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Long-term Focus Consultation
Corporate Law and Governance
Department for Business, Innovation and Skills
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A Long-Term Focus for Corporate Britain: A Call for Evidence

Dear Sir / Madam,

Thank you for giving the Institute of Directors (IoD) the opportunity to comment on your consultation document, published in October 2010. Issues surrounding corporate governance are of considerable interest to the IoD and its membership. We are therefore pleased to present our views on your paper.

About the IoD

Founded in 1903, and granted a Royal charter in 1906, the IoD is an independent, non-party political organisation of 45,000 individual members. Its aim is to serve, support, represent and set standards for directors to enable them to fulfil their leadership responsibilities in creating wealth for the benefit of business and society as a whole. The membership is drawn from right across the business spectrum. 92% of FTSE 100 companies have IoD members on their boards, but the majority of members, some 70%, comprise directors of small and medium-sized enterprises, ranging from long-established businesses to start-up companies.

General Comments

This section of our response addresses the overarching issue of the consultation: whether a stockmarket listing leads to excessively short-termist behaviour on behalf of UK companies. A subsequent section provides responses to specific consultation questions.

The time horizon of a company

The company is a legal vehicle that may be used to pursue a variety of commercial activities. The time horizon of these activities can vary considerably. In some sectors of the economy, e.g. pharmaceuticals or technology, it may be important to take a long term investment approach. However, in other circumstances, a shorter-term horizon may be essential for the company's survival and prosperity.

Ultimately, the company's relevant time horizon can only be determined with regard to the specific circumstances of the company. It cannot be assumed that the adoption of a long-term approach is

always optimal. This is an issue that is best determined by boards of directors – in consultation with shareholders - in the light of a company's distinctive strategy and business environment.

The most important feature of governance for any company is not whether it adopts a short or long-term management perspective. Rather, it is whether its management is properly accountable (to the board and shareholders) for the implementation of the agreed strategy. Company management that fails to achieve short-term goals defined by the strategy is just as guilty of poor performance as management that pays inadequate attention to the longer term.

Sources of short-termism in quoted companies

A potential source of short-termism in stockmarket-quoted companies is the uncertainty engendered by a volatile share price. In particular, a falling share price is unsettling for company management. It is suggestive of poor performance. It increases the company's cost of capital and makes it potentially vulnerable to a takeover bid. Furthermore, the remuneration of company executives may be tied to share price performance.

Unfortunately, the possibility of significant share price movements is an inevitable consequence of a stockmarket listing. Movements in share prices arise, in part, due to the high levels of corporate disclosure that are demanded by stockmarket listing rules. External investors require high levels of both transparency and market liquidity if they are to be persuaded to invest large sums of money in enterprises from which they are relatively distant. Share price volatility may also occur as a result of changing market perceptions of growth and risk, both in relation to the company and the broader economy.

Despite these potential problems, the overwhelming view of our members is that the short-term pressures arising from a stockmarket listing can be appropriately managed by an effective board of directors. The benefits of gaining access to significant capital market resources outweigh the costs.

The role of investors

Share price volatility is undoubtedly exacerbated by the short-term investment horizon of many institutional shareholders. The investment strategy of a significant proportion of fund managers is oriented towards share trading rather than long-term company ownership.

The newly-introduced Stewardship Code is an attempt to encourage institutional shareholders in UK companies to adopt a longer-term and more engaged approach to company ownership. However, it is important to be realistic about the likely impact of the Stewardship Code. There are a number of reasons why its effect on investment behaviour is likely to be relatively limited.

- **Many active fund managers are subject to relatively short-term performance pressures**. In most cases, this leads them to concentrate their efforts (and human capital) on stock-picking and equity trading rather than long-term engagement with their companies under ownership.

