BIS | Department for Business Innovation & Skills

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:

	Quoted company
	Other company
	Investor or investment manager
	Business representative organisation
	Investor representative organisation
	Non governmental organisation (NGO)
	Trade Union
	Lawyer or accountant
X	**Other (e.g. consultant or private individual)**

The Board of Directors

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

Comments
In my experience, yes. However, long-term focus is relevant not only when it comes to planning, but also in deciding on a response to a given situation. UK boards will not readily adopt long-term plans which significantly hit their results in the short/medium term – apart from anything else on account of exposing vulnerability to takeover before the strategy has borne fruit. **Faced with a takeover, short-term considerations are to the fore – since experience has shown the difficulty of getting across to shareholders a long-term case in the face of the sort of premium normally on offer.** **Remuneration targets with time horizons also have their impact on strategy.** **As an aside, I question the statement in the Consultation Paper to the effect that the British model of corporate governance puts more emphasis than the US model on the importance of shareholders being able to hold the directors to account. The risk of a class action in the US if something "goes wrong" makes directors of US companies highly aware of the possibility of their being held to account.**

<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?

Comments
Yes, in my experience – although I haven't had direct experience of the wholesale changes in the membership that a company experiences when it "comes into play" in a potential takeover situation.

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?

Comments
The consultation paper looks, for comparison, to some extent to the US. It would also be desirable to look at Far Eastern markets – both because there the relationship of shareholders to board works differently, and because of the ongoing shift in world economic power. The Hong Kong equity markets, for instance, have had high-volume trading for decades – with a near total focus by shareholders on short-term returns, and the consequent lack of empathy between most shareholders and investee company boards that is often now to be seen in London. **Stock market capitalism is much newer in Asia than in London – so the way in which listed companies in Asia are able to manage their long-term strategies is by ensuring that the companies are controlled, generally by the founding family. It is worth giving this point emphasis: virtually all listed companies (hardly any exceptions) in China, Hong Kong and Singapore are takeover-proof in the absence of agreement by shareholders whose appointees control the board. Although outside my personal experience, I imagine the same also to be true in Japan (although there the result is achieved by cross-shareholdings rather than through family control).** **Although it is not hard to find examples of abuse, this undoubtedly facilitates the adoption of long-term strategies by listed companies. By definition there is unity of view between the controlling shareholders and the board. It also results in a much tighter control of remuneration than is to be found in the UK (see questions 11 to 14). I cannot imagine that these Asian controlled companies could allow to exist the sort of expectation found here as to the allocation of a proportion of profit to an executive bonus pool. It would be interesting to analyse the extent to which the resulting governance contributes to financial performance – over and above the advantages derived from participating in the Asian growth story.** **In Asia any listed company not protected by control would almost certainly be taken over rapidly. In the UK, the combination of the institutional investor (eager to take advantage of the occasional takeover premium to boost its investment record) and the investor from overseas has made almost all listed UK companies vulnerable to takeover. This has certainly had three results. First, the importance of running the company so as at all times to minimise the risk of an attempted takeover. Second, the significant number of major UK companies that have been taken over (often by overseas acquirers), particularly in the boom years running up to 2007/8. Finally, the focus by senior executives on their rights in the event of losing their jobs**

following a takeover.

Two further points:

- **I do think that the nature of portfolio investment means that active involvement by institutional investors will be limited – at least until something has "gone wrong". Institutional investors are discouraged from taking board positions (apart from anything else, their nominees would be liable not to be "independent" under the Corporate Governance Code) – and the complexity of the issues is always going to reduce institutional investor effectiveness, save in relation to issues they really focus on (e.g. whether a takeover premium is high enough, or where a problem has clearly manifested itself).**

- **The increase in the proportion of shares that are owned overseas has the potential to cause difficulties in certain cases. I well remember the dismay with which the French authorities realised, some years ago, that the takeover situation that had come to affect three of France's major banks might be capable of being decided not in France but by shareholders in London.**

