THE
INSTITUTE OF
CHARTERED
ACCOUNTANTS
OF SCOTLAND

Response from
The Institute of Chartered Accountants of Scotland
to the Department for Business Innovation & Skills

A Long-Term Focus for Corporate Britain

14 January 2011

INTRODUCTION

The Business Policy Committee at ICAS welcomes the opportunity to respond on the Department for Business Innovation and Skills call for evidence on a long-term focus for Corporate Britain.

As the Institute's Charter requires, we act in the public interest, and our proactive projects and responses to consultation documents are therefore intended to place the general public interest first, notwithstanding our charter requirements to represent and protect our members' interests. The Institute's Business Policy Committee is broadly based with members drawn from practice, industry, the investment community and also the legal profession.

The Committee acknowledges the view held in some quarters, particularly in relation to the recent activities of hedge funds, that there should be some restrictions introduced to curb excessive short-termism. Conversely, the Committee also acknowledges there is a contrary view held by others that this is no more than a single cog in the overall market picture and should not be seen as something that is inherently unhealthy. We have a certain amount of sympathy with the latter view and would refer the Secretary of State to the final paragraph in his own foreword to the call for evidence:

"The best solutions are those which are owned and driven by market participants, investors and companies. We need clear, consistent rules which work with the grain of the market".

In the last year, we have seen changes to the UK Corporate Governance Code, the introduction of a UK Stewardship Code for institutional investors and also a review of certain aspects of the regulation of takeover bids from the Takeover Panel. We believe that in order for all market participants to ensure they are working towards these "best solutions", they must be given a period of stability to operate within the new framework and that any resultant legislation or regulation from this call for evidence may do more to hinder this process than assist it.

We would therefore urge the Government to take a step back at this present time from taking any action which may ultimately "over-regulate" UK businesses to such an extent that it becomes ultimately unattractive to operate effectively in the UK. If the Secretary of State and the Government firmly support the above quote from their call for evidence, they must allow businesses the necessary space and time to evolve and find these "best solutions" within a stable regulatory framework. Indeed, the UK Stewardship Code highlights that it expects the content of the Code "to evolve over time to reflect developments in good engagement practice, in the structure and operation of the market, and the broader regulatory framework" with a decision on the timing of the first review to be taken in the second half of 2011. We believe it would be prudent for the Government to adopt a similar approach.

The key points from the call for evidence which we believe the Secretary of State should consider are:

- Allowing time for the new codes and practices to develop and pulling back from any direct or indirect Government intervention in how the market and/or companies operate;
- Encouraging institutional investors to look to the longer term and place less reliance and expectation on detailed company quarterly earnings statements reports;

- Recognising that the term "shareholder" cannot be thought of as one homogeneous group with similar reasons for holding shares and future aspirations;
- Recognising that the fundamental rights of all shareholders must be upheld and any attempt at disenfranchisement would not welcomed;
- Leaving the issue of fund managers' remuneration to evolve via the Stewardship Code and not be a matter for regulation;
- The Takeover Panel in the UK is respected worldwide and is better placed to oversee the processes involved in takeover bids than Government;
- The current bid process already has sufficient safeguards for shareholders of the acquirer company in major transactions and there is no need for Government intervention.

Our responses to the consultation questions are set out below.

The Board of Directors

Q1: Do UK boards have a long-term focus – if not, why not?

We believe that while boards need to manage their company's operational issues on a short-term basis, they are sufficiently and effectively focussed on and engaged in their strategic development of their business for the longer-term.

That is not to say this is an easy process, with boards ever mindful of shareholder and analyst expectations, which can require statements of earnings and financial position to be reported on a quarterly basis. We would acknowledge this is not a UK requirement, unlike interim management statements, but is standard practice in the United States and has been adopted by many UK companies. As such, we believe that if a long-term focus is to be achieved, there needs to be a realisation by shareholders and analysts that relying on such short-term reports and measures to request changes in strategy or tactics is detrimental to that goal. We also believe that there may be an onus on companies whose short-term performance can be more volatile to enter into a process of education with the markets to ensure that their business model is sufficiently explained and their trends understood through high quality narrative and other reporting as well as briefings.