- Engagement between shareholders and boards is often infeasible due to the diversified portfolio strategy of many institutional fund managers. Such institutions hold relatively small percentage stakes in large numbers of listed companies**. As a result, they lack the incentive to meaningful engage with any individual company.**

- Many institutional fund managers are deterred from devoting significant resources to engagement due to the costs involved and the "free-rider" benefits that competitor fund managers with stakes in the same company would gain as a result of such activities.

None of these underlying problems is overcome by the introduction of the Stewardship Code. Consequently, we are sceptical as to whether many fund managers will fundamentally change their investment behaviour in favour of a long-term ownership approach.

Other models of corporate ownership

It is worth noting that the short-termist pressures arising from a fluctuating share price are not a feature of the private company model. Private companies do not have stockmarket-determined share prices, and their shares cannot be easily transferred between investors.

As a result, company management is less exposed to fluctuations in company valuation, and can focus on achieving longer-term operational success. For this reason, many significant companies may choose, quite reasonably, to go private or forego a public listing.

The transmission of short-term pressures from stockmarkets is also reduced in listed companies with a controlling shareholder or blockholder. Although such companies have a market-determined share price, this will not necessarily influence management behaviour if the blockholder is willing to take a longer-term view.

Unfortunately, there are very few controlling or significant shareholders of large UK listed companies. Ownership is dominated by institutional shareholders with small percentage ownership stakes.

Given the key role of institutional investors in mobilising savings in the UK, it is hard to envisage any change to this situation. This contrasts with corporate sectors in continental Europe and many other countries outside of the English-speaking world, where blockholders continue to dominate company ownership.

Overcoming short-termism – the key role of the board

The IoD believes that the short-term pressures arising from a stockmarket listing can be most effectively addressed through the actions of boards rather than through regulatory changes or changes to the shareholder voting regime.

The board must be active in ensuring that the company adopts a time horizon that maximises corporate value creation. There are several ways in which it can do this.

Firstly, boards should actively seek to attract shareholders to the company that share the strategic time horizon of the company. Although many UK institutional shareholders do not have a long-term investment horizon, shareholders are not a homogeneous set of actors. Certain types of shareholders may be willing to adopt a longer-term oriented investment approach.

This is more likely to be the case if shareholders fully understand the company's strategy and key performance indicators. **Boards should therefore place a high priority on clearly communicating the corporate mission and strategic timeframe of the company to potential investors and other stakeholders.**

One way of achieving this is through a Board Mandate[1]. A Board Mandate is a statement by the board of its strategic intent with respect to performance outcomes. With respect to investors and other stakeholders, a mandate provides a clear investment proposition, with identified parameters of success and risk, and helps manage expectations in terms of timeframes.

[1] Tomorrow's Good Governance Forum. Tomorrow's Corporate Governance: The Case for the 'Board Mandate'. December 2010.

With the help of such a mandate, or something similar, the board can explicitly communicate the time horizon to which the CEO and the rest of the management should be held accountable. In this way, the board can work towards encouraging an ownership structure that makes sense for the company.

Secondly, the board should ensure that the timeframe of executive remuneration policies is matched to the overall strategic timeframe of the company.

If corporate success is defined on a longer-term basis, the board should avoid incentivising the pursuit of short-term financial targets by executives. The remuneration committee should define financial and non-financial performance criteria that best align the time horizon of executives with that of the company.

Thirdly, if short-term market pressures are brought to bear on management, e.g. through the volatility of the share price or the emergence of a hostile takeover bid, the board should play a key role in shielding management from these external pressures. They should continue to offer this support as long as they remain convinced that the existing management team is best placed to implement the long-term strategy.

During times of short-term uncertainty, the board should not allow the CEO and the executive team to become distracted from their operational management of the business. **Boards should support them by playing a significant role in communicating the existing business strategy to the market, and by building a supportive dialogue with investors.**

Answers to specific questions

The Board of Directors

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

In general, we believe that UK boards of directors do a good job in aligning the behaviour of management with appropriate business timescales. Whether this is a longer or shorter-term timescale depends on the nature of the business and the specific circumstances of the company. The key point is that management are held properly accountable for the implementation of the business strategy.

