A Long-Term Focus for Corporate Britain

Joint response of the Company Law Committees of the City of London Law Society and the Law Society of England and Wales

The City of London Law Society ("CLLS") represents approximately 14,000 City lawyers through individual and corporate membership including some of the largest international law firms in the world. These law firms advise a variety of clients from multinational companies and financial institutions to Government departments, often in relation to complex, multi jurisdictional legal issues. The CLLS responds to a variety of consultations on issues of importance to its members through its 17 specialist committees.

The Law Society of England and Wales ("Law Society") is the representative body of over 140,000 solicitors in England and Wales. The Society negotiates on behalf of the profession and makes representations towards regulators and government including the EU institutions.

We are pleased to have the opportunity to respond to the call for evidence from the Department for Business, Innovation and Skills on the existence of short-termism and market failures in UK equity markets. This response has been prepared by a working party comprising members of the Company Law Committees of the CLLS and the Law Society. These committees are made up of senior and specialist corporate lawyers.

Our comments below are made with reference to the numbered questions in the call for evidence paper.

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

We offer no answer to this question - which we think falls principally to directors to answer. However, we offer the following observations:

the statutory expression of the fiduciary duty of directors "to promote the success of the company" and the requirement that directors must "have regard … to…the likely consequences of any decision in the long term" [1] does not exclude proper consideration of short term factors;

- it is likely that the relative emphasis on longer and shorter considerations will be influenced by the nature of the decision.

- the decisions boards have to take in relation to takeovers (which are transactions between the bidder and shareholders (and not the company) and on which therefore

[1] Section 172(1)(a), Companies Act 2006

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shareholders make the final decision) are qualitatively different from those they take in relation to the management of the business of the company and transactions entered into by the company. In relation to takeovers, therefore, whether the outcome is determined by long or short term considerations is a question about how shareholders (not boards) reach their decisions.

Boards do, of course have a significant role to play in relation to takeovers and we expect that the changes to the Takeover Code that the Panel has outlined[2] will reinforce the position of boards of target companies by providing increased protection for boards against hostile bidders (particularly in relation to hostile "virtual bids"). However, it is clear that under the current system boards are expected to facilitate takeover transactions where they believe that will provide the best financial outcome for shareholders. Such facilitation takes two principal forms: (a) opening the company's books for a bidder to carry out due diligence and (b) offering a recommendation to their shareholders as to whether to accept the offer. In the case of a cash offer this involves assessing the value of the cash in hand against the longer-term, but inevitably uncertain, future value of the target company on a standalone basis. It is possible to contemplate a system in which the board has a greater role in takeover decisions (for example, the US system discussed in relation to Question 6) but any move to such a system would involve a fundamental rethinking of the roles of boards and shareholders in the UK corporate governance system.

Question 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?

We note that paragraph 3.10 refers only to companies' investigatory powers under Part 22 of the Companies Act 2006. For listed and quoted companies[3] the disclosure regime under chapter 5 of the Disclosure and Transparency Rules requires the proactive disclosure by shareholders whose interests represent 3% or more of the votes exercisable at general meetings. In the context of a takeover bid, the Takeover Code requires disclosure of interests that represent 1% or more. In our view, the combination of the DTRs, the Part 22 powers and Takeover Code disclosure rules provide such companies to obtain the information they require on the identities of their principal shareholders. We note that the existing regime requires disclosure of a broad range of interests in shares (in addition to beneficial owners holding shares through nominees, the interests that must be disclosed include interests arising from agreements to acquire shares, derivatives that relate to the shares and entitlements to deal with voting rights). We do not see any reason to change this regime (for example, by reducing the threshold for disclosure), which is now reasonably well understood[4]. Any change would have cost implications for investors, which would have to be balanced against any benefit that was perceived to be gained from a change.

We believe that Part 22 gives unquoted public companies sufficient power to obtain information on the beneficial ownership of their shares.

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[2] In the Response Statement to the consultation launched in June 2010 (Statement 2010/22 21 October 2010).

[3] This includes companies whose shares are admitted to trading on the markets operated by the London Stock Exchange or by Plus Market.

[4] We also note that the 3% level for disclosure under the DTRs is lower than that required under the Transparency Directive (5%). Adopting a lower threshold would represent further gold-plating.

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

We do not comment on the implications for equity markets. In relation to corporate governance, we note the following as possible implications:

- codes of conduct for shareholders (such as the Stewardship Code) will have diminished significance if only UK based institutions commit to following them.

