, this would help all parties involved understand the role investors are playing and adjust their future decisions accordingly.

Foreign companies listed on a UK stock exchange may be less responsive to engagement, due to their relative unfamiliarity with some of the standards and issues which prevail amongst some UK and other investors. Differences in corporate culture are often a challenge for those involved in engagement. However, by listing in the UK, they will be exposed to broader considerations and may be encouraged to think in a more long-term manner.

Engagement by investors is likely to be more effective if they have (or develop in the course of the dialogue) clear objectives and timescales for any changes or

developments sought or agreed and ensure that these are documented.

There are many practical lessons about successful engagement (like discussing issues with companies in the context of their peer groups, focussing engagement around strategy where relevant and finding an appropriate level of "ask") but many of these are not always easy to define unambiguously.

Collaborative engagement (where investors group together to raise issues of common concern with a company) or even informal discussion, is important. It gives a clear signal from the asset-owner and asset-management community as to what they are expecting from companies. Such action can be inhibited by the effect of rules designed to prevent investors acting in concert, and it would be helpful to reinforce the more robust view that as long as a change of overall control (involving, for example, multiple changes in board membership) is not envisaged, investors can be confident in working together to improve the long-term sustainable value of their company by engaging with the board and exercising their rights as owners in relation to environmental, social, governance or other long-term issues. The practicalities of engaging with a 3,000-8,000 share portfolio across the world which face larger asset owners, mean that without a capacity to share the load with other like-minded investors it is simply not going to be feasible for them to play the role of engaged and responsible owners. Even the fear of (or uncertainty about) the legal framework here can be a major disincentive to active participation. The UN Principles for Responsible Investment offers an opportunity for institutional investors to inform each other of issues of concern and pursue collaborative engagement together. An increasing number of EIRIS clients are also interested in pursing engagement on environmental and social issues.

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

Comments

It is best if there is proper and full co-operation between the various teams in investment firms. At worst the portfolio managers may wonder what the point of corporate governance (or ESG) analysts is, and the corporate governance analysts (often now including environmental and social considerations within that brief) are allowed to process the votes, but otherwise bemoan the lack of commitment from others on integration between their work and that of portfolio managers.

This arises partly because of different time frames involved. Many traditional governance concerns aim to deliver value over a period of several years (next board succession, major transaction or proper oversight of "unlikely but unpleasant" risks), and environmental and social considerations (maintaining human capital through a business cycle or responding to the climate change challenge) can relate to value over decades in some cases. The portfolio manager, on the other hand is daily facing many more immediate issues.

But the dialogue between these functions is important to ensure that the investor speaks with one voice to the investee company (even if the message is complex).

This will be facilitated within investment firms if the firm is clear at the top level about the significance it places upon ESG issues and has explicitly given thought to how to integrate long, medium and short-term considerations into its investment process. This will give clarity about how the ESG aspects fit into both their investment process and the work of the portfolio managers, and therefore how different colleagues should relate with one another within that framework.

In practical terms it would be helpful if that message was regularly reinforced by senior managers in investment firms in terms of practical examples as well as in theory, by including their assessment of the significant ESG (and other long term) risks (and opportunities) in the market place in annual or other reports for investors and shareholders together with an explanation of how their firm is addressing those issues. This would also help asset owners and other stakeholders understand the extent to which such considerations play a part in the work of each asset manager.

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

Voting is significant in its own right and it can be used as part of, and in tandem with, other forms of engagement.

Responsible owners of companies should give due consideration to how they exercise their shareholder vote. They should not solely outsource their vote to others (such as proxy voting agencies). Active voting demonstrates an interest by the shareholder in how the company is being run.

Voting can also be used in addition to engagement. Voting can register concern about a company's performance by voting shares accordingly. Investors should be encouraged to vote on and place or promote environmental-, social- and governance-type resolutions, as in the BP / Shell resolutions that gained prominence in 2010.

The benefits to institutional shareholders and fund managers of disclosing publicly how they have voted outweigh the potential costs (e.g. loss of confidentiality on how they have voted and the time involved in displaying this information publicly on a website). Please also see answers to question 4 on what can make this a more effective form of engagement. Increasingly it is seen as best practice for shareholders to: a) vote all their shares and b) publicly disclose how they have voted their shares. Following this practice shows accountability to the ultimate owner and gives a clear message to companies of how that investor viewed their performance, as expressed by the voting. End beneficiaries of institutional investors have a fundamental right to understand how their investments are being used. Reporting on this on at least an annual basis should be a minimum

requirement.

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

Comments

There have been a wealth of recent publications as well as academic and media commentary on short-termism in equity markets and suggestions for how this can be addressed. Areas to address include, amongst others:

- reduction in the average time investors hold each share;
- increased focus on quarterly performance;
- encouragement of asset owners by consultants to focus on short-term performance;
- requirement for regular valuations by regulation for a balance sheet, solvency or market-transparency purposes (which may take little consideration of long-term factors);
- greater coverage given by the media to short-term performance comparisons between products and funds;
- adoption by sell-side research of a more short-term focus, and
- the growth in new short-term trading strategies by hedge funds (automated trading).

Crucially, current prices in the equity market appear unlikely to reflect the longer-term risk and value of shares if many of those operating in that market pay insufficient regard to long-term factors. If current prices in the market reflected the long-term potential of the shares, then other forms of shareholder engagement would be less important.