However, we also recognise that many market and regulatory mechanisms (for example quarterly analysts' presentations and quarterly reporting) can promote a short-term management orientation. However, in general, boards are able to manage these tensions.

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?

There are two mechanisms by which companies can identify shareholders on the corporate register. Public companies have the right under section 793 of the Companies Act 2006 to demand the identity of their beneficial owners and to place restrictions on the shares in question if the owners do not respond. In addition, the FSA Disclosure and Transparency Rules (DTRs) require a notification by investors to the issuer when an investor has acquired an interest in more than 3% of the issued share capital.

However, there are problems with the practical implementation of these procedures. Our members inform us that it is relatively easy for shareholders who wish to remain anonymous on a corporate

register to do so (particularly if they are based outside the UK). This is an area where we believe it would be beneficial to make minor regulatory changes to ensure speedy and effective shareholder identification. However, such changes should ideally occur as part of a wider European review of cross-border shareholder identification.

The DTR rule changes made in June 2009 requiring disclosure of positions in contracts for difference and other derivative products were useful in giving companies a clearer picture of the identity of those with significant economic control over shares.

Shareholders and their role in equity markets

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

The implications of the changing nature of UK share ownership for corporate governance cannot be underestimated.

Modern listed companies no longer operate in a world where an identifiable and homogenous group of domestic institutional investors are representative of company owners. Foreign shareholders now own more than 40% of UK listed companies. In contrast, the share of UK pension funds and insurance companies has declined to less than 25%.

Substantial investment by sovereign wealth funds (both before and during the financial crisis) represents an interesting new phase in the development of UK corporate ownership. Worryingly, many of these funds disclose little about their objectives and operations. However, more positively, they represent a potential new source of patient capital that could provide UK companies with committed and long-term shareholders in the future.

The trading activities of hedge funds are sometimes a source of legitimate concern for directors. Directors often feel aggrieved by the short selling of their company's shares. In our view, institutional investors should be subject to a disclosure regime with respect to stock lending activity (which underpins the short-selling of hedge funds). This would include the following components of best practice[2]:

- Institutional shareholders should have a clear and disclosed policy with respect to the lending of shareholdings;
- Lending policy should be mandated by the ultimate beneficial owners of the shares;
- Where lending activity may alter the risk characteristics of a portfolio, the investor's investment policy should state the extent to which this is permitted;
- The returns from lending should be disclosed separately from other investment returns when reporting to clients or beneficiaries;

As a general principle, it should be regarded as bad practice to borrow shares for the purpose of shareholder voting.

4. What are the most effective forms of engagement?

There are many forms of engagement, e.g. private discussions, shareholder voting, public debates, etc. The most appropriate form of engagement in a particular situation is a matter for the board and its shareholders. However, we believe more use could be made of web and electronic media to facilitate more engagement with a broader group of investors.

[2] These principles are based on the International Corporate Governance Network's Securities Lending Code of Best Practice (2007).

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

We are concerned about the apparent lack of interaction between investment and governance teams. Our fear is that investor governance teams are just a form of public relations activity, rather than being part of the core business activity of a fund manager. Given the nature of the business model of many investors – based on equity trading rather than active engagement – this remains a challenge for the fund management community.

6. 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?

Voting is an important engagement mechanism. However, it should not be over-emphasized. Many shareholders seem to think that the mere act of voting their shares – either directly or via a proxy advisory firm - discharges their entire ownership obligations.

Ideally, shareholders should engage with their companies throughout the year in a variety of different ways. Voting represents a bare minimum in terms of shareholder engagement.

Fund managers should be required to disclose their voting decisions. There is a lack of accountability in this area. This is in need of reform, both in the UK and across Europe.

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

See general remarks above.

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?

