A LONG-TERM FOCUS FOR CORPORATE BRITAIN
Call for Evidence Response Form

A copy of the consultation available at: http://www.bis.gov.uk/consultations.

Responses to the Consultation should be received by 14 January 2011.

Completed copies of the response form should be returned:

Via email to: clgconsultations@bis.gsi.gov.uk

Via post to:

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Please tick the box from the following list of options that best describes you:

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The Board of Directors

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

Comments

There is some research evidence to suggest that boards often feel under pressure from their investors to prioritise short-term performance over the long-term. For instance, in a 2004 US study, 78% of financial executives interviewed said that they would give up long-term economic value to maintain smooth earnings flows to their investors in the short-term. 55% said that they would avoid initiating a very positive Net Present Value project if it meant falling short of their earnings targets for the current quarter.[1] Andrew Haldane, the Bank of England's Executive Director for Financial Stability, has suggested that the increasing availability of company information – for instance, the shift from annual to quarterly reporting cycles – has exacerbated tendencies towards short-termist behaviour in the financial markets, which inevitably has an impact on board decision-making.[2] And in a recent article in the Sunday Times, Terry Leahy, departing CEO of TESCO, criticised investors for their reluctance to act as long-term owners.[3]

The consultation document notes (section 3.5) the directors' duty, under section 172 of the Companies Act, to take an enlightened approach to the long-term success of the company. But there is little authoritative guidance as to what section 172 means for directors. The government could seek to rectify this as part of this review. As we suggested in our response to the Walker Review, this section could also be amended to make clear that the board's overriding duty is to promote the long-term success of the company, rather than, as at present, merely requiring them to have regard to the likely long-term consequences of any decision. As we also suggested, the existing requirement that directors have regard to "the impact of the company's operations on the community and the environment" could be expanded to include specifically the impact on the integrity of the financial system and on the economy as a whole.

Although the concept behind section 172 was that of 'enlightened shareholder value', there is also a mismatch between this provision and the law governing shareholders themselves.

Firstly, notwithstanding the references in the consultation document to "ownership responsibilities"[4] and to the government's belief that "shareholders

[1] Graham et al, 2004, *'The Economic Implications of Corporate Financial Reporting'*
[2] Haldane, 2010, *'Patience in Finance'*
[3] REF
[4] Section 4.9

have responsibilities to engage as stewards in constructive dialogue with companies in which they invest", [5] shareholders in general are not subject to legal duties parallel to those of directors.

Secondly, many fiduciary investors – particularly asset owners such as pension funds – appear to believe that their legal obligations to their beneficiaries actually *preclude* them from acting in an enlightened way which takes account of wider considerations than short-term profit maximisation. This widespread view is currently acting as a brake upon company directors who wish to take a more enlightened, long-term perspective of their own duties. As academics such as Keith Johnson[6] of the University of Wisconsin and Claire Woods of Oxford University[7] have suggested, prevailing interpretations of fiduciary obligation militate against long-termist investor behaviour (see our response to question 8). It is perhaps unsurprising that short-termism persists at corporate board level when the foundations of the pursuit of 'enlightened shareholder value' – namely, enlightened shareholders – seem to be missing.

This misalignment may make the Stewardship Code will be less likely to fulfil its intention to complement the Corporate Governance Code and "underpin good governance".[8]

Another well-established factor is the persistence of short-term incentives in the remuneration both of directors themselves, and of investment managers, whose mandates from asset owners often see them judged on short-term performance against industry benchmarks. The self-interest of key market participants therefore militates against a long-term focus. A shift in this underlying incentive structure will be essential to the effectiveness of any measures to encourage long-termism, whether voluntary or regulatory.

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?

Comments

[5] Section 4.13

[6] See for example Johnson, 2009, *'Modernising Pension Fund Legal Standards for the 21st Century'*

[7] See for example Woods, forthcoming 2011, *'Funding Climate Change: How pension fund fiduciary duty masks trustee intertia and short-termism'*, in Hawley & Williams, *Institutional Investors, Risk / Return Tradeoffs, and Corporate Governance Failures*

[8] FRC, The UK Stewardship Code, July 2010, page 1.