Boards also have the added pressure brought about by the recent revised UK Corporate Governance Code where directors are now faced with the prospect of annual re-elections. We commented to the Financial Reporting Council (FRC) in March 2010 that we did not agree with the proposal for annual re-elections as this does not sit easily with the principle of the board being responsible for the long-term success of the company and we firmly remain of that view. In particular, boards have to guide companies through the business cycle for their industry, and this requires steadfast adherence to long-term goals which may need explanation to shareholders where in the short term events drive adverse results. This is again an area where shareholders have a part to play in better understanding these cycles and thus having the confidence in the board that they know the operations of the business sufficiently in order to deliver results and add to shareholder value in the long-term.

Q2: 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?

Whilst unravelling nominee holdings can present challenges for some companies, it is by no means an impossible task under the current legal framework and it should be well within the capabilities of companies, albeit perhaps aided by specialists, to access whatever information they require. In some circumstances, shareholders may be represented to companies as 'fiduciary clients' of a fund manager and requests to understand the true beneficial holder are rebuffed. The law should permit a full understanding of who the beneficial holders are through an s793 request under the 2006 Companies Act.

We also believe this is an area where the Stewardship Code will provide some assistance, at least from the UK share ownership perspective.

Shareholders and their Role in Equity Markets

Q3: What are the implications of the changing nature of UK share ownership for corporate governance and equity markets?

The UK competes in a global market and in attracting overseas companies to list on a UK stock exchange, invariably leads to an increase in overseas shareholders. With regard to the ownership of UK companies, we see no real concerns in an increase in overseas ownership. In terms of outlook, we do not perceive that overseas pension funds, for example, would have a markedly different approach or attitude to their shareholding than a UK based pension scheme. The situation with Sovereign Wealth funds may differ where there could be other reasons for the share ownership but ultimately, we do not consider these to be of material concern.

Our main concern would be as we expressed to the FRC in response to the consultation on the UK Stewardship Code, which is the first code of its type in the world and is applicable only to UK investors. Non UK based investors are encouraged to engage with the Code and we believed this may have the unintended consequence of placing UK institutional shareholders at a commercial disadvantage in the UK with the lack of a level playing field when compared to their overseas counterparts.

We would acknowledge that take up of the UK Stewardship Code has been encouraging but the list of organisations with published statements on the FRC website unfortunately does not highlight the level of overseas engagement with the Code.

Engagement and Dialogue

Q4: What are the most effective forms of engagement?
Q5: Is there sufficient dialogue within investment firms between managers with different functions (i.e. corporate governance and investment teams)?
Q6: 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?

We believe that from an institutional shareholders' perspective, effective engagement can only take place via regular face to face meetings with the company Chairman/CEO/CFO/senior executive management. These meetings should focus on strategic matters for the company at present and going forward. It is widely acknowledged that meetings such as this are already commonplace for the largest companies and remain of great importance for both the company and institutional investors. It is also worth noting that Principle 3 of the UK Stewardship Code states that institutional investors should monitor their investee companies and that they need to determine when it is necessary to enter into an active dialogue with their boards.

We also believe there is a place for a separate meeting between the company Chairman and institutional shareholders, probably on an annual basis. This would show a clear signal of intent on both sides for effective engagement and include discussions on a number of topics including Governance related matters.

We would also comment that from the smaller shareholder perspective, the provision of clear, timely and unambiguous information and communication on company issues as well as the opportunity to speak openly at the AGM is in all probability the full extent of engagement at this level.

Voting is important as it provides shareholders the opportunity to express their views to management on the specific issues under consideration. Whether or not it is considered an important form of engagement is another matter and we would conclude that it is not always as effective as it should be with votes being withheld or even shares being sold prior to the vote rather than investors entering into dialogue and airing their concerns to management to try and find a constructive way forward. Adherence to Principle 4 of the UK Stewardship Code whereby institutional investors are encouraged to establish clear guidelines on escalating their activities as a method of protecting and enhancing shareholder value should hopefully make institutional shareholders consider their options more carefully before deciding on a particular course of action.