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

Comments
Realistically, this differs according to the listed company and the particular shareholder. A major listed company (e.g. one of our major banks) will have no difficulty in accessing the key people on the investment side of any institution. A FTSE 250 company will have great difficulty in doing the same, outside of an exceptional situation – and is all too liable to be fobbed off with a corporate governance person literate only in the language of corporate governance. **A particular area of difficulty arises in relation to tracker funds. Great frustration will inevitably be experienced by a listed company asked to summon up the enthusiasm to talk to the corporate governance expert of a tracker-following institutional investor.** **An important area that has gone wrong, however, concerns the formal documentation called for by our regulatory authorities. Annual and interim accounts have become so technical that their detailed content (as opposed to headline numbers) has become meaningless otherwise than to a limited number of specialist users, as reference documents or as defence documents in a litigious or regulatory scenario. The same is true in spades of the documentation called for in equity fund-raising and takeover situations. The problem here is not limited to investors – understanding accounts, rights issue or takeover documents in their**

present form must be beyond many directors. The human frame is simply unable to deal with an annual report that runs to 500 or 600 pages – and the same must be true when it comes to deriving any real conclusions from the sort of statements on risk factors that currently appear.

I don't suppose that it will be practicable to roll back the regulatory approach that produces this result. The solution must lie in recognising the reference only nature of these documents (and the fact that they demonstrate that the headline numbers comply with the accounting rules) – and supplementing them with short material capable of being understood both by those putting it forward and by investors.

It will be interesting to see whether narrative reporting is effective to remedy matters – and the suggestion of a standard opening page to the totally indigestible directors' remuneration report could help here. Of course, companies boil down what they really want to say in slide presentations to analysts – which function outside of any formal regulatory framework and are directly available only to a few. However, this hardly seems a properly intellectual answer to the fact that the regulated documents are in reality indigestible background material.

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

COMMENTS

Only very rarely. Investment teams will generally be uninterested in a corporate governance topic only when something has "gone wrong" as a result of an action contrary to the Corporate Governance Code. Corporate governance people will rarely have the degree of focus on investment matters required to enable them to participate in a substantive merits discussion with the company. I was surprised by the statement in the Consultation Paper which seems to suggest that corporate governance teams in institutions may have more effective relationships with boards of investee companies. I would have thought it would, at least with FTSE 100 companies, be the other way round.

<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?

Comments

Boards will wish to understand the issues underlying voting – and where appropriate subsequently to take up those issues with the institution concerned. I do not have information on the second half of this question.

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

Comments
The UK approach in equity markets has developed over some one and a half centuries, and is a fact. I doubt the practicality of addressing short-termism as a factor in bid situations. The desire to take advantage of a bid situation that produces a share price thought unlikely to be replicated for some time is always liable to provoke profit-taking by a substantial body of shareholders. They can sell in the market or accept the bid. **It does not seem practical to me to disenfranchise shareholders who have only owned their shares for a limited time. That could result in a bid succeeding or failing at a percentage level which logically would be expected to produce a different result. And it would invite the development of structures designed to overturn the intent of the legislation.**

<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?

Comments
Please see my previous comment. Given the remarkable way in which the average holding period of investments has come down, I would not be optimistic here. **One suggestion would be to re-think the (rebuttable) presumption made in the Corporate Governance Code against the independence of a non-executive director appointed to represent a significant shareholder. Independence (of non-executive directors) in the Code is concerned mainly with independence from the executive. Nothing could more improve the engagement between an institutional investor (or group of institutional investors) and a listed company than representation on the board – and nothing could more encourage a long-term focus by the institution(s) concerned. The rationale behind the present presumption lies partly in a concept of the purity of independence (surely too**

abstract a concern) and partly in a concern to avoid conflicts of interest. As to the latter, my experience is that this can be sufficiently addressed by some mechanism such as a wholly independent "governance committee" – absent mala fides, where different remedies will anyway be called for. I have long thought that this particular presumption should be reversed.

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

Comments
No comment from me on this.

<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
No comment from me on this. Greater transparency hasn't helped in other areas.

Directors' Remuneration

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

Comment

“Big Bang” in the City at the end of the 80s had many positive results – but a more debatable consequence lay in the import into the UK of Wall Street remuneration practices for much of the financial services sector. This resulted, in due course, in hugely increased remuneration for key people in the financial services sector (as well as changed loyalties, which came for many to focus almost entirely on short-term remuneration considerations).

It took time for the impact of these higher remuneration levels to spread more widely into senior positions elsewhere among non-financial listed companies – but this has now happened, encouraged by the growth of private equity. The trend has been significantly boosted by two other factors – transparency in relation to directors’ remuneration, and the near universal use of remuneration consultants by remuneration committees consisting of independent non-executive directors. I fear that these factors must account for the dramatic increases since 1998.