We make no comment on this specific question, which we assume to be directed at boards. However, we do believe there is a case for wider transparency about the ownership of publicly listed companies. Currently some information is available in principle if someone makes an appointment with the company secretary's office to view the share register. In addition information about major shareholders is disclosed in the Annual Report. However, it is generally impossible to identify the beneficial owners, as opposed to nominees. This means that ultimate owners lack visibility on the equity holdings of their pension funds. We find ourselves dealing with enquiries from fund members as to whether their pension fund is invested in a particular company, something they cannot find out either from their fund or from the share register. As the government appears to be considering greater openness and transparency in equity markets as part of this review, this might also be an area worth examining.

Shareholders and their role in equity markets

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

Comments

Distinctions between UK and overseas investors should not obscure the potentially more significant differences between types of institutional shareholder within the UK. With the decline in the proportion of UK equities held by domestic long-term investors such as pension funds and insurance companies (section 4.2), investors with short-term perspectives will continue to hold a significant – and perhaps increasing - percentage of shares in UK companies. Such investors may well not engage at all. Where they do engage, it will likely be to exert pressure in favour of corporate policies calculated to maximize profit in the short-term. (This latter tendency may be encouraged by the limited liability which they enjoy, as where highly leveraged policies offer potential "upsides" that exceed any "downside" risk.)

By contrast, much of the rise in overseas ownership is accounted for by pension funds and sovereign wealth funds which, in theory, have the same long-term interests as UK pension funds, insurers and endowment funds. These overseas investors are increasingly engaging with UK companies, often in collaboration with UK investors. We welcome this trend and believe the government and regulators should find practical ways to encourage it.

In this context, however, it is important to recognise that investors who are long-term (in the narrow sense of tending to hold shares for a long time) but who do not exercise a stewardship role are also a problem. For instance, many funds with passive investment policies are also passive in respect of

engagement – although we do not believe this necessarily needs to be the case (see our response to Question 5). As the consultation document points out, because passive management is concentrated in the equities market, the proportion of equities managed in this way is substantially higher than the average 20% of all assets managed by IMA members.[9]

As the consultation document notes, the rise of institutional (as opposed to individual) shareholders also has significant implications for corporate governance because of the increasing length and complexity of investment chains – this is discussed in our response to question 9.

It is important that the UK corporate governance framework responds to the increasing internationalisation of ownership, and does not assume that UK norms are sufficient to protect UK businesses. As well as pursuing domestic initiatives such as the Stewardship Code, the UK must engage constructively with debates in Europe and elsewhere to promote a coherent international framework for corporate governance. Conversely, if the Stewardship Code aims to protect long-term returns for beneficiaries – as we believe it should – it is vital that it applies beyond investments in UK companies. We therefore welcome the FRC's statement that "UK institutions that apply the Code should use their best efforts to apply its principles to overseas holdings."[10]

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

Comments

Engagement is still a relatively young discipline and it is important that investors are encouraged to experiment with different ways of reducing risk and enhancing long-term value, depending on the company and issue in question. In this context there are three particular points we would make:

- The distinction between information seeking and engagement that seeks to influence is an important one. Engagement which aims to inform analysts' valuations, although worthwhile, is clearly a different enterprise from engagement aimed at improving a company's risk management or instigating dialogue on strategic issues. In this regard we would also reiterate a point made in our response to *The future of narrative reporting* consultation: at present, much engagement effort is directed towards obtaining information which should be made available by companies as a matter of course, rather than towards influencing companies' management of substantive issues (with last year's resolutions on oil sands being a good example). Better quality reporting, not least narrative reporting, might therefore be expected to enhance the quality and effectiveness of investor engagement.

[9] Section 4.6
[10] FRC, 2010, *The UK Stewardship Code*

- The hugely diversified shareholder base of many UK-listed companies makes effective engagement more difficult, even for large institutional shareholders. Facilitating collaborative engagement is therefore vital. More consideration could also be given to the potential of portfolio models that are based upon a smaller number of larger holdings, so as to promote an ownership culture and maximize the long-term financial advantages to be obtained from engagement.
- We would caution against complacency about the superiority of UK corporate governance in this respect. Despite the greater emphasis placed on shareholder oversight (as opposed to regulation or stakeholder involvement) in the UK framework, it has not been our experience that UK shareholders are more ready to engage with their investee companies, or more effective in their engagements, than overseas investors. If anything the reverse may be true, particularly in relation to shareholder resolutions: we find that US investors are much more willing both to file and to support shareholder resolutions than their UK counterparts, who tend to regard this as a 'nuclear option'. This cultural difference is exacerbated by the difficulty and cost of filing shareholder resolutions. We would therefore welcome measures to clarify and simplify this process (as detailed in previous submissions to BIS).