We would also hope that Principles 6 and 7 on the need for a clear policy of voting and disclosure of voting activity and also the periodic reporting of this will also act as a catalyst to institutional shareholders and their voting behaviours. The recent introduction of new disclosure requirements by the Financial Services Authority should lead to greater clarity on the position of institutional investment managers on stewardship matters. Nonetheless, many institutional holders vote their shares in accordance with the wishes of their clients. Disclosure has to reflect these underlying shareholder decisions, not the nominee position in order to give any clarity.

Short Termism, Agency and Transparency in the Role of Fund Managers

Q7: Is short-termism in equity markets a problem and, if so, how should it be addressed?
Q8: 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?
Q9: Are there agency problems in the investment chain and, if so, how should they be addressed?
Q10: What would be the benefits and costs of more transparency in the role of fund managers, their mandates and their pay?

Markets, by their very nature, are imperfect and this can throw up from time to time "curve balls" which causes uncertainty and anxiety for some shareholders and companies. The market does not always get things right but again this is only to be expected in a market led economy. Can the Government legislate/regulate to create what they perceive as "perfect" market conditions? It is arguable as to whether or not this is possible or ultimately desirable.

Whilst we do not agree with or condone the type of selling behaviours that came to light in the proposed sale of Cadbury plc to Kraft Inc in late 2009/early 2010, we do not believe that restricting the rights of shareholders, irrespective of how long they have been shareholders, is appropriate, warranted or necessary. One of the benefits of a market economy and a share market is liquidity. Restrictions on that for any group of shareholders risks an increase in the cost of capital, and that would not be a good result. We believe that the Government must place a greater emphasis on "selling" the benefits of taking a long term view to shareholders as opposed to quick "knee-jerk" reactions to curb what they see as the unacceptable practice and behaviours of short termism.

We believe the Government needs to effect a cultural change in its thinking of shareholders and recognise that the term "shareholder" cannot be thought of as one homogeneous group with similar reasons for holding shares and future aspirations. The Government needs to appreciate the individuality of shareholders (institutional or otherwise), understand their reasons for holding the shares and provide them with compelling reasons as to why they should think about their shareholding in the longer term. In our view, this may only be achievable through the provision of fiscal incentives for long-term ownership which itself is not a perfect solution, but may be the only one open to the Government to cause the sea change in responsible share ownership that they believe is required. We do not regard increased regulation as being the way to effectively deal with what the Government views as short-termism and to encourage greater shareholder engagement.

Whilst we would acknowledge that the growth of hedge funds has introduced a new short term dynamic to markets in recent years, we are unsure what specific regulatory measures could be taken here without significantly altering the historic and fundamental rights of shareholders. We do not consider that any kind of disenfranchisement is a viable option.

Whilst the new UK Stewardship Code provides guidance on voting policies and their disclosures and subsequent reporting, it does not provide any assistance as to how fund managers are paid. Whilst we would acknowledge this is a sensitive area, we would regard the disclosure of some basic information on the terms of the fund management contract as the next logical step in the evolution of the Code and not necessarily a matter for increased regulation at this present time. A clear description of the terms of fund management contracts (where these are not already required) would assist in making the role of the fund manager more transparent.

We would however acknowledge the practical difficulties that may exist with this type of disclosure and appreciate the sensitivities that exist in a fund manager/client contractual relationship. We would consider a system whereby the clients and prospective clients of fund managers are made fully aware of the remuneration codes and structures that exist through the initial tendering process could assist in aiding the transparency surrounding the remuneration of fund managers.

