14 January 2011

Our ref: ICAEW 7/11

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Dear Adam

A Long-Term Focus for Corporate Britain – A call for evidence

We welcome the opportunity to comment on the call for evidence *A Long-Term Focus for Corporate Britain* published by the Department for Business Innovation & Skills (BIS) in October 2010.

ICAEW is a professional membership organisation, supporting over 136,000 chartered accountants around the world. Through our technical knowledge skills and expertise, we provide insight and leadership to the global accountancy and finance profession.

Our members provide financial knowledge and guidance based on the highest professional, technical and ethical standards. We develop and support individuals, organisations and communities to help them achieve long-term, sustainable economic value. We are a founding member of the Global Accounting Alliance with over 775,000 members worldwide.

ICAEW has participated in consultations regarding the Combined Code/UK Corporate Governance Code (the Code) throughout the history of the Code and we play an active role in the development of corporate governance in the UK and internationally.

This response has been drafted after consultation with ICAEW's Corporate Governance Committee which includes representatives from the business and investment communities. We have also received input from committees active in the areas of company law, corporate finance and financial reporting. We have highlighted some general observations below in response to the consultation questions and follow with responses to the specific questions in the call for evidence.

GENERAL OBSERVATIONS

We support the objective of identifying issues around the relationship between markets and corporate behaviour with the aim