- code of conduct for companies (such as the UK Corporate Governance Code) that are not mandatory but operate on the basis of "comply or explain" may have less force if non-UK institutional shareholders are not interested in whether their investee companies comply.

- non-UK shareholders may not fully understand the checks and balances inherent in the corporate governance system in the UK and may seek to apply strategies that are effective in their home jurisdiction but which have a different effect on the board of a UK company.

- the increased diversity of shareholders can, at least in some cases, make it more difficult in practice for directors to decide what is “for the benefit of [the company’s] shareholders as a whole” as required by section 172 Companies Act 2006.

- some non-UK institutional investors may be more likely to rely on voting preference services without being prepared to invest the time in a dialogue with companies, which may lead to those services exerting a disproportionate influence.

We are not suggesting that there is any reason to discourage non-UK shareholders (even if that were a practical option). It is not necessarily the case that the objectives of non-UK based shareholders are different from those of UK-based investors. Furthermore, non-UK based investors make an extremely important contribution to the liquidity of the London equity markets and so to reducing the cost of capital for UK issuers.

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

We offer no answer to this question.

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

We offer no answer to this question.

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?

Voting as a form of engagement

The *opportunity* to vote, in particular on the election or re-election of directors, or their removal, is a cornerstone of the corporate governance system in the UK. The fact that such votes rarely go against the proposals made by boards does not indicate any failure of the

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system but rather that it forces boards to take into account the wishes expressed by their shareholders (including the guidelines published by voting advisory services) and encourages engagement in advance between boards and their shareholders. Contentious votes (where a substantial number of shareholders do not support a proposal put by the board) often indicate a failure of engagement.

In the UK, the emphasis is on shareholder voting as the primary means by which shareholders can hold boards to account (with almost no recourse to litigation). This provides shareholder control at lower cost than a litigation based system. However, the inevitable consequence is that boards are more susceptible to the demands of shareholders. If those shareholders have short term objectives, boards will not be encouraged to focus on longer term value creation.

Two key features of shareholder control in the UK system that have the effect that shareholders are able to drive the strategic objectives of companies are:

- the ability of shareholders to remove directors by simple majority;

- the requirement under Chapter 10 of the Listing Rules for shareholder approval of material transactions (Class 1 transactions).

The first of these is the principal reason the threshold at which takeovers may become unconditional is set at 50% of voting shares. This principle could be changed but doing so would have an important effect on the balance between shareholders and boards. It would be seen as entrenching management. In the context of the current debate some might consider that desirable, if it is thought that boards generally have a longer term view than shareholders (we express no view on that).

The second is important because it imposes a constraint on the freedom of boards of companies with a Premium Listing in London that is not generally a feature of the listing regimes in Europe and the US. This requirement puts premium listed companies at a significant disadvantage when competing for assets with companies that are not subject to the same requirement (to a seller of an asset, a purchaser with a “walk away” right for its shareholders is much less attractive than one without such a right). It may also prevent boards pursuing transactions with long term benefits but short term costs, if they are not confident that a majority of shareholders will give their support.

We note that in paragraph 2.5 it is said that :

> “The British model puts more emphasis than the US model on the importance of shareholders being able to hold the directors of the company to account…..”

While this is true if one looks at shareholder voting as the means of holding directors to account, the courts provide an effective means of achieving that end. While in the US it was formerly much more difficult than in the UK for shareholders to exert direct control by removing directors (although that is changing), instead, shareholders in US companies have been able to use litigation to constrain the actions of their boards, when they diverged from the requirements imposed on them by the law. However, in doing so the US courts have given boards a measure of freedom to concentrate on the longer term and resist shareholder pressure for short-term value.

We are not advocating a change to the current approach in the UK but we think it important that any policy decisions in this area recognise that the system of corporate governance in the UK is a complex combination of legal requirements, generally accepted behavioural

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norms and market pressures. Any adjustment to the system must beware of the potential for unintended consequences if any part of the existing intricate balance is disturbed.

Shareholder disclosure of voting

We are not in a position to comment on the costs and benefits of requiring shareholders to disclose how they exercise their votes but we do suggest that care needs to be taken that increased transparency in this area does not lead investors into unquestioning adherence to the recommendations of voting preference services. Some institutional investors may not be prepared to pay the costs of a proper review and individual decision making on each proposal in relation to all individual investee companies in their portfolio (it may not be economically rational for them to do so) If forced to vote in these circumstances investors may delegate voting decisions to others, by following the recommendations of voting preference services. We perceive that the experience in the US suggests that this would be the case. As we have noted above there is a risk that voting preference services could come to exert a disproportionate influence.

