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
	Other (e.g. consultant or private individual)

Human Potential Accounting (HPA) helps organisations measure, manage and report on their human capital more accurately and transparently for the benefit of stakeholders and potential investors. It conducts research and encourages professional debate through its not-for-profit interactive website HubCap http://alpha.hubcapdigital.com and its microsite Accounting for People 2.0 www.accountingforpeople.org, which can be used by anyone contributing to the evidence base needed to transform the systematic reporting of human capital assets and liabilities.

In more detail its **Objectives** are to ensure that organisations can:

1. **Measure, Manage and Develop their Human Capital** – in order to make informed people decisions based on risk, value and cost
2. **Report on Human Capital** – using appropriate, balanced and comparable metrics, consistent with accounting protocols, to inform all stakeholders (including investors, shareholders, auditors, government, employees and their representatives)
3. **Objective 1** is internally focused, providing immediate analysis of data to inform and guide organisations in all aspects of people management.
4. **Objective 2** is internally and externally focused, providing 'Accounting for People' reporting in a form consistent with developments in global financial accounting and relevant legislation.

Respondents
This response has been brought together in conjunction with a number of experienced and influential individuals who have endorsed this submission. Please see the list below:

- Stephen Newton: Managing Director of DLO Associates
- Adrian Henriques: Visiting Professor of Accountability and CSR at Middlesex University Business School
- Dermot Toberty: Director HR Services, Royal Mail
- Morgen Witzel: Author, Honorary Senior Fellow at University of Exeter Business School and Corporate Consultant
- Tony Palmer: Managing Director at Marple Partnership
- Dr P.T. Brown: Visiting Professor in Organisational Neuroscience, London South Bank University and Visiting Professor in Individual and Organisational Psychology, the Nottingham Law School
- Raj Thamotheram: Senior Advisor with AXA Investment Managers
- Don Young: An executive in British industry for more than 40 years, with senior board roles including director of Organisation and Human Resources for Thorn EMI plc and Redland plc. Chair and co-founder of YSC Limited
- Andrew Dakers: Former Councillor for Brentford Ward and Leader of Hounslow Liberal Democrats 2006-2010

The Board of Directors

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

Comments
The UK system of involving shareholders has the opportunity to provide safeguards and ensure a balanced short- and long-term focus. However, much evidence exists that investors are lacking information about the longer-term focus, along with data about previously considered 'intangibles,' such as sustainability and Human Capital assets and risks. Companies which do report consistently and reliably on the intangibles have been shown to be more profitable and sustainable, and they manage people well. The recent CIPD report "Human capital reporting: what information counts in the city?" and the McLeod Review of employee engagement provide some evidence for this. It seems that the interests of shareholders (and potential shareholders – i.e. investors), employees (including Board members), analysts and customers of the company in question are not necessarily aligned. **In short: Boards are inhibited from taking a long-term view because they are hobbled by reporting standards and practice that preclude treating people as investment rather than mere cost.**

<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
No, the legislation does not go far enough. If investors identified themselves and their interests routinely, rather than on request, the company/investor dialogue would be encouraged, boards would understand more and be able to influence the thinking of investors, as well as the reverse. Boards may not in fact be willing and/or able to influence investors without assistance. The first step towards influence is the provision of relevant and sufficient information, through legislation if not voluntarily. Then board/investor meetings and communication could be improved to allow both parties to educate and influence. Potential conflicts of interest would need to be resolved.

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
Investors are increasingly global institutions, rather than individuals in the UK. This makes it hard for investors to 'know' the boards of companies in which they have share ownership. Conversely, companies have difficulty knowing with whom to communicate in order to influence investor strategy. Globalisation has made it easier to fudge transparency, and bury simple truth under a mound of superfluous detail.

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

Comments
Engagement between boards and investors has been shown to be effective when based on factual information covering all aspects of the business. As this improves in the UK, investors are now beginning to understand the value of asking more about the previously intangible but significant data and boards are encouraged to take the longer-term view. The most effective forms of engagement are: •Board/investor interaction wherever possible, based on facts. See for example the report from the Institute of Corporate Directors, "Shareholder Engagement: Harness the Potential for Your Board" at http://www.corpgov.deloitte.com/binary/com.epicentric.contentmanagement.servlet.ContentDeliveryServlet/CanEng/Documents/Board/Anderson_ShareholderEngagement.pdf •Consistent and reliable reporting, including on the intangibles. See for example the CIPD report "Human capital reporting – what information counts in the city?" and the 2003 report of the Task Force on Human Capital Management, "Accounting for People". •Voting by shareholders •Applying Corporate Governance and Stewardship Codes, and reporting on them These measures have been introduced specifically in order to provide more effective forms of engagement. Research to validate these, and other measures, will be useful.

<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 evident that generally there is not. Those organisations where corporate governance is taken seriously, such as Schroder Investments Ltd and MAM Funds PLC, are seeing benefits. They have had to take it seriously because many clients ask for reports on voting and the process by which the voting decisions had been taken.

<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
Voting is a key form of engagement. Voting should be transparent to allow boards to see where they need to communicate and how they can exert greater influence on investors.

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

Comments
Yes, a serious problem. It can be addressed by •research into the effects of longer-term investing •widely publicizing successful examples of longer term investment decisions. As noted above, Accounting for People 2.0 is focused on bringing together research and good examples of longer-term investment. See http://www.accountingforpeople.org/.