See general remarks above. A number of commentators have suggested that investors should be given economic incentives to pursue a long-term investment approach, e.g. loyalty dividends or preferable tax treatment. We do not believe that the equity market should be distorted in this way. Long-term investors – such as passive index funds – may devote minimal resources to company engagement. In contrast, short-term investors can, in certain cases, exert a beneficial effect on a company's governance through an active and constructive process of company dialogue. It would be inappropriate for the latter group to be disenfranchised (or otherwise disadvantaged) as shareholders.

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

The modern fund management industry has constructed a long and complex investment chain between money managers and ultimate beneficial owners (e.g. involving proxy voting agencies, investment consultants, custodians, and other forms of intermediary). This distorts lines of accountability between fund managers and beneficial owners.

However, it cannot necessarily be assumed that actual or potential beneficial owners of shares (e.g. trustees, policy holders, retail investors) demand a long-term stewardship orientation from their

investment suppliers. It could in fact be seen as exerting a negative impact on investment returns (e.g. through higher administration costs or by inhibiting the flexibility of the investment process).

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

Transparency in the role of fund managers and their remuneration would be beneficial for market participants, especially for the ultimate beneficiaries in the investment chain.

Directors' Remuneration

As a general observation, we think that it is important to distinguish between the concept of directors' remuneration and that of senior executives (including the CEO). They are not the same thing. In most cases, the remuneration debate centres on the pay of executives not directors. The clarity of the debate would be improved if this distinction were made in future policy deliberations.

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

The additional disclosure brought about by the Directors' Remuneration Report Regulations, introduced in 2002, and the increasing use of remuneration consultancies pushing for top quartile performance, may have been factors ratcheting up executive pay in recent years.

Boards have historically operated on the assumption that superior shareholder value can be achieved if the interests of management are aligned with those of shareholders. However, while equity compensation may be appropriate as an incentive, other types of incentives may also be relevant in aligning management's interests with the interests of the company (including its optimal time horizon). Ultimately this is something that can only be determined, on a case by case basis, by individual remuneration committees.

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

We do not believe that this would be desirable. Independent non-executive directors are best placed to properly evaluate executive remuneration policy. We do however believe that the activities of remuneration consultants need to be more closely monitored by the board, and that companies should give greater disclosure on the activities of remuneration consultants including their fees and any other work that they are engaged to undertake for the company.

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

We believe that shareholders have more than sufficient powers to hold companies to account in respect of executive remuneration.

However, ultimately the remuneration committee, composed of independent non-executive directors, is the best forum in which to make an informed judgement about executive pay.

We do not think that a shareholder vote on golden parachutes is necessary.

14. What would be the impact of greater transparency of directors' pay in respect of:

- ***linkage between pay and meeting corporate objectives***
- ***performance criteria for annual bonus schemes***
- ***relationship between directors pay and employees pay?***

We would like to see greater transparency in the linkage between executive pay and meeting corporate objectives. However, it should also be recognised that this may not be possible in certain instances, due to the possible need for confidentiality in respect of aspects of corporate strategy. An independent board (and remuneration committee) is the most viable means of monitoring the robustness of the link between executive pay and performance.

We do not feel that publication of the relationship between executive pay and employees pay is helpful from a corporate governance perspective. We see this proposal as motivated more by political considerations rather than any potential impact on corporate effectiveness.

Takeovers

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

In general, we believe that boards do understand the long-term implications of bids. However, shareholders also have an obligation to fully engage on any bid and engage with the company if there are areas of concern.

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?

We believe that the shareholders of the acquiring company should play a significant role in the takeover decision-making process.

From a corporate governance perspective, it is puzzling that decision-making in respect of a takeover has historically focused on the shareholders of the target company. The acquiring company's shareholders are actually more exposed to the longer-term consequences of the takeover than those of the target company (who may not remain as shareholders in the combined entity).

Significant takeovers are distinct from many other types of corporate activity in their capacity to transform the prospects of the acquiring company in a relatively short period of time. The stakes are particularly high for offeror shareholders - a significant amount of academic research suggests that many takeovers have negative implications in terms of value creation for the shareholders of acquiring companies[3].