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

We offer no answer to this question.

Question 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?

One of the factors that may encourage the short-termism identified in paragraph 4.23 is the difficulty in measuring performance of a company against its longer term strategy, which can lead shareholders to focus on shorter term indicators, such as quarterly reports and share prices. If markets are reasonably efficient, it should be the case that the current share price approximates to the value of the share in the longer term, ignoring specific events such as potential takeovers or capital raising proposals. If that is the case, one way to encourage a longer term view in equity markets could be to improve the communication by companies of the financial implications of their longer term strategy and of the way current period results are likely to affect the reporting company's ability to deliver those financial results.

Companies in the UK have traditionally been more reluctant than in other markets to provide clear financial guidance on longer term prospects. We perceive that this is an ingrained cultural approach, which we believe may have its roots in, or at least is reinforced by, two aspects of the regulatory regime within which listed companies operate:

- the rules on profit forecasts (both under the Prospectus Rules and the Takeover Code) discourage companies from producing explicit forecasts, at least for the near term - listed companies are materially constrained in their willingness to provide meaningful forward-looking financial information because profit forecasts published as part of regular reporting may require to be repeated (in circumstances where the directors face personal liability without the benefit of the protections provided by section 463 of the Companies Act 2006) and reported on by independent accountants;

- the way the continuous disclosure obligations (for listed companies, under Chapter 2 of the Disclosure and Transparency Rules, implementing Article 6 of the Market Abuse Directive) are interpreted and enforced by the FSA tends to mean that if a company has provided financial guidance on its longer term prospects but there is a change in

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circumstances that makes achievement of that guidance more challenging it will be required to make early disclosure of that by issuing a profit warning. Generally markets react adversely to such disclosures and companies may be reluctant to give guidance in order to reduce the risk of having to issue profit warnings.

If it is desirable to encourage UK companies to provide better forward-looking information, we think the rules require a major overhaul with a view to creating a climate in which efforts made in good faith by management to identify longer-term financial prospects are not perceived to expose the company concerned, and its management, to unacceptable regulatory risks. It may not be easy to achieve a balance between, on the one hand, the requirements of investor protection (given the risks associated with forward-looking statements that are inevitably to some extent speculative) and keeping the markets informed and, on the other hand, the need to facilitate better long term disclosure, but we think the effort should be made.

A regime that encourages companies to provide clear guidance of their financial prospects together with the companies' assumptions regarding external factors and risks that may prevent achievement would provide a sounder basis for focus on longer term performance.

We take it that the second part of the question is seeking views on the costs and benefit of provisions that would reward longer term holding of shares, which might include:

- a minimum holding period before a shareholder becomes entitled to vote
- multiple votes attaching to shares held for a long period
- providing other benefits to shareholders (e.g. an enhanced dividend) held for a long period.

The first point we would make is that there is nothing in UK company law as it stands, or in the rules applicable to listed companies, that would prevent a company adopting such provisions, although we are not aware of any that have done so. We express no view on whether such provisions would be desirable (or on their costs and benefits) but note that any provisions of this kind would have to deal with a number of problems including:

- whether the reward for long term shareholdings would depend only on registered holdings or would look behind that to beneficial ownership of shares held by a nominee (or more complex forms of indirect ownership); a system that looked only to the registered position could be easily avoided but a system that tried to go behind the register would be (a) complex (and would not be certain of success[5]), and (b) inconsistent with the basic principle that shareholders' rights depend on the register;
- if the reward was in additional votes, it would become considerably more difficult for companies and their shareholders to know who controls the votes attached to shares; the total number of votes and therefore the percentage of votes held by any shareholder would fluctuate with changes in the numbers of shareholders qualifying as long term holders;
- providing a financial reward would create complexity for companies (which would find it difficult to know how to fix a per share dividend).

[5] For example, it would not be easy to look through arrangements that maintained ownership but transferred the economic benefits.

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This idea is not very different from the share structures with differential voting rights that were formerly used to retain control of a company within a limited group (for example a family). The enhanced voting shares were generally closely held and illiquid. Institutional shareholder opposition to such arrangements led to the unwinding of most of these structures.

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

We offer no answer to this question.

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

We offer no answer to this question.

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

We offer no answer to this question.

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

We assume that widening the membership of the Remuneration Committee contemplates including non-directors on the committee. If this involved giving non-director members of the committee the right to participate in the decision-making process, it would be necessary to deal with the following questions:

- who would decide on the appointment?
- what duties would such members have and to whom?
- how would the non-director members be made accountable for their decisions?
- would the board's responsibility for the management of the company be diminished?
- if there were more non-directors than directors and the decision taken differed from the views of the directors, how would this affect the duties and potential liabilities of the directors?