Directors' Remuneration

Q11: What are the main reasons for the increase in directors' remuneration? Are these appropriate?
Q12: What would be the effect of widening the membership of the remuneration committee on directors' remuneration?
Q13: 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?
Q14: 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 would initially take this opportunity to comment that the vast majority of issues in relation to remuneration seem to have arisen from the problems that emanated from the crisis in the banking sector rather than business wide issues. We remain to be convinced this link is entirely warranted. We would also comment that remuneration is a very emotive issue and what may seem "reasonable" to one person (particularly in an international context) may be regarded as "excessive" to another (in say a local context) depending on a number of different factors which influence and motivate the individuals concerned. This can make it difficult for a constructive debate to develop especially where the international and local contexts are so remote from one another.

With many large companies operating on the international stage, and wide mobility of top executives, it is impossible to ignore global pay comparisons on remuneration whilst paying attention to acceptable practice in the UK. It is a fact that on occasion, you have to sometimes pay over the going rate to attract the best talent. A number of leading UK institutions have produced clear guidelines on remuneration which in the main have been successful in driving good practice in aligning reward with performance to eliminate "reward for failure". We also believe that evidence suggests there has been greater moderation in Executive Remuneration arrangements over the last few years and we see no reason for this to change, especially as a result of increasing shareholder engagement.

We do not believe that widening the membership of the Remuneration Committee would be beneficial or lead to material changes in directors' remuneration. The Remuneration Committee must have members who have a full understanding of the company's strategy, and we believe that the current Non-Executive Director structure is still fit for purpose. It must be noted that Remuneration Committees should, can and do take independent advice on the remuneration structures they propose and their appropriateness to the company and the general remuneration environment. The last few years have undoubtedly brought about a greater awareness of the correlation between pay and performance and we believe this trend will continue, with boards and Remuneration Committees being mindful of the adverse shareholder and press reaction should they be seen to be advocating large remuneration increases on the back of posting poor results.

We can see there being some merit in linking executive pay to meeting corporate objectives but would advocate this is a decision for boards and shareholders to agree on and should not be one that has arisen through legislation or regulation. However, we see no merit in a company being required to produce a comparison in the relationship between directors' pay and employees' pay. Whilst this may provide a good story for the press, we view this as being divisive and misleading as it is a calculation for the sake of a calculation and does not provide a true evaluation of what it is trying to measure.

Takeovers

Q15: Do boards understand the long-term implications of takeovers, and communicate the long-term implications of bids effectively?

We regard this question as implying that some boards have a poor understanding of the acquisitions they are making and the longer term effects of those acquisitions for the business in general. Boards have to act in the best interests of their shareholders and make decisions on the available information that will hopefully provide for an increase in shareholder value and we would suggest that these are decisions boards do not take lightly. We are confident that boards take great care when considering the long term implications of bids and that every effort is made to communicate these simply and effectively to shareholders

Q16: 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 do not agree with the suggestion that the shareholders of the acquiring company should, in all cases, be invited to vote on takeover bids. As we noted in our response to question 15, boards have a legal duty to act in the best interests of the shareholders and we see no reason why this duty should be diluted in the manner described.

The Listing Rules already require listed companies to seek the approval of their shareholders in General Meeting for bids classed as a major transaction relevant to the size of the company. These Class 1 transactions compare the size of the listed company with the size of the transaction in question (the threshold being 25% under any one of the class tests: assets, profits, consideration to market capital and gross capital). We would also suggest that in practice, and in keeping with good governance and investor relations, the larger and more influential institutional shareholders already make their views known about a particular acquisition to the company and we see no need for this process to be formalised. We would also comment that any move such as the question suggests could prove to be fairly emotive and risks preventing perfectly good deals (for all concerned) from taking place due to sentimentality taking precedence over the business decision process.

We would finally point to our response to question 3 above on the changing UK corporate share ownership landscape. We fail to see how the measure alluded to in this question could be effectively introduced with regards to a situation where a UK owner company and a non UK owner company are bidding for the same target company and believe that the Government would be placing unnecessary obstacles in the way of UK companies in such a situation. We regard this as unhelpful, unwelcome and unnecessary.

Other

Q17: Do you have any further comments on issues relating to this consultation?

We have no other comments to make.