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

Comments

It is vital that engagement – including on environmental, social and corporate governance (ESG) issues – is seen as a core part of investment firms' strategy of value creation, rather than an optional extra or an activity that can be sidelined into the corporate governance or responsible investment team. Anecdotally it appears that engagement activities are not always well aligned with buy/sell decisions and that some corporate governance teams have minimal influence on decisions in other parts of the firm.

Having said this, we would also note that, as long as engagement takes place consistently and effectively and is not directly undermined by decisions elsewhere in the firm, it has value regardless of buy/sell decisions. It is important to overcome the perception that the two are intrinsically linked and that engagement is therefore irrelevant for firms or funds with passive investment strategies. If anything, engagement is all the more important for passive managers, since they do not have the option of exit, making this their only means of safeguarding or adding value.

The Stewardship Code already states that it applies equally to active and

passive investors, and we think that the FRC (and trade bodies within the investment management industry) should take every opportunity to emphasise this point

<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 publicly how they have voted?

Comments

As indicated in our response to question 4, we believe voting is an important form of engagement and have ourselves helped to co-ordinate shareholder resolutions at the AGMs of UK companies. We believe that shareholder resolutions and voting on management resolutions are an undervalued form of engagement in the UK, in contrast for example to the US, where they are a more routine part of engagement activities.

We also believe there are clear benefits to public disclosure of institutional investors' voting records (as opposed to only disclosing to clients). Indeed, this has been recognised by the FRC's Stewardship Code and by the government, both of which have confirmed that public disclosure is expected.

- Firstly, public disclosure fosters competition amongst fund managers and enables the market to function more efficiently, allowing prospective clients as well as existing clients to scrutinise and compare managers' records.

- Secondly, mandatory disclosure would help replace a culture of secrecy with a culture of accountability to ultimate asset owners, such as pension fund members. At present, individual pension fund members are often unable to access information about voting decisions even when they specifically request it. This was the experience of many people who contacted their pension providers about last year's oil sands resolutions at BP and Royal Dutch Shell. Given the length of investment chains and the large numbers of ultimate beneficiaries, public disclosure is the simplest and lowest-cost way of enacting these individuals' right to information.

- Thirdly, mandatory public disclosure might encourage investors to make more considered use of their voting rights. In the US, voting disclosure is said to have counteracted the tendency created by compulsory voting (which we do not support) for shareholders to blindly follow the advice of proxy voting agencies.

- Finally, in the wake of the financial crisis, few would dispute that there is a clear public interest in the voting decisions of major institutional investors. As Sir David Walker noted in his review, *"while shareholders enjoy limited liability in respect of their investee companies, in the case of major banks the*

taxpayer has been obliged to assume effectively unlimited liability."[11] Greater transparency and accountability must be key parts of a new, more responsible and sustainable financial system.

In our view, the arguments put forward that mandatory disclosure of voting records would incur significant or disproportionate costs are unconvincing. The main arguments thus far have been:

- Disclosure would compromise commercial confidentiality. This argument has been comprehensively discredited by the increasing number of firms who do disclose: in our most recent survey, 82% of leading asset managers disclosed at least some voting information.[12] The fact that F&C, which provides the most comprehensive disclosures, is also a market leader in engagement further demonstrates that disclosure does not entail commercial disadvantage.
- Disclosure would be overly burdensome. Again, this argument has been largely discredited. Since most asset managers already collect this data, the only burden of disclosure should be the bare cost of publication – which, in the internet age, is minimal. In the first year one might expect some transitional costs, but reports should quickly become very easy and cheap to produce automatically.
- Disclosure is an unnecessary cost because nobody will use the information. This is simply incorrect. Thousands of people asked about their fund's voting intentions on last year's tar sands resolutions. It is reasonable to assume they would also have made use of retrospective information if it were available. We also believe that the act of disclosure itself would add momentum to the growing number of people taking an interest in the investment of their pension savings. At present, many people receive inadequate responses or none to their enquiries and are discouraged from engaging with their pension provider in the future. Finally, although it might be expected that relatively few people would access the information in its raw form, disclosure makes possible the compilation of reports and rankings by third party organisations, such as ourselves, in a format that is genuinely useful to a large number of consumers – enabling them to entrust their savings to firms that they can see to have adopted high standards of stewardship or that accord with their values.

