The co-operative
asset management

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Via e-mail to clgconsultation@bis.gov.uk

A long-term focus for corporate Britain: A call for evidence

Dear Adam,

This submission is made on behalf of The Co-operative Asset Management (TCAM), which carries out the fund management activities of The Co-operative Financial Services (CFS). The Co-operative Financial Services (CFS) is part of The Co-operative Group, the UK's largest mutual retail business with around five million members, more than £14 billion turnover and core business interests in food, financial services, travel, pharmacy and funeral care. The Co-operative Group has more than 5,000 trading outlets across the UK. CFS' merger with Britannia, in August 2009, created a strong diversified financial services business with £70 billion of assets, 13,000 colleagues and nearly nine million customers.

TCAM offers a distinctive responsible investment approach which fully integrates consideration of financial and ESG (environmental, social and governance) issues throughout the investment process. We consider that sound corporate governance in the companies in which we invests is of central importance to create and sustain long-term shareholder value. We also consider that it is the responsibility of institutional investors to act as owners of the companies in which they invest and we will seek to maximise value from our investments by using our influence as a shareholder, through engagement and the use of our voting rights, to further good corporate governance in investee companies.

We welcome the opportunity to respond to the consultation and would be pleased to discuss further the issues raised in our response.

Yours sincerely,

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Introduction to the response

TCAM, like other market participants, has an inherent interest in developing a market infrastructure that allocates capital efficiently while maintaining 'natural capital' such as resources and a stable climate, allowing companies to prosper over the long-term. In seeking out these important goals it is worth remembering that while providing a structure for society to function, financial markets should serve the interests of the providers and recipients of capital; and not act simply as a tool for rent capture by intermediaries across the investment chain.

Economic theory suggests that interests are aligned at every principle-agent juncture in the chain, from the owners of capital, to trustees, to advisors, to the managers of capital, to the ultimate recipients. Meanwhile, the company responds to the signals of its owners by making decisions to provide returns to them over the long-term. Prices will equate to the consensus of investors' expectations about the discounted value of future cash flows. When all these imperatives and agents are working efficiently there should be an enlightened chain of self-interest, to the benefit of all.

The problem is this is not always the case. Due to a number of information asymmetries along the way between the various principals and agents, there is a tendency for mispricing and therefore momentum, eventually causing market bubbles and crashes. It is the perception of momentum in markets, large swings in share prices disconnected from underlying fundamentals, that creates the perception of short-termism. But is this a reflection of what the consultation indicates as a form of short-termism? Momentum investing can also indicate ignorance, irrationality and herd mentality in decisions that may be motivated by sincere desires to create long-term value. Furthermore, it is mis-pricing, its identification and correction that enable competition; that is, benefiting from others' mistakes and in doing so enabling relative performance. In a truly efficient market only tracker funds would be of interest as pockets of mis-pricing would be shut down before they emerged. In reality, every active manager believes he or she is keeping the market honest by participating in the elimination of mis-pricing and being rewarded for this enlightened self-interest by outperformance. But in the absence of perfect information available to all it is logical that that the majority of active investment decisions that identify alleged mis-pricing are, in fact, wrong. Furthermore, sometimes a short-term approach is appropriate for the requirements of the beneficiary e.g. a speculative investor in a short-only hedge fund (despite the destabilising effects that this activity may have on the system). It is important that we understand the illness before deciding on the medicine. What we understand by short-termism in the pejorative sense is a pattern of behaviour perpetually, exclusively focussed on short-term gain with no regard to how individual, accretive and collective short-term decisions end up causing net harm to beneficiaries' long-term interests. Conversely we define a long-term approach as one which is providential, which seeks to be judged by delivering a net benefit to beneficiaries over many years or decades as appropriate with acceptably smooth returns, rather than being judged to have succeeded or failed based on one quarter's results alone.

The biggest intermediaries in markets, banks, have over the last decade contributed to a significant increase in financial liquidity which in turn has lowered trading costs. Liquidity is necessary and beneficial to efficient markets but according to the Bank of England, the evidence suggests that increased liquidity and information availability has led to increased trading and increases in share price volatility. By 2007, investment banks came to account for 40% of aggregate corporate profits in the UK and US, even after investment banks had paid out salaries and bonuses amounting

to 60% of net revenues[1]. These figures alone, while startling, surely expose excessive levels of rent capture by investment banks at different stages in the investment chain.

This could reflect inefficient intermediation by investment banks and is marked by excessive fees and a lack of competition. For example, trading in securities has a natural element of monopoly: trading venues with the largest turnover offer customers the highest levels of liquidity and therefore the best chance of dealing, thereby providing a magnet to business, which the operator of the venue can exploit by higher prices. It may also be the case that dominant investment banks are more the facilitators than the cause of excessive trading, given the long-term historical trend to the splintering and proliferation of shares, increased numbers of public offerings and mass participation in listed markets. This increases the potential for information asymmetries which when combined with a preference for active management and the inevitability that only a minority can outperform means the potential for volatility and error of judgement compounds.