<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
It may be helpful to divide possible solutions into those designed to make current prices better reflect long-term considerations, and those on the other hand which are designed to boost the voice of those who operate (or wish to operate) to a "longer than consensus" timeframe and find their voice drowned out, or failing to reach sufficiently far, down the investment chain. EIRIS has recently carried out a survey for the investment community called 'Making Markets more long-term'. Responses are not yet complete, but in this we gave respondents options of various approaches to effectively making long-term issues a larger part of the current valuation of companies including, amongst others: o discouraging a sole focus on quarterly / half-yearly reporting; o asset owners remunerating asset managers on a longer-term basis; o analysts / consultants, including sell-side brokers and buy-side analysts, providing more research into (and using) scenarios that explore how issues that play out over the long term can affect a company's plans and opportunities; o analysts explicitly stating what part of their valuations relate to 5+ years in the future and how they evaluate the company's strengths for that long-term period; o investment consultants need to include longtermism in their advice to asset owners and other institutional investors, particularly when recommending fund managers. Asset owners mandates should therefore have specific reference to longtermism in their investment management agreement and statements of investment principles; o there is also a need to encourage the accountancy profession to devise and promote metrics and indicators that measure risk and long-term stewardship of a company by investors, and o regulators introducing trading schemes designed to price in and internalise more long-term impacts (e.g. carbon markets). In the meantime, investors can also be encouraged to counter short-termism through joining ventures like the UN Principles for Responsible Investment or the Carbon Disclosure Project and by becoming active members. Investors can use voting and engagement strategies to communicate their longer-term concerns directly to the companies in which they invest and work towards clearer mandates for consideration of long-term risk and opportunity at all stages of the investment chain. They can also press directly for directors' remuneration to be geared more towards long-term returns, risk management and opportunities, rather than short-term performance. There is a tendency to only think of longer-term issues (such as environmental, social and governance concerns) once disaster has struck. If investors and other parties considered these issues as part of their mainstream analysis, arguably some disasters could have been avoided, such as the potential disasters oil companies face when operating in fragile environments and on the edge of technical capacities. We need a comprehensive understanding of risks by all, including analysts, civil society and the media; this would pay due, close attention

to all issues and threats to companies in the long term.

It appears to us that there are many suggestions for making markets more long term, but as yet little successful adoption of these. The EIRIS Foundation is hoping to run a project that explores the gap between and obstacles to the adoption of proposals for greater longtermism. We want to aid the development of financial institutions which place long-term value at the heart of their business models to better serve the long-term interests of investors as well as society and the environment.

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

Comments

As noted in paragraphs 4.23 to 4.29 of the Consultation, there are problems between the agency and principal in the investment chain and in some cases potential conflicts of interest with regards to long and short-term perspectives.

There is also the specific problem that many asset owners delegate much of their governance role in relation to their ultimate investments to their investment managers. In relation to many sectors this can work well, and there are many examples of good governance and ESG teams created by asset managers in response to this demand from asset owners. But it is less obvious that the governance of the finance sector itself should be left in the hands of other fund managers who may lack the detachment or ability to question conflicts of interest around excessive focus on the short term, when the same focus is present in their own organisation as well.

Asset owners might therefore be encouraged to give a particular focus to the governance of the finance sector (including asset managers). Due to time and resource constraints, asset owners are limited in the extent to which they can "govern" a whole portfolio of investments though their voice remains an important one; but their unique contribution could be to spend time selecting asset managers that reflect their values, timescales and risk concerns more closely and taking more interest in the governance of the finance sector generally in order to help foster the culture and leadership that can help ensure that the investment chain operates in the long-term interests of the ultimate owners.

As noted in paragraph 4.25 of the Consultation, the income generated by fund managers for themselves through fees related to the number of portfolio changes, is a significant issue. Investment managers need to inform clients how their pay is structured and to what extent their pay linked to short- compared to long-term funds managed, so that the asset owner can make an informed choice of manager. Asset owners could more actively request this information.

In essence, we need to encourage completion of the chain through consideration and communication of long-term issues at all stages. Under the King Code III in South Africa, the direct responsibility of asset owners (such as pension funds) to their members is emphasised through reporting requirements to members. This

ensures that asset owners are more actively interested in including these issues further down the investment chain and receiving reports from their asset managers on such issues.

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

Comments

The benefits could include increased informed choice for asset owners, potentially greater business for the fund manager and general encouragement of investment over the longer term. The costs might be considered to include disclosure of competitive advantage (such as levels of pay), but ultimately, we would expect that greater accountability and transparency would be rewarded by greater confidence in the fund manager. In our opinion, the benefits would outweigh the costs.

At the very least, there needs to be greater transparency between asset managers and their clients, including asset owners. Please see the answer to question 9 above with regards to greater disclosure by asset managers to asset owners on how their pay is structured. Asset owners must give managers a clear mandate. Asset managers can then report back on how this mandate has been implemented. If a long-term element has been included in the investment management agreement, there will be a need to report back on the efficacy of implementing that element of the mandate.

Some asset owners may not be currently aware that asset managers could include long-term risk considerations in their risk assessments of investments, or that they do not. It may be an issue of increasing awareness. For example, in the case of charities investing, this might be a desire to align objects / mission with the impact of a charity's invested money. In this context the EIRIS Foundation has created a free online resource for charities interested in aligning their mission with their investment: www.charitysri.org .

Directors' Remuneration

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

Comments

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

Comments

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

<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
In terms of the linkage between pay and meeting corporate objectives, if senior management and board pay are dictated by short-term considerations, then others working in an organisation are going to be encouraged to work in the same fashion, in order to progress. The resulting corporate culture therefore discourages longtermism. We want to encourage the linking of pay to longer-term performance metrics and appropriate risk management and payment over longer periods of time (i.e. for bonuses and vesting of share options), as an incentive to achieve long-term corporate performance.

Takeovers

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

Comments

<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

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

Comments