We would also note that mandatory voting disclosure would bring two key benefits over and above voluntary disclosure:

- Comparability. One of the key findings of FairPensions' most recent survey of fund manager disclosure[13] was that the quality of information disclosed by asset managers varies enormously, from bare summary statistics to detailed information on individual voting decisions. If

11 Sir David Walker, 26 Nov 2009, *Final Recommendations,* p12.
12 FairPensions, December 2010, *'Stewardship in the Spotlight'*
13 Ibid

disclosure is to deliver the benefits outlined above, comparable, substantive information is essential.

- Coverage. Although the Stewardship Code has catalysed welcome progress, voluntary initiatives risk leaving existing laggards behind, and are unlikely to deliver universal disclosure. Mandatory voting disclosure would impose no additional burdens on those already following best practice, but would ensure a level playing field between firms.

We therefore remain of the view, expressed in previous consultation responses on this issue, that regulations should be made under section 1277 of the Companies Act 2006 requiring full disclosure of voting records. Our recent report also recommended that the FRC publish a standard template to clarify what is expected and promote comparable and meaningful disclosures.

Finally, we would note that voting disclosure must be translated down the investment chain if it is to be effective. If asset managers are required to disclose their voting records, pension funds must signpost this information to their members, who might otherwise find it impossible to trace the information relevant to their savings. This is discussed further in our response to question 9.

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

Comments

Short-termism in equity markets has long been recognised as a problem. As the consultation document notes, Lord Myners identified many of the issues we are now debating in his review ten years ago. The diagnosis is well-established; the cure is much more elusive.

Short-termism is a problem not just because, as the consultation document suggests, it may result in inefficient capital allocation due to missed opportunities (section 4.20). It also creates the danger that long-term *risks*, including systemic risks, will be underpriced and neglected. Climate change is an obvious example: in our research, one reason given by asset managers for the industry's slow progress at integrating climate risk into their decisions is the *"imbalance between the relatively short term horizons of mainstream investment analysis and the relatively long term nature of the material business impacts of climate change."*[14] This finding was replicated in a study by Mercer and Trucost for WWF carried out in the same year.[15] We very much hope that this review will address itself not only to the last crisis caused by

14 Henderson Global Investors, in FairPensions, 2009, *Preparing for the Storm* p8
[15] Trucost, 2009, *'Carbon Risks in UK Equity Funds',*

economic short-termism, and the particular governance failings it exposed, but to others which may take place in the future.

In particular, we hope that the review will be alert to the intimate connection between the aim of encouraging long-termism and the sustainability agenda which the coalition has pledged to prioritise across government. We were encouraged by Vince Cable's recent article which highlighted these connections and expressed the hope that this review would "*help us build a new framework founded on long term economic and environmental logic*" .[16] We therefore trust that DECC will be fully involved in this review and that government will explore ways to maximise its contribution to the UK's climate objectives.

How might short-termism be addressed? We do not pretend to have all the answers to an endemic and intractable problem; however, constructive approaches might include:

Tackling fund managers' incentive structures. Long-term asset owners, such as pension funds, should change the terms of the mandates they award – for instance, to employ longer-term assessment periods. Again, this recommendation is nothing new: the paradox of long-term investors driving short-termist behaviour through their mandates is well rehearsed. It is therefore the obstacles to this shift taking place which must be addressed:

- Many occupational pension schemes are under immense pressure to fill deficits, meet short-term liabilities and perform well in triennial valuations based on mark-to-market accounting.
- As Oxford academic Claire Woods observes[17], institutional inertia is enhanced in this case by current interpretations of fiduciary obligation, which create an intense fear of deviation from the status quo. Here the government may have a role both in clarifying or amending the legal position (see response to Q8), and in providing an impetus to overcome inertia and collective action problems.

Improved transparency and accountability to ultimate asset owners. The interests of ultimate asset owners such as pension savers are inherently long-term. As Vince Cable notes in his foreword to this consultation, the status quo is characterised by returns being *"captured by a small number of intermediaries at the expense of the many who provide the capital."* Restoring the balance of power between intermediaries and ultimate owners is a necessary condition for fairer and more sustainable financial markets. Transparency, although not a panacea, is essential in this context. Encouraging alternative ownership models in financial services, such as mutuals, may also be an interesting avenue to explore.