Active fund managers, like TCAM, seek out returns by identifying misvaluations on offer and by doing so, take the prices of companies back to fair value. If a company's value moves beyond our view of valuation then we are duty bound to our clients to sell; the underlying asset is no longer an optimum allocation of capital for the ultimate owners. Such is the speed at which information is processed in the modern world; other investors can incorporate the same information in a relatively short period of time. This means we can hit our target price over a short period of time. We do not consider this a form of short-termism. Neither do we find it inappropriate for a short-term focus to be taken on occasions where the specific circumstances of a company or sector dictate a shorter term priority. For example, different sectors tend to participate in different industrial cycles which to some degree influence the management priorities of the time; albeit that these ought to be at all times underpinned by longer-term objectives.

The primary factor driving fund management decisions are the objectives of the providers of investment mandates, our clients. Where there may be potential for shorter term considerations to impact decisions through the investment chain is in the tendency for mandates to be awarded over a relatively short period of time and for performance to be measured over even shorter time-horizons.

In many ways, active management inherently indicates a contrarian view of the markets; this can mean marginal departures from market valuation or long-term convictions over larger discrepancies that may take longer to unfold. Unfortunately, this means that those fund managers whose judgement is right, but timing wrong, stand a high chance of losing their mandates. This is evidenced by previous market crashes where, for example, fund managers lost mandates (and jobs) for not participating (or contributing) to large momentum swings in capital that were dislocated from genuine capital asset pricing. This was most evident for example during the dotcom / telecoms bubble. The decision of whether to keep or fire an asset manager becomes a battle between fair value and momentum.

Central to this problem is the inherent asymmetry of information between asset owners and managers and hence the role of investment consultants in advising on the process towards identifying the best portfolio of investment mandates. Paul Wooley[2] explains well the problem this asymmetry causes:

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[1] Why are financial markets so inefficient and exploitive – and a suggested remedy. Paul Wooley. 2010.
[2] ibid

"The asset owners have imperfect knowledge of the ability of the fund managers they invest with. This means they have uncertainty over whether underperformance relative to a benchmark arises from the manager's prudent avoidance of over priced companies or rather, is a sign of incompetence. As shortfalls grow, investors conclude the reason is incompetence and react by transferring funds to outperforming managers, thereby amplifying the price change that led to the initial underperformance and generating momentum."

For this reason, investment consultants have a very important role to play in markets by overcoming imperfect knowledge. It is the investment consultants that guide the asset owners' perception of performance and how they construct investment agreements. However, we cannot ignore that consultants generate more fees from more mandates and even more fees from the churn of mandates. Why are pension funds advised to seek such extensive diversification at mandate level as well as fund portfolio level? Studies indicate that the principle benefit of diversification, to reduce portfolio volatility, reduces rapidly after 20-50 stocks (though the benefit of diversification varies according to the stability of prevailing market conditions). As well, let us not forget that it is the consultant that will advise the asset owners on the above scenario described by Paul Wooley. It is rather convenient for consultants to focus on the performance of a fund over the relatively short past, as this is more likely to bring about mandate churn and therefore more fees.

One impact on how fund manager performance is appraised and therefore the nature of investment mandates relates to the changing role of equities in portfolios. The existence of stamp duty on shares, the repeal of the dividend credit and the different tax treatment of debt and equity are examples of how the tax system discourages the ownership of UK equities. A consequence of the rebalancing of typical mandate portfolios by insurance and pension funds towards lower yielding asset classes has been that those funds left in equities are required to make even greater returns in order to make up for the relatively low returns elsewhere.

As outlined, the combination of excessive intermediation, asymmetric information, momentum and excessive portfolio diversification leads to a market architecture that has a tendency to veer towards short-termism, or rather inefficient capital allocation. There is no single smoking gun; rather there is a combination of decisions made at every stage of the investment chain, running all the way down to a manager's final capital allocation into the economy. We have highlighted various issues and proposals in response to the specific questions of the consultation that relate to problems further down the capital chain; however, while these are important to the functioning of markets, unless the importance of a long-term focus is hardwired into the beginning of the chain, into the decisions taken by the asset owners, we are doubtful of their success.

We therefore consider it imperative that trustees think very carefully about how they structure asset management mandates, with a particular focus on time-horizons of contracts, the time over which performance is measured and consideration of trading costs. We would advocate further enquiry into the nature of existing agreements and how they could be designed to mitigate short-term pressures down the investment chain. For example, the volatility and distortions caused by mispricing, as discussed, mean that equity indices may not always represent optimal portfolios and therefore should not always be the holy grail of performance appraisal.

A starting point is to lengthen the performance review time period and reduce emphasis on relative returns. One solution that wouldn't entrench asset managers on long fixed term contracts would be to appraise their performance on a rolling basis

over three to five years and applying performance water marks. In terms of fee arrangements, asset owners should consider introducing performance fees that are spread over multiple years. In measuring performance it may be beneficial to supplement index comparisons with broader fundamental indicators of economic performance, for example, GDP growth.