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
Investors should be required to ask boards for longer-term strategies. Investors should be required to then report on how they have allocated funds, taking this into account. It is becoming conventional wisdom that the increasing pace of change is one of the most important issues for company management teams – hence the increasing focus in some Business Schools (and hence consultancies) on tactical implementation rather than on strategy development.

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

Comments

Yes, definitely. All involved in the chain leading to investment must be bound by the same good practice and include short and longer-term data.

Another Code required? For fund managers?

The component elements in the investment chain (i.e. pension funds, sell-side analysts, buy-side analysts, consultants, corporate bodies, etc) add up to a dysfunctional system.

Or it could be said to function as coherently as a Swiss watch – except that it doesn't actually tell the time except to those with vested interests.

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

Comments

Transparency would highlight where problems and inconsistencies occur so they can be addressed.

However, requiring fund managers to report on their activities more will have a cost attached and may lose some of their commitment for improving the process. Consultation will need to be sensitive to this.

Increasing transparency in one part of the system will probably not fix the problem overall, but is an essential starting place.

Directors' Remuneration

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

Comments

The main reasons for the increases are:

- Lack of firm involvement by shareholders and remuneration committees in the design and implementation of board pay structures
- Lack of shareholder and remuneration committee knowledge about how to construct pay structures
- Lack of monitoring and reviewing by shareholders and remuneration

committees
- Perceived competition in order to retain valued board members
- Greed on the part of directors

Another factor is the extent of mutually interlocking directorships in which remuneration committee members look after each other's interests, thus effectively reducing competition.

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

Comments

The effects would be:

- Greater transparency
- Better design of pay structures
- Better links to results
- More monitoring
- Greater likelihood of firmer stands being taken when proposals appear inappropriate

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

Comments

They are not as effective as they could be at present.

Experience indicates that shareholders at present do not really care about Directors' pay unless it is perceived to be unduly high.

Shareholders may not have the knowledge required to take a firm stand on pay. They may need education, or could employ specialists.

More aspects of board pay, not fewer, should be required to be scrutinised by appropriately trained shareholders.

<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?**

Comments
The impact of greater transparency on all the above items would be devastatingly effective for current beneficiaries. Publication in the press in the past year of directors' pay, the lack of links with performance and the relationship with the pay of employees has created anger and led to some limited change. This BIS initiative is proceeding on the basis that change is essential. The term 'pay' needs to be interpreted very broadly to include all forms of compensation, including pension arrangements.

Takeovers

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

Comments
In spite of encouragement by the Takeover Panel and the Takeover Code, board members usually have limited knowledge of the long-term implications of takeovers. The majority of boards do not communicate the long-term implications of bids effectively. They have little interest in doing so at present. If this were to change, it would add valuable perspectives to any bid. It may well be the case that most mergers and takeovers fail to generate the anticipated shareholder value. If investors were more active in seeking to understand the reality of longer term value generation different decisions might be taken. **In the context of research which consistently demonstrates that a majority of mergers and acquisitions fail to achieve anticipated financial returns and that the reason given in a large majority of these cases is**

attributed to people issues, it is astonishing that due diligence, top heavy in financial and legal considerations, rarely delves below Board level in terms of human capital, and that submissions to the Mergers and Monopoly Commission invariably fail to offer an accurate estimate of job losses, preferring rather to refer to economies of scale.

<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

Yes. There would be a stronger possibility of wiser Merger and Acquisition activity.

Shareholders invited to vote would demand solid information which would improve the standard of information collected prior to bids.

The problem is that the interests of shareholders on both sides of the transaction, of the Boards involved and also of the advisers (such as Investment bankers) need to be understood and steps taken to gain alignment. That rarely occurs because most transactions are hostile to a greater or lesser degree.

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

Comments

- Globalisation should not deter us in the UK or slow us down from raising our own standards, admitting nonetheless that co-ordinating the various UK and international standards bodies and Codes is useful and timely.
- The UK should take a lead in taking a long-term focus and transparency over pay. This will be to the competitive advantage of the UK in the long term.
- In most developed countries, government takes a much more active part in defending national interest when it comes to foreign takeovers. Over the last 20 years the UK has lost over 90% of its large advanced technology companies to foreign takeovers. The fact that investors in the London market are averse to long-term investment in technologically advanced industries, and will sell at the drop of a hat, makes Britain almost uniquely vulnerable to losing advanced

knowledge industries.

- Investors are not one class of people. In the London market, the majority are short-termists, churning portfolios by about 90% per annum, while only a few buy and hold like Warren Buffett in the US. And then there are the Hedge Funds and Private Equity industries... What we tragically lack are venture capitalists and long-term investors with deep industry knowledge. We need to build more of this class and it will not happen simply through greater "transparency". Positive incentives are badly needed, like substantial tax breaks for long-term investment and holding and positive engagement (not currently allowed) by board involvement or special roles as advisers.
- Pension fund trustees should have a duty of care towards the organisations in which their agents, the fund managers, invest. This would have a marked effect on investor behaviour.
- So, the opening sentence of the consultation, which implies that the investment markets are generally well organised etc., is wide of the mark.
- The UK investment markets have been a source of national disadvantage which will not be changed without fairly radical change. The good thing is that most of it can be achieved by the sort of incentives that have been mentioned above, rather than by what can be seen as punitive regulation.