[16] Guardian, 19 October 2010,'*Cable looks to the long term'*
[17] See footnote 5

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?

Comments
As Andrew Haldane noted in his recent paper, *Patience in Finance,* evidence suggests that 'hyperbolic discounting' of future outcomes – placing less value on distant future gains than immediate opportunities – is a deep-rooted part of human psychology. This may explain why the market left to its own devices has so far consistently failed to overcome the problem of short-termism. There is clearly a role for government in encouraging long-termism by asset owners and managers, whether by altering incentives or by proscribing certain behaviours, or both. One possible area for government action is clarification of the fiduciary obligations of institutional investors. In theory, the fiduciary duty of prudence should encourage pension fund trustees to adopt a long-term strategy aimed at preserving beneficiaries' capital and sustainable value creation. However, in practice, the opposite appears to be true: the duty of prudence is interpreted as a duty to herd around conventional investment strategies, which has led to a focus on short-term returns, often at the expense of long-term value or risk management. The law on fiduciary obligation is ambiguous and in many areas outdated, creating an urgent need for government guidance or statutory clarification. A renewed concept of fiduciary obligation could have benefits beyond the shrinking sphere of trust-based pension funds. Investment managers of all kinds routinely describe themselves as 'fiduciaries', yet what this means in practice is unclear, and there is much confusion over the legal position. This creates an arbitrary distinction between the protection afforded – at least in theory – to members of trust-based occupational pension schemes and to clients of retail pension providers. Clarity over the fiduciary obligations owed by insurance companies and other providers – including the duty to act in beneficiaries' long-term best interests rather than the short-term interests of the intermediaries – could help to catalyse positive change. We therefore recommend a fundamental review of fiduciary obligation in the investment sphere, based on a re-examination of underlying principles and their applicability in the contemporary pensions market. This issue will be explored further in our upcoming report, *Protecting our Best Interests: Exploring the Future of Fiduciary Duty.* As indicated in our response to question 1 we also believe there would be value in considering how the principles of section 172 of the Companies Act could be applied to fiduciary shareholders themselves, to ensure that the

duties and interests of directors and investors are aligned and constitute a coherent whole. We are currently developing draft provisions on fiduciary shareholders' duties, modelled on section 172, which will form part of the recommendations of our upcoming report. We look forward to discussing these in due course.

In order to encourage longer holding periods, actions that have been suggested include:

- Incentivisation through conditions on tax relief applied to pension savings, as proposed by Paul Woolley of the LSE.[18] This would have the benefit of concretely altering the incentives of key actors. It would need to be carefully designed in order to avoid the charge of penalising pension savers rather than those making investment decisions. However, as the consultation document notes (section 4.25), reducing levels of churn in pension portfolios is clearly in the interests of pension savers, as well as of wider financial stability.
- Preferential voting rights for long-term investors, as proposed by Lord Myners. Since voting rights are already under-used in the UK (see our response to questions 5 & 6), it is unclear how much impact such a move would have. We are aware that concerns have also been expressed over the principle of creating a 'two-tier' system of shareholder rights. Nonetheless the question of whether the corporate governance framework could be amended, not just to incentivise long-term holdings but also to reflect some shareholders' greater interest in and contribution to the long-term success of companies, deserves further consideration. Any review of this question should take into account the point made in the Walker Review that "Shareholders who do not exercise...governance oversight are effectively free-riding on the governance efforts of those that do". [19]
- It would also be possible to use future revisions of the Stewardship Code to explicitly endorse longer holding periods. This would be in keeping with the Code's aims of encouraging the effective exercise of ownership responsibilities. However, it clearly has limitations: as a voluntary initiative its coverage is restricted to those who choose to apply it, and firms with the most short-termist business models are already explicitly excluded from its scope. Of course, excessively short holding periods are clearly a problem among investors with theoretically long-term horizons, such as pension funds. But the Codes' 'one size fits all' approach has so far produced limited guidance for these large asset owners. We would therefore see any action through the Stewardship Code as part of a package of measures rather than a solution in itself.