Finally, we strongly advocate the inclusion of stewardship responsibilities into investment agreements. As pointed out at various stages through this response, the legitimacy of the modern system rests on the strength of the relationship between the shareholders and directors. This assumes full participation by both parties within the comply-or-explain framework. We propose that asset owners consider tying a meaningful portion of fees to the quality of stewardship provided by their investment managers. Indeed they could go further and stipulate minimum stewardship requirements in their tender selection process. It does not require a great deal of re-working to accommodate this model for differing investment styles.

However the scale of the turnaround cannot be underestimated. The current market infrastructure and characteristics described above are inimical to the principle of stewardship which compels investors to investing for long enough to make it worth their while stewarding rather than trading. As long as the market is strongly influenced by speculative, hyper-sensitive trading adopting a stewardship stance by the few is essentially a symbolic protest vote with occasional wins. This is why structural reform, which is backed by attitudinal change about what it means to be a fiduciary is required to align enough of the market to fully justify the cost-benefit to stewardship.

The Board of Directors

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

In general, we find that companies develop strategic plans that reflect the time-horizons of their respective industrial cycles however it is frequently the case that communication of these plans to stakeholders requires improvement. Importantly, our sense is that companies with the intention of long-term thinking may be compromised by the influence of short-term movements in the share price. This has implications given that all executive directors' performance pay is in some way tied to the share price.

Studies into the area find that senior management are fearful that long-term capital investment decisions regarding, for example, research and development will scare investors due to the high up-front costs. For example, in the U.S. a survey[3] of 400 executives found that a staggering 80% would decrease spending on items as diverse as R&D, advertising, and maintenance in order to meet short-term earnings targets. Approximately half also indicated that they would mothball projects even if it meant sacrificing genuine value creation over the long-term. The tendency also of markets to react hyper-allergically to short-term bad news only re-enforces timidity and decisions based on avoiding censure rather than creating long-term value, analogous to the dilemmas faced by democratically elected governments seeking to ensure re-election.

[3] Breaking the short-term cycle, CFA Centre for Financial Market Integrity / Business Roundtable Institute for Corporate Ethics, 2006.

Such factors are particularly problematic for society in the context of the sustainability challenges that society faces at the current time and given that a significant number of industries with the highest intersection with sustainability, particularly the utilities, are now publicly listed. Long duration infrastructure, such as power generation assets, gas distribution, water storage and distribution and transport infrastructure, will be operating in ecological contexts that are markedly different from those of today, yet such considerations will fall outside the planning horizons of the current management teams, and certainly outside of their incentive structures.

<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?

The relationship between principle and agent, the shareholders and the directors, is the cornerstone of the UK market. The system is underpinned by the comply-or-explain framework that seeks to overcome agency problems with a Corporate Governance Code. The ownership model relies on good quality explanations by companies and a fully engaged shareholder base. Given that there is such a strong emphasis on the dialogue between shareholders and companies it is entirely illogical to not have a fully transparent ownership landscape. We support mandating full disclosure of the shareholder register.

The legitimacy of modern corporate governance rests on the premise that, in shareholder elections, shareholders are economically motivated to vote in a manner that maximises the value of companies' shares. Voting and economic interests are assumed to be aligned. This alignment has been severed due to the changing nature of ownership via the proliferation of cash settled derivatives such as Equity Swaps or Contracts for Difference; economic interest can be dislocated from legal ownership.

It is surprisingly easy for investors to construct portfolios that increase in value as a company's stock price declines while retaining the right to exercise influence by casting large blocks of shares at shareholder elections – a typical total return equity swap. The risk then arises that the investor is motivated to vote in a manner that causes economic harm to the company. Remarkably this can all be done unbeknown to existing shareholders, which we find entirely incongruous to market transparency, given the price signalling implications.

While in the UK s.793 (CA. 2006) has helped to a degree, the disclosure framework could go a lot further. The issue of equity derivatives is currently being considered at European level under the Transparency Framework and we certainly urge regulatory bodies in the UK to take an active role in the debate.

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?

As picked up in the précis to the consultation document the composition of owners in the UK market has undergone major changes over the past 20 years, with ownership of UK equities by UK institutional investors has decreased from around 60% to 40%. Such a fundamental shift inevitably brings new realities to the principal – agent

model. As mentioned above, another change has seen the rise of alternative equity instruments, which can distort the concepts of beneficial and economic ownership.

There are a number of factors driving the changes in ownership, including the general trend of international diversification of equity assets, as well as more specific factors increasing the asset allocation of bonds relative to equities for pension and insurance fund investors, both naturally long-term investors. For pension funds the repeal of the tax credit for dividends directly reduced returns and the attractiveness of the equity allocation, while the general aging of the workforce increases the requirement for yield compared to capital growth. Regulation has also driven pension funds towards bonds, with increased liability matching regulations, while MiFiD has similarly driven an increased weighting of bonds at insurance companies. One consequence of these changes is that they increase the return requirement placed on the remaining equity portions.

As pointed out in question two, the legitimacy of the modern system inherently rests on the full participation of both companies and investors within the comply-or-explain framework. However, the 20% shift described reflects a decline in traditionally engaged institutional investors and so a dilution of stewardship. To counterbalance this, it is necessary to draw together existing shareholders through a common set of ownership principles and this has been the main driver behind the launch of the FRC's Stewardship Code.

While a significant step forward, the global breadth of holdings by the most influential investors in the UK still presents quandaries. Currently global investors have to make a trade-off between depth and breadth in allocating corporate governance resources. If they are more weighted towards a country with a poor corporate governance framework, there may be an argument for targeting in-house stewardship resources at bigger margins of improvement, say in China or Russia, rather than the UK. This has led to more out-sourcing via proxy voting agencies, whether entirely or through voting recommendations, a reliance that can dilute understanding of important company specific issues. At TCAM we believe that 'top-down' corporate governance policies need to be understood in the context of 'bottom-up' individual and commercial circumstance and as such dedicate significant resource to analysing governance in our investee companies in house.

This is not to say that proxy research and voting agencies do not have an important role to play as their research certainly helps investors cultivate an understanding of companies. Rather, the problem relates to the potential for such research to be used as an entire replacement of the engagement process. When that is the case then clearly stewardship as it should be is undermined. A negative by-product of this trend is the animosity it can cause between companies and investors – in some cases leading to a complete breakdown in dialogue.

While each asset management business will ultimately take a distinctive approach to the way they structure their corporate governance research and engagement team (if they have one); our feeling is that (relative to the stocks covered) many are hugely under resourced. This, in combination with delegated engagement leads to a void in stewardship. We remain hopeful that the FRC's Stewardship Code can 'fill the void' but unless many of the signatories allocate more resources to the area we are doubtful it will have the desired effect.

Note also the growth of inflows to passive and exchange traded funds. In theory, because passive investing precludes stock bias and seeks long-term gains in the broad equity market; passive funds and stewardship should be natural bedfellows.

Yet they largely pay scant attention to corporate governance. Index fund marketing tends to focus on a low fee model that compensates with stock-lending fees (another example of divorced ownership). A study of UK investment firms revealed that passive managers allocated the least resources to stewardship. Additionally, while passive investing underpins the equity portfolios of a substantial proportion of pension's funds, few scrutinise the stewardship activities of passive managers. Trustees typically focus exclusively on tracking error and performance.

In line with our central view, as discussed in the introduction, the investment chain needs to take more formal account of the need to allocate resources to important stewardship tasks. Given the underlying structure of markets, with some pension funds segregating their assets into 50 plus mandates, this has to be driven by the ultimate owners. Asset management companies, the intermediaries, are ultimately driven by client requirements and unless such responsibilities are formally captured within tender processes and investment agreements, we are doubtful that it will be hardwired into the ownership chain sufficiently.

<u>Question 4</u>: What are the most effective forms of engagement?

It depends on the circumstances. Approaches that focus too much on *telling* companies they are not conforming to best-practice tend to illicit defensive responses and lead companies to be more trenchant in defending their status-quo. Approaches that move away from being the antagonist to the protagonist have been more successful. Behavioural economists would probably characterise this as 'nudging' the company by showing them something market leading that would benefit and improve them. At its simplest form it is about demonstrating another option for a company to take, explaining why it would benefit them, facilitating buy-in from key agents, and creating an environment in which the company would feel comfortable executing the changes, knowing they are making them on their own volition. While this describes broader long-term approaches to protecting and enhancing shareholder value, another important component of stewardship is exercising ownership rights at company general meetings – please see question six.

However, while we find this approach tends to be more successful for initiating effective on-going dialogue, sometimes no amount of well intentioned dialogue will result in appropriate changes. In such instances we will escalate our activities, whether via collaboration with other investors, or ultimately by tabling a shareholder resolution.

Moves by investment consultants such as Mercer to assess the quality of stewardship at asset managers may have a positive impact on the market overall by pushing pension funds to seek out market leaders when allocating mandates.

Moreover, we have to be careful not to turn stewardship into a numbers game; an engagement that lasts 1-3 years at a company with major problems may be much more beneficial to clients than one that lasts a couple of months. Finally, engagements may strengthen the hand of a non-executive on the board who is trying to reform practices. For example, feedback from non-executive directors indicates that while engagement by investors may not achieve instant results it changes the dynamic on the board by strengthening the agenda of reformers over time.

For more information about how we approach our compliance with the UK Stewardship Code see:

http://www.co-operativeassetmanagement.co.uk/advisers/stewardship-code.php

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

The short answer is that our anecdotal experience is; "not nearly enough" though improving more in the last 3 years than perhaps in the preceding 10, as Environmental, Social and Governance risks (and to some extent opportunities) become more apparent in terms of investment impact. Each individual asset management company will be organised according to their business model and investment style. At TCAM our distinctive responsible investment approach fully integrates ESG risks and opportunities into our investment process. We do this because in our experience it significantly increases our understanding of companies risk & opportunity profiles assisting in both the investment and engagement functions. This has been achieved through a long term change management process and all market participants that wish to ensure an appropriate level of internal dialogue will have to go through a similar process.

There are a number of general challenges relating to improving dialogue within investment firms and varying drivers for such change, not least due to differing priorities in different participants. One difficulty for all organisations is the challenge of obtaining sufficient buy-in from the fund managers. This is natural, as the role of the fund manager requires sifting through often vast amounts of information and maintaining a degree of scepticism about arguments offered, which breeds a naturally conservative bias. The historic perception of ESG as relating to risk, rather than opportunity has also provided a poor basis for dialogue. Finally, investment managers and buy side analysts are concerned to protect their access to senior management and can view engagement on ESG issues, usually by the same professionals involved in integration analysis, as a distraction at best and a risk to their relationship with the company at worst. These relationship issues may be compounded where ESG professionals are also involved in ethical screening, which may be viewed by the investment mangers as restricting their investable universe.

Nevertheless, a number of factors has driven increasing acceptance by mainstream investors of the relevance of ESG factors. These include an increasing understanding of the seriousness of such issues as resource depletion, climate change, the governance failings that led to the collapse in the financial system and the collapse in BP's share price and the passed dividends following the disaster in the gulf of Mexico. The subject of ESG is increasingly less taboo in the fund management industry and is seen as a potentially valuable risk mitigation tool as well as offering opportunity in the longer-term. This is both the product of, and supportive of greater dialogue.

<u>Question 6</u>: 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?

Engagement with companies is usually a highly iterative process and voting at company meetings is in many ways the culmination of the process. After much talk and diplomacy, the vote is the ultimate signal to companies. At TCAM if we are dissatisfied by the results of on-going dialogue and explanations provided by companies then this will be reflected in our voting decisions at meetings. These

decisions are not taken lightly and neither are they made in isolation from financial analysts and fund managers, both of which are represented on our Responsible Shareholder Committee formed to provide counsel on such issues. However, we note that the voting decision itself should not be used as an indicator of the quality and quantity of engagement; voting blind, in the absence of genuine dialogue, may do damage to longer-term effort to reform companies.

While industry practitioners are forever emphasising how much more important meetings are over actual votes, and it is true that uninformed voting can be damaging, there is a danger that style (dialogue) has replaced substance (voting). For example, there appears to have been a trend towards horse-trading around the actual vote, with some institutional investors continually refraining from taking voting action based on the understanding of certain informal commitments by companies. The problem is such commitments rarely manifest in concrete actions by companies. As a result many asset managers can over emphasise the vaguest of assurances in exchange for not voting against.

This is problematic for a number of reasons, but chiefly among them is that it distorts important market signals to other investors and companies. Voting in favour of a resolution, despite marked concerns, based on the type of assurances noted above, deprives the wider market of vital feedback. In our experience companies can provide rather flimsy concessions and tend to be fully aware of the supine nature of various institutions. The lack of transparency clouding the whole process has led to an accountability void. Given the commercial implications and sheer magnitude of importance attached to many voting decisions, particularly in respect of capital raising and M&A activity, we find it surprising that the UK has been so hesitant in mandating statutory voting disclosures, which has not been problematic in other jurisdictions.

In 2002, we became the first institutional investor in the UK to publish our voting record and summary analysis on our website. Furthermore, our voting policy is available online *http://tinyurl.com/5vyqn4m* and we have extensive coverage of our UK and global voting records in The Co-operative Group's Sustainability Report and our Annual Engagement Review. Given the levels of transparency that are asked of listed companies, institutional investors should adhere to the same principles.

While we did not find any of the above disclosures to be onerous or costly to implement, it is true that it could be for some of larger global asset management companies given the diverse bespoke voting requirements different pensions funds require. Nonetheless the barriers to implementing such disclosures on a larger scale are still relatively minor.

Finally, given the strong influence of proxy voting advisors we believe that it would be suitable for them to follow suit and disclose publicly voting recommendations made to shareholders. This is particularly important for some of the international investors in the UK that tend to rely quite heavily on such advisors, or in some cases, follow their recommendations verbatim.

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

As responses to questions 7-10 overlap considerably we have attempted to capture this within the narrative of the introduction to our submission.

<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?

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

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

Directors' Remuneration

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

While there is some evidence of the competitive market for talent driving pay, in our experience, this can often be used by companies as a smokescreen for a lack of internal talent development and general succession planning. External candidates cost a tremendous amount more and in reality the evidence suggests that internal candidates have longer tenures, bring stability and return better results.

The next view to tackle is that the general increase in transparency since the inception of the Directors' Remuneration Report Regulation in 2002 has caused a form of brinkmanship and a race to the top. While it is true that excessive benchmarking against peers has the effect of perpetuating increases in base pay this view does not explain the fact that pay has increased in countries with poor transparency. Rather, this brings us back to the correlation between company size and pay and underlines the poor link between pay and performance. This can only indicate a failure of the decision makers charged with setting remuneration policy – remuneration committees.

The main reason for this is that the very non-executive directors who populate these committees, whose putative role in ensure that executives are paid as much and no more than is needed to ensure company performance to the satisfaction of shareholders and in a way that reflects its stated strategy are also almost always executives in their own right at other large companies. It is in none of their interests to force downward pressure on pay while being too easy to give an executive the benefit of the doubt; after all, the non-executive may wish the same benefit extended to him or her one day.

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

The typical composition of remuneration committees requires appraisal. Due to the lack of diversity of backgrounds we see a strong reinforcing tendency in decision making. The majority of members, having been executive directors in the past, have a shared belief in the normality of, or requirement for, big awards – an entitlement culture pervades.

Research into group dynamics suggests that those dominated by like minded individuals reinforce and amplify each others' opinion which may lead to more

extreme decisions[4]. Remuneration Committees were first justified ostensibly on the grounds of bringing independence, reason and accountability to executive remuneration. The insidious effect of 'group think' on a homogenous group has arguably achieved the opposite: an apparatus for entrenching bad habits.

The most radical tonic is to challenge the composition orthodoxy and extend membership. Employee participation is sometimes proposed but what is needed are people who have an interest in the company's success but have nothing to lose by voicing an unpopular opinion (this sounds like what a non-executive should be, but on the issue of remuneration sadly this is often not the case). Radical proposals could include a non-board committee comprising for example a trustee of the corporate pension fund (which has an interest in long-term shareholder value preservation) and representatives of top shareholders. Disinterested advice is also supposed to be provided by remuneration consultants however these also play a role in pushing remuneration ever-higher as they are more likely to be retained by boards that they tell to be more generous.. A diversified remuneration committee, representative of a company's long-term interests that can judge without fear or favour could also appoint and re-appoint remuneration consultants who would now be serving new masters whose horizons are longer. Moreover this same committee's decisions would be subject to general shareholder approval on the ballot. The very fact that such options need to be considered acknowledges the partial failure of non-executives to do their job. The existence of a representative, independent committee beyond non-executives might focus minds on making a balanced decision in the first place - or it might erode their authority. As a first step, we feel it is important to re-enforce the representative nature of non-executives and while the annual re-election of directors is a big step forward, we believe there should be more structured dialogue between major shareholders and non-executives in setting policy.

The process towards the finalisation of remuneration proposals would be significantly improved by the formalisation of a more structured ex-ante consultation process with shareholders. This could, for instance, require consultation with the top 10-20 shareholders. We always make the time to contribute and feedback when we are approached to participate in such consultations. We sometimes hear from companies reassuring or protesting that they "consulted shareholders", implying consent when in truth the actual level of dissent may have bee significant. Proponents could be required to declare that they conducted the consultations, and encouraged to provide more disclosure in relation to any objections that were raised and what remedial actions were taken following the process. This would have the added benefit of providing transparency in relation to how various institutional investors enacted their stewardship responsibility in particular instances.

<u>Question 13</u>: 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?

There is quite irrefutable evidence from events over the last ten years that shareholders as a whole, the highly dispersed owners of UK plc, have not been tough enough on executive pay. At The Co-operative Asset Management one of our ownership principles is to take an 'all-weather approach to stewardship'[5]. This is not something that could be said of all market participants. The feeling among the

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[4] *Going to Extremes,* Cass Sunstein, 2009 cited in PIRC Client Briefing / May 2010: Pay and behaviour.

[5] The best example of this is opposing the remuneration reports of *inter alia* Northern Rock, Bradford & Bingley and RBS continually in the years running up to 2007/8, not to mention being the only institutional investor to oppose the acquisition of ABN Amro by RBS.

industry is that there is a danger some shareholders, or rather agents of beneficial owners, may take their foot off the pedal on the return to bullish market conditions. There is clearly less collective desire to upset the apple cart when companies are providing good returns. We see this as a mis-guided abdication of stewardship. The potential for a remuneration policy cooked-up at the start of a bull run as actually planting the seed of value destruction down the road has been amply demonstrated by the problems in sub-prime lending and the resultant credit crunch. Notwithstanding any of the above, the debate started by Sir Paul Myners when he coined the phrase 'absentee landlords' is far more complex and relates more to underlying structural issues referred to in the introduction to our submission.

Contractual termination provisions or 'golden parachutes' form a very important part of executive pay yet are some of the least transparent. Inappropriate termination provisions can be problematic due to the behavioural implications of a gold-plated indemnity on leaving a company. The level of discretion non-executive directors can apply in determining whether an executive is a good-leaver or otherwise is problematic. Given the uncertainty regarding the nature of the circumstances prevailing when a director leaves a company there is tremendous potential for significant reward for failure as things stand. This is compounded by boards wishing a director to go quietly which may make them more forgiving in enforcing a rigid line on remuneration. This triggers the possibility of perverse incentives as having such significant indemnity may alter the psychology and decision making of management.

For example, there is arguably an insurance policy (in some cases) for directors to take on disproportionate levels of risks to meet highly charged bonus targets, all the while knowing that if things go wrong their personal wealth is insured by their service contracts and exit provisions. Further disclosure relating to the nature of departure and how this equates to the payments made on departure would certainly help. Additionally, further information on how discretion has been applied in relation to mid performance-cycle share awards when pro-rating is applied for time and performance would aid transparency.

However, aside from exceptional circumstances when additional amounts are granted on a fully discretional basis, predominately, it is the case that such 'golden parachutes' form part of directors' contractual provisions. Therefore, it is difficult from a legal stand-point to make changes on an ex-post basis. We suggest a twin-track proposal.

Firstly, in relation to those awards permitted on a discretionary footing, they must be at all times subject to time and performance pro-rating so that they only relate to the time in office and the actual performance delivered. Company disclosure on this point requires significant improvement.

Secondly, we would argue that given the potential for reward for failure and therefore perverse incentives, contractual provisions are of equal significance and importance as share schemes. Therefore, similar to the formation of share schemes, executive contractual terms ought to be subject to shareholder approval on an ex-ante basis. This does not necessarily imply a vote for every new executive director, but should rather relate to the approval of a 'model-contract' from which recruitment negotiations would have to work off moving forward.

<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?**

Before going into specific responses there is an important point to be made more broadly about the nature and type of disclosure currently on display. Disclosure at companies needs to be re-engineered to provide a great deal more focus on the actual outcomes of short and long-term pay incentives. So much is written about what a share scheme hopes to achieve, why it is necessary, why it fits next to benchmarks and so on, while almost nothing is written on how the policies worked in practice. It is how such incentive systems work in practice, the outcomes, that ultimately convey how successful the link is between pay and performance. There is so much more that can be done in this area.

Disclosure relating to performance conditions for payment to directors is of fundamental importance to the veracity of pay-for-performance policies espoused by companies. While it is clearly important to have confidence in the information provided on performance conditions, those chosen can be significantly undermined if they bear no resemblance or alignment with the strategic imperatives identified in the Business Review. It is a common phenomenon to find 'off the shelf' performance share plans with conditions entirely dislocated from a strong range of Key Performance Indicators (KPIs) in a Company's Business Review.

We believe that there should be a much greater link between a Company's strategic considerations that lead to the identification of KPIs and those considerations that lead to identifying targets under management incentives. Proponents of the abolished OFR like us had seen it as a framework to link objectives, strategy and KPIs with executive remuneration. Much in the same way as the Business Review ought to describe effectively both the operational developments during the year as well as the financial, we believe that performance targets should be relevant to a company's financial and non-financial performance.

It is logical therefore for consideration to be given to the inclusion of companies' sustainability objectives among the performance targets for the vesting of shares under long-term share schemes. Director leadership on such issues is crucial so that the importance of the various objectives filters through an organisation; alignment with management incentives underlines the importance of their leadership on long-term non-financial goals.

A recent development that is increasingly problematic is the use of adjusted calculations for the purpose of reflecting 'underlying' performance. This is most frequently applied to Earning per Share (EPS) targets. In any one annual report one can be confronted with a multitude of different EPS figures, whether the basic accounting standard 'base' EPS figure, an EPS figure to be presented in the Business Review or an entirely different EPS figure for the purposes of determining variable rewards. The use of adjusted EPS for remuneration is problematic unless the disclosure is able to sufficiently describe and justify the specific accounting items over which discretion has been applied. There is the same problem with capital efficiency measures such Return on Capital Employed (ROCE) which arguably has a greater and more opaque margin for discretion.

At a FTSE100 retailer we recently identified a significant differential between Business Review ROCE and remuneration report ROCE. The problem was that no

explanation or specific accounting calculation information was provided. For shareholders to have confidence in the veracity of information provided for performance targets we advocate stronger disclosure requirements concerning the calculations applied for the purpose of determining awards and where there is material divergence from other calculations across the annual report, for explanations to be provided.

While a few more companies are linking up strategic imperatives to variable pay drivers, the majority still make no real reference to how linkage is reinforced via pay policy. In this spirit we would advocate the formalisation of a section under the Directors' Remuneration Report Regulation (DRRR) detailing these important considerations. It is logical that such strategic grounding could form the foundation for disclosure that details how the performance provided during the past period justifies the variable award that vested. There is an urgent need for significant improvement in the level of retrospective disclosure of the performance that led to the awards being granted under bonus schemes. It is still the case that more companies than not provide no information to justify large annual bonus awards.

One of the weakest areas is in the semi-automatic award of 100%-200% of salary in performance shares. Although these carry vesting conditions there is very little transparency over the magnitude and basis for the original award.

In our view, past targets are no longer commercially sensitive; therefore, given the magnitude of award and importance to overall incentives, shareholders should be provided with quantitative information of performance that triggered any award next to the target set.

Takeovers

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

The decisions taken by directors surrounding M&A activities expose most acutely the tension between long and short-term considerations when promoting the success of companies, their statutory duties[6] and return to shareholders. We strongly support the need for an open and thriving market for corporate control as this can help deter rent capture by managers at the expense of shareholder interests and maintains an pressure for efficiency.

To assure shareholders that companies understand the long-term implications of their M&A activities and communicate this effectively, we support calls by the Investment Management Association to require disclosure in the offer document on how directors believe the offer fulfils their duties under the Companies Act to promote the success of the company and to consider the long-term effects on all stakeholders. We note that on the latter there is a lack of a proportional approach to different stakeholders in M&A activity.

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?

[6] Companies Act 2006 S.170

We believe the current arrangements provide the right balance between ensuring shareholder accountability and allowing companies appropriate powers of autonomy in running the company. The Listing Rules of the FSA already impose an obligation for shareholder approval on transactions that exceed a 25% materiality threshold as determined by the various 'Class Tests'. Also it is not clear how the proposal could be implemented for foreign acquisitions, or for example private companies. Finally, the Takeover Panel has recently proposed new measures that would require the acquiring company to make a firm offer within four weeks of any announcement of approach and disclose information on financing and advisor fees.

Merger and acquisition transactions tend to be vital inflection points for companies; some fit key pieces of a jigsaw together while others destroy value on a gigantic scale. There has certainly been a distinct increase in the influence of merger arbitrage funds that can derive considerable profit from pushing deals through. Investment banks have come in for justified criticism here also for their role in artificially stimulating demand for M & A activity which generates substantial fees for intermediaries. It is hardly surprising that many of these deals prove to be sub-optimal. Clearly such investors are not interested in the potential long-term value of an organisation. What was notable about the Kraft / Cadbury deal was the speed at which the Cadbury share register changed dramatically through the negotiations. But such funds still have to buy the shares in the market and clearly those selling believed they had realised an appropriate value. Given the changing dynamic here we believe there is an argument for raising the threshold for a successful takeover to two-thirds of shareholders though on the other hand, careful consideration would have to be given to whether this might entrench complacent or self-serving management. On balance however we feel that a simple majority is inadequate. Due to the magnitude of such transactions, with a potentially profound effect on a company and the interests of shareholders, it is surprising that a higher threshold is not already in place. BIS may also wish to enquire what the effect would be of applying a minimum holding period before shareholders are able to vote on deals.

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

For question 5, we discussed the barriers to be overcome in getting ESG taken seriously inside investment managers. It is worth pointing out that ESG knowledge, in as much as it has the ability to help adjust returns for risk and opportunity, should not be assumed to be synonymous with 'ethical' or 'responsible' investing as they are commonly understood i.e. directed at social goods and avoiding profiting from unpalatable activities. ESG information is amoral: it is how it is applied that determines whether an investor is 'responsible'. An extreme example would a so-called 'sin fund' deliberately constructed from activities like tobacco and gambling that would place as much a premium on understanding attempts to derail progressive tobacco legislation as any 'socially responsible' fund - though the two funds sought opposite outcomes.

A conflict of interest may arise where an investment manager holds to the principles of stewardship and the 'responsible' connotations that come with it while an objective appraisal of ESG issues may, on occasions, lead to logical decision to invest in something that is profitable in the short-term but detrimental to a sustainable environment and economy in the long-term. The classic example is regulation arbitrage: whereby capital follows companies whose operations are escaping e.g.

climate regulation, even though that regulation, universally applied would help establish a more stable footing for sustainable economic growth.

A recent example of this sort of challenge is represented in the oil sands investments in Canada. Here, there are two long term interests at play for investors, particularly pension fund managers. The science is clear that all the oil sands cannot be extracted and used without pushing the climate past the threshold of dangerous change, with dramatic consequences for society and strongly negative implications for economies. Pension funds as universal investors have an interest in slowing the onset of climate change. Consistent with this view is the belief over the longer term that rationality will prevail and that legislation will be enacted and behaviours changed to respond appropriately to the scale of the problem. In which case there is a significant risk that capital expenditure undertaken now on oil sands may be stranded by future legislation.

However, for investors with a shorter time horizon, the returns available to oil sands in current legislative contexts are attractive. The problem that they suck capital away from lower carbon energy infrastructure is not relevant in that context. Only 15% of investors took the long view at the BP Annual General Meeting when shareholders asked management to prepare more information on the basis for investment in oil sands.

In short, what may be justifiable as acting in accordance within fiduciary duty in the shorter term does not automatically translate into a responsible decision in the long-term. This is one reason why the Stewardship Code is right in asking for adherents to disclose a conflict of interest policy.