The complexities of remuneration structures, and the obvious importance of not allowing the loss of key personnel on account of out-of-line remuneration levels, has led remuneration committees to rely heavily on remuneration consultants. At the same time, the effect of these consultants is to ratchet up pay. They will often make comparisons with “first quartile” remuneration in comparable companies – but never to “last quartile”!

Key people can make a tremendous difference – so it is difficult to say that what is happening is inappropriate. It cannot be healthy in the long-term for remuneration to be at dramatically different levels in the financial and non-financial sectors. However, as the Consultation Paper shows, the gap between CEO and average salaries has now reached remarkable levels. The controlling shareholders who predominate in Asia (where there is not the same transparency in remuneration levels – nor, so far as I am aware, are remuneration consultants extensively used) are only going to allow pay to get to stratospheric levels when deemed appropriate to award truly impressive results.

Committees of independent non-executive directors will, with the best will in the world, have to work with the CEO (except in relation to the CEO’s own remuneration) and remuneration consultants. They will only exceptionally be able to take the same ownership of this difficult topic as controlling shareholders will often do.

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

Comments

I doubt whether this would have much (downward) impact. Chairs of remuneration committees already ensure that they are up to speed both with the perceived "market" (through remuneration consultants), and with the thinking of the company chairman and CEO.

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
I am certainly not clear that shareholders (other than controlling shareholders) are effective in relation to pay. The trouble with formalities in relation to the remuneration topic (including golden parachutes) is that the considerations are detailed and complicated. If the opening page of the directors' remuneration report that is currently under consideration were baldly to state the effect of summary wrongful dismissal for each executive director at the latest date before the finalisation of the annual report, then shareholders would at least understand what was being put before them. However, the figures might look pretty dramatic, and the downside to this proposition would need evaluation before adoption.

Question 14: What would be the impact of greater transparency of directors' pay on the:

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

Comments
No particular comment from me here.

Takeovers

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

Comments
Clearly they sometimes do, and sometimes don't. The three greatest misfortunes experienced by UK banks in 2008/9 all derived from takeovers – the acquisitions of ABN AMRO, HBOS and Household Financial. Presumably if the long-term implications are not understood by the board, they will not be communicated effectively. **A truly remarkable feature of takeovers is the role accepted (universally, I think) for the financial advisers to bidders. In formal terms, this is limited to advising on implementation – the financial adviser to a bidder does not advise on the desirability or otherwise of the bid in the bidder's financial interest. In circulars to shareholders, this position is laid out in terms clear to the City cognoscenti, but not in a way that would make the position apparent to most shareholders. They will no doubt assume that the organisation named as "financial adviser" gives financial advice on the merits of the transaction they are invited to consider. Financial advisers are normally heavily incentivised – but that incentivisation is merely to have the bid succeed.** **Were all the directors involved in the three problem financial bids just mentioned aware that the financial advisers concerned were not expressing views on the merits of the bids? At the least, the position should be spelt out in terms that clearly bring the position home.**

<u>Question 16</u>: 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. The Listing Rules so require in the case of major acquisitions. What should and should not be subject to a mandatory shareholder approval requirement should be a question decided on relative size considerations – not on the nature of the transaction. Just because a takeover bid is involved, as distinct from a private agreement, should not be the determining factor.

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

Comments

I would make one observation, given the current focus on whether takeover bids can be sufficiently relied on to take proper account of long-term factors, and on current high levels of senior executive remuneration. This concerns the Corporate Governance Code requirement that the current board balance model – a chairman who was "independent" on appointment and at least half the board, excluding the chairman, being "independent" non-executive directors.

The intent of this requirement is that there should be a board majority capable of taking a view contrary to that of the executive – especially if that is seen to be the wish of a majority of the shareholders (in particular the institutions). Given that such a majority will wish a bid at what is deemed the "right" price to succeed, the board balance is thus consistent with price, rather than long-term vision (if not adequately reflected in price), being the determining factor in a bid.

Per contra, the independent non-executive director requirement on remuneration committees does not, I would think, deliver as committed or strong a result as in the controlling shareholder model.

Thus, on the twin measures of takeovers and remuneration, the UK's focus on independence is liable to produce a weaker result than its Asian counterpart.