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

[18] In LSE, 2010, *The Future of Finance*
[19] Walker Review, Final recommendations, paragraph 5.8

Comments
Agency problems are at the heart of many of the issues facing modern capital markets. As Paul Woolley noted in a recent paper for the LSE, *"delegation creates an incentive problem insofar as the agents have more and better information than their principals and because the interests of the two are rarely aligned."*[20] This means that "*agents are in a position to capture for themselves the bulk of the returns from financial innovations*."[21] This analysis accords with the recent experience of pension investments: from 2000-2009, returns collapsed to 1.1% per year, with high year-on-year volatility[22] - in sharp contrast to the fortunes of investment intermediaries. A 2008 report by Watson Wyatt estimated that pension funds' payments to these intermediaries rose by more than 50% between 2002-2007, with most of this attributable to higher investment management fees and transaction costs reflecting the rise in exposure to alternative asset classes.[23] In our experience this also creates confusion among participants in the investment chain about their respective responsibilities. For instance, when asked to explain the relatively low mainstream attention to long-term risks such as climate change, asset managers say that their mandates from pension funds do not ask them to monitor such issues,[24] while pension trustees say that they assume their asset managers will factor in material ESG risks as they would any other material issue.[25] This confusion contributes to industry inertia. Solutions to agency problems which rely on one link in the investment chain to take control of the situation – eg. asset owners through their mandates – can therefore be only part of the solution. Government and regulators have a key role to play as actors outside the investment chain who are able to address the problem as a whole, and to clarify the role and responsibilities of the various actors in the chain. We therefore believe government action is essential to tackling agency problems. As indicated in our response to Q8, we believe a review of fiduciary obligation would be one useful model for such action. One of the key features of a fiduciary relationship is the beneficiary's vulnerability to unaccountable risk to their property created by the agent, in part because of information imbalances. Fiduciary obligation attempts to deal with this by imposing strict standards of care on agents, including a requirement to uphold the interests of beneficiaries

20 LSE, 2010, *The Future of Finance* , p122
21 Ibid, p121.
22 Ibid, p135
23 Watson Wyatt, 2008, *'Defining Moments*: *The Pensions & Investment Industry of the Future'*
24 FairPensions, 2009, *Preparing for the Storm? UK investment managers and the risks and opportunities of climate change.*
25 Solomon, 2009, *Pension Fund Trustees and Climate Change* (ACCA), p24

rather than their own interests. This directly addresses the key problems with the principal/agent relationship identified by Woolley, and provides a framework for addressing the key problem of conflicts or misalignments of interest.

A re-examination of fiduciary obligation must go hand in hand with a renewed focus on chains of transparency and accountability to ultimate beneficiaries, which we believe is essential to tackling agency problems. There is a tendency to view pension funds as the 'principals' and to ignore the end beneficiaries - the scheme members. We have found that the length and complexity of investment chains considerably reduces accountability for these ultimate owners. For instance, at least one person who contacted their pension fund over last year's oil sands resolutions was told that the trustees did not know how their fund manager had voted, and had no intention of finding out. Others were told that the pension fund could not pass the member's concerns on to the fund manager since interfering with a manager's decision would be a breach of the trustees' fiduciary obligation. As Steve Webb noted in a recent adjournment debate, *"There is occasionally a need to remind those who manage our money that it is our money."*[26]

<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?

Comments

Please see our response to questions 6 and 9. We believe that transparency is essential in order to:

- promote competition and a well-functioning marketplace
- refocus minds on the individual providers of capital to whom investment agents should ultimately be accountable
- empower ultimate owners to take an interest in how their money is managed
- facilitate public scrutiny in light of the clear public interest in fund managers' behaviour

It might be argued, as it has been in relation to bankers' pay, that transparency on pay would produce a 'race to the top' resulting in higher salaries as firms competed with their rivals. This seems somewhat implausible, not least because it implies firstly that financial services professionals are currently underpaid relative to their market value, and secondly that firms at present have no way of finding out what salaries their competitors are offering. Ultimately, the cost of all the remuneration received, in whatever form, by all the professionals in and around the investment

[26] Hansard, 14 Dec 2009

chain is borne by the ultimate owners, including taxpayers, pension scheme beneficiaries and policyholders. As those who bear the cost and the risk, it ought to be possible for them to see what they are paying for services provided. Given that remuneration is one of the largest and most variable costs involved in managing money, it seems unavoidable that greater transparency on remuneration must become the norm if accountability to end users is to be achieved. It is a matter of public interest whether these earnings are subject to the discipline either of a true market or of effective regulation or whether, on either of those measures, they are excessive.

As indicated in our response to question 6, we do not accept the argument that disclosure of such information is commercially impossible or overly burdensome. More to the point, it is information which ultimate owners have a right to access, since it has an enormous impact on their financial security.

Clearly, transparency is not a panacea. It is necessary to tackle the underlying imbalances of power between principals and agents, and information is only one of these imbalances. Given the increasing complexity of financial innovations, it would also not be realistic to assume that greater transparency alone will empower principals to prevent investment behaviours which are irresponsible, self-serving or destructive of long-term value. In short we believe that transparency is a necessary but not sufficient condition for responsible capital markets.

Directors' Remuneration

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

Comments

We shall not attempt to give a comprehensive answer to this question but would like to comment on three specific points mentioned in the consultation document, which we have raised in previous responses to the FRC's consultations on the Corporate Governance Code and the Walker Review:

Firstly, we agree with suggestions that the non-executive directors who comprise remuneration committees may not be "sufficiently independent and able to align effectively the remuneration of directors to the longer term interests of the company and its shareholders" (section 5.11). In our submission of May 2009 to the FRC's first consultation on the then Combined Code,[27] we suggested various amendments to the Code's provisions relating to the independence of non-executive directors (now contained in section B1.1

[27] The submission is on the FRC website (see page 7)

of the Corporate Governance Code). For instance, that executive directors should not participate in board decisions as to which NEDs are to be considered independent, and that there should be an absolute prohibition on any NED being regarded as independent if any co-director of the company is also a co-director of the NED in another company and has any role in determining the NED's remuneration in that other company. We continue to believe that such changes would be valuable.

Secondly, we agree that remuneration committees are not "sufficiently sensitive to wider factors which may be relevant to the long-term interests of the company and its shareholders – in particular to pay and conditions elsewhere in the group" (Section 5.11). As we argued in our submission of March 2010 to the FRC's final consultation on the revised Code,[28] there is compelling evidence that the Corporate Governance Code's requirement to consider pay and conditions elsewhere in the group is largely a dead letter. We suggested that, as a minimum measure, the Code should require remuneration committees to report on precisely how they had taken this into account and to publish comparative figures. (This appears to be similar to the proposal mentioned in section 5.14 of the consultation document.) We still consider this to be a necessary, if perhaps not sufficient, requirement.

Thirdly, the consultation document refers to the lack of transparency surrounding the significant influence of the remuneration consultants who advise the remuneration committee (section 5.12). In our submission of September 2009 to the Walker Review[29] we suggested various ways in which the new code of practice for remuneration consultants should be strengthened.

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

Comments
No comment.

Question 13: Are shareholders effective in holding companies to account over pay? Are there further areas of pay, e.g. golden parachutes, it would be beneficial to subject to shareholder approval?

Comments

[28] The submission is on the FRC website (see pages 7 and 8)
[29] The submission is on the FRC website (see page 25).

Shareholder interest in pay does appear to have increased in the wake of the financial crisis, with management resolutions on remuneration being among the most controversial votes of the most recent AGM season. However, as the consultation document notes, directors' pay continues to grow out of all proportion to average salary increases or to any increases in share values. This very fact suggests that shareholders' activity in this area has not been highly effective.

We would suggest that this is another instance of agency problems in the investment chain. This is a clear example of the alignment that often exists between the public interest and the long-term interest of enlightened shareholders. Yet the outrage of ultimate asset owners about excessive boardroom pay has not been matched by the robustness of shareholder engagement on this issue.

In addition to enhancing shareholders' rights to approve pay packages, government must examine the reasons why existing shareholder rights are not being used to better effect. This, of course, feeds into many of the other questions posed by this review.

None the less, we do also favour increases in shareholder powers in this respect. In particular, as we have argued in the FRC's previous consultations on what is now the Corporate Governance Code, we believe that the Companies Act 2006 should be amended to make the present advisory vote on the Directors' Remuneration Report under section 439 mandatory, and that pending such amendment the Code should recommend that the advisory vote be treated as mandatory.

We also agree with the specific suggestion in paragraph 5.18 of the consultation document that shareholder approval should be required for payments to directors for loss of office, whether or not such payments are due under existing contractual arrangements. As we have said previously in relation to mandatory approval for remuneration generally, we think that contractual arrangements should in future be expressed to be subject to shareholder approval.

<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?**

Comment

Please see our comments in questions 6, 9 and 10 regarding the value of transparency in general, and in question 11 regarding transparency on pay ratios in particular.

Takeovers

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

Comments
No comment.

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?

Comments
No comment.

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

Comments