Although it would be possible to deal with such questions we think it is preferable for executive remuneration to remain a matter for directors, operating within the well-defined legal framework of duties that applies to them.

We think that any proposal to include non-director members to represent shareholders would be particularly problematic, and should be unnecessary. The independent non-executive directors who sit on the remuneration committee are representatives of all the shareholders.

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The problems described above would not be so acute if the proposal was limited to requiring remuneration committees to include non-director members who would not have a vote, although the problem of how they would be appointed would remain. If the objective is to ensure that a broader range of inputs is taken into account by remuneration committees in making their decisions (we do not comment on whether that is desirable) that objective could be dealt with effectively through guidance on best practice, possibly reinforced with a requirement to report annually what steps have been taken.

When considering whether any specific proposal should be taken, careful consideration should be given to the importance of maintaining the attractiveness of the UK as a place for companies to list their securities or to incorporate. Companies have a choice on these matters. Imposing requirements that are regarded as inhibiting the ability of boards to pursue the best interests of their companies would be a major negative factor weighing against the UK when such choices are being made.

In relation to the points made in paragraph 5.11, we comment as follows:

- the UK Corporate Governance Code requires remuneration committees to be composed of independent directors. We are not aware of any reason to think the current standards for independence are insufficiently rigorous;

- if the concern is, as suggested in paragraph 5.12, that the involvement of remuneration consultants is not always "fully transparent", one possibility might be to require disclosure of the substance of the advice received by the committee in reaching its decisions.

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?

We confine our comments to the question relating to possible further areas of pay that might be made subject to shareholder approval.

In relation to the general question, we suggest that the implications of adding to the matters that require shareholder approval be considered carefully before any such proposal is adopted. Experience in relation to the statutory limit on the term of directors' service contracts suggests that a requirement for approval of particular elements of a director's terms of service will often amount to a prohibition. A requirement for approval of a director's remuneration as a whole is impractical (a person considering a prospective appointment is very unlikely to agree to go through such a public process, particularly if still employed elsewhere).

In relation to what the paper refers to as "golden parachutes", the problem is different. Payments made to directors who resign at the request of the board are typically agreed as a settlement of the contractual claim of the director concerned for the premature termination of their service contract.[6] Such a settlement made in good faith does not require approval by shareholders[7]. In practice, the amount that should be paid by way of damages is a matter of

[6] The calculation of damages payable will start with the length of notice required to terminate the contract. The reduction in the length of directors' service contracts to 12 months, which is now the norm as a result of institutional shareholder pressure, has led to a significant reduction in the amounts paid for early termination.

[7] Sections 217 to 219, Companies Act 2006 establish the principle that payments to directors for loss of office require approval of shareholders. Section 220, Companies Act 2006 provides an exception to this:

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judgement, rather than being just a mathematical exercise, and involves consideration of factors such as how quickly the director will be able to obtain another role and at what remuneration. This is the kind of judgment that would typically be left to directors, to be made by them by reference to their fiduciary duties (after taking appropriate legal advice). Is it being suggested that remuneration committees are generally failing to comply with those duties in relation to these payments? Is there any evidence for that? Our experience is that public company non-executive directors take their responsibilities seriously when taking these decisions.

Making such a settlement subject to shareholder approval presents a number of problems:

- what disclosure would be made to shareholders? The alternatives seem to us to be (a) to provide full disclosure of the circumstances and the legal advice received (which we think will be unpalatable to companies and shareholders alike), and (b) to provide a confirmation from the remuneration committee that in their view the proposal represents a "reasonable" settlement in the circumstances. We think alternative (a) is impractical. Alternative (b) amounts to little more than an assurance to shareholders that the remuneration committee believes it has acted in accordance with their legal duties

- if shareholders failed to approve the settlement, the director concerned would still have their legal rights which they would be entitled to pursue through the courts. The information provided to shareholders would be available to the court, which would make it very difficult to dispute liability (by claiming that dismissal was justified) or quantum. The company would presumably be unable to settle at any point without shareholder approval and therefore would be compelled to continue litigating, which could result in the company incurring higher overall costs than if it had been able to settle at an earlier stage

- the costs of convening a shareholder meeting may be material compared to the amount of any proposed payment to the director.