At such a crucial moment, it is important to ensure that the interests of management and shareholders are properly aligned, i.e. that shareholders fully buy into the logic of the takeover. In our view, this is best achieved by making all significant takeover transactions conditional on securing the

[3] The following articles provide a review of the available academic evidence: Andy Cosh and Alan Hughes. June 2008. Takeovers after Takeovers. Centre for Business Research, University of Cambridge; Marina Martynovaa, and Luc Renneboog. October 2008. A century of corporate takeovers: What have we learned and where do we stand? Journal of Banking and Finance; Christian Tuch and Noel O'Sullivan. 2007. The impact of acquisitions on firm performance: A review of the evidence. International Journal of Management Reviews.

approval of shareholders. This condition would apply equally to acquiring companies from both the UK and overseas.

As well as ensuring an alignment with shareholder interests, such a “say on takeovers” would also provide wider society with greater assurance that the potential risks and negative externalities of a hostile takeover are justified by the benefits in terms of longer-term value creation. As a result, the legitimacy of takeover activity in the eyes of employees and other stakeholders would be increased.

It has been argued that it is not feasible to demand shareholder approval from the shareholders of a non-UK company. Such companies lie outside of the UK’s jurisdiction. This may affect the ability of the UK to make demands concerning their internal governance or decision-making mechanisms.

We are not convinced by these arguments. It is legitimate for the UK to be able to define the “rules of the game” that apply in respect of a takeover of a UK company. Compared to most other major economies (including the United States), the UK has a remarkably open and unrestrictive takeover regime. In relation to the obstacles that can placed in the way of takeover bids in other jurisdictions, e.g. poison pills and various forms of government interference, the requirement of shareholder approval would represent a modest constraint on the freedom of action of the acquiring firm.

It has also been argued that the requirement of a shareholder vote would be a mere formality for a company controlled by a blockholder (i.e. a shareholder with a large controlling stake). This would in some way reduce its value. Blockholder controlled companies are common outside of the Anglo-American corporate sectors, and amongst unlisted companies. In contrast, UK and American listed companies tend to have a diffuse ownership structure.

However, this criticism misses the point of what shareholder approval is trying to achieve. A shareholder vote is aimed at ensuring that there is an alignment between the interests of shareholders and management. In other words, it indicates that the suppliers of risk capital are satisfied that the proposed takeover represents a productive use of their resources. Although it may be easier for blockholder controlled companies to gain shareholder approval, this does not change the meaning of such an assurance.

At the current time, UK companies with a premium listing on the London Stock Exchange are subject to the significant transactions rules of Chapter 10 of the FSA’s listing rules. These may require shareholder approval of proposed takeover transactions that exceed a specified relative size threshold[4]. However, the rules do not apply to acquiring companies without a premium listing, e.g. non-UK listed companies or UK companies without a premium listing.

In our view, all bids for large UK listed companies (e.g. those within the FTSE 350 or with a premium listing on the LSE) should be conditional on the approval of the acquiring company’s shareholders. Such large listed companies are in some sense, public interest entities; i.e. they have systemic importance for the UK economy, regardless of their size relative to the acquiring company. Consequently, hostile bids for such entities should always be subject to the scrutiny of shareholders.

For smaller UK listed companies (e,g, those outside of the FTSE 350, or with a standard listing on the LSE, or a listing on AIM or PLUS), there is a stronger case for arguing that the need for a shareholder vote should depend on the relative significance of the transaction for the acquiring company. In such circumstances, the FSA significant transactions criteria (or something similar) could be used in order to determine the threshold for a shareholder vote.

Other

[4] This occurs when the takeover qualifies as a “class 1 transaction”. This would typically occur if the target company represented more than 25% of the acquiring company in terms of metrics such as gross assets, profits, market value, or gross capital.

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

No.

Thank you once again for inviting the Institute of Directors to participate in this consultation. We hope you find our comments useful.

Yours sincerely,

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