We note that in the US, the recently adopted Dodd-Frank Act[8] requires US companies to offer shareholders the opportunity for a “say on pay” vote (a non-binding vote on executive remuneration, similar to the UK’s requirement for the Remuneration Report to be submitted to shareholders for approval) and for a similar advisory vote on compensation paid to the senior executive officers that is based on or relates to a change of control of the company. The UK’s requirement for quoted companies to include details of termination payments made to directors in the remuneration report and for that report to be subject to a shareholder approval has the same effect and is not limited to payments related to a change of control. We believe this provides sufficient opportunity for shareholders to express their views on golden parachutes. We would not be in favour of requiring a separate non-binding resolution on such payments.

“(1) Approval is not required under section 217, 218 or 219 (payments requiring members' approval) for a payment made in good faith—

(a) in discharge of an existing legal obligation (as defined below), (b) by way of damages for breach of such an obligation, (c) by way of settlement or compromise of any claim arising in connection with the termination of a person's office or employment, or (d) by way of pension in respect of past services.”

The general exclusion of pension payments may be regarded as anomalous, as it does not depend on a pre-existing legal obligation.

[8] The Dodd-Frank Wall Street Reform and Consumer Protection Act.

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Question 14: 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?**

We offer no answer to this question.

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

There is a difference between (a) the long term implications of a bid for the company including its employees, locality, customers and suppliers, R&D etc., and (b) the financial implications for shareholders. The directors' ability to decide what the long term effect of a bid will be for the company depends on the information provided by the bidder about its future plans. Our experience suggests that boards do generally understand the long-term implications of takeovers for the company (based on the information provided by the bidder). However, the amount of focus this receives in board consideration of a takeover offer where the consideration is to be cash may be limited. That is an inevitable result of the focus of shareholders, who are the primary addressees of the board's views on the offer, being on the financial merits of the offer for shareholders. That this is the case is evident from the press comment on any bid, which always focuses on the value case for shareholders. Where the consideration is shares in the combined entity the Board will typically devote much more time to understanding and analysing the combined group, which inevitably involves consideration of the effect on the target company. This is even more so in the case of a merger (by which we mean a combination of two parties of relatively equal size, where no, or very little, cash is paid).

In relation to communication of the implications, there are Code requirements for disclosures to be made and efforts are made to meet those although often, in the case of cash bids, with relatively brief disclosures. Again we perceive that this is because the primary addressees are shareholders who do not exhibit a high level of interest in these disclosures.

Question 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?

In our view, the FSA's Listing Rules provide adequate protection for the shareholders of offeror companies which have a Premium Listing of equity shares as they require shareholder approval of major (Class 1) transactions. We cannot see any case for adopting a materiality standard for public offers that is different from the level applying to other transactions Any reduction in the current test of materiality (25%) would exacerbate the problems discussed above in the response to Question 6 .

There are a number of problems with any attempt to impose this requirement on other bidders:

- we agree with the observation of the Code Committee of the Takeover Panel[9] that "it is entirely inappropriate (and unfeasible) for UK law or regulations to seek to afford

[9] PCP para 7.11, putting the arguments against the proposal.

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protections extraterritorially to the offeror's shareholders (who would not otherwise be protected by UK law or regulations), simply because the company in question was making a takeover bid for a company to which the Takeover Code applied"

- not all offerors are widely held public companies, how would the rule apply, for example, to private equity backed bidding vehicles or a sovereign wealth fund bidder?

- it would be relatively easy for loopholes to be found

- such a requirement could also reduce the certainty of delivery of an offer, to the detriment of offeree company shareholders. If, for example, after an offer was commenced, market conditions changed to the detriment of the offeror, offeror shareholders would be able to vote against the transaction, with the result that the offer would fail, although the offeror might not be able to lapse its offer for any other reason.

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

As has been stated above, the corporate governance regime is finely balanced and changes to the regulation of directors' and or shareholders' duties, rights or responsibilities and any change should be made only after a careful review of the potential consequences. In particular:

- given the very different circumstances of different companies, provisions that save one "good" company from losing its independence could equally inhibit or prevent the takeover of another company whose business would have prospered more under new management;

- overseas investment, may be encouraged by the relative openness of UK capital markets, and anything that removes that attraction could increase the cost of capital for UK issuers and make major recapitalisations such as occurred in 2009 more difficult;

- it would disadvantage London if new companies were deterred from listing in the UK (a number of new entrants to the FTSE 100 in recent years have specifically chosen to domicile themselves in the UK and/or to list in London, thereby opening up investment opportunities in global companies to UK investors and increasing the concentration of capital in the UK capital markets)

- it would be undesirable to add a further incentive for UK companies to redomicile elsewhere.

We have no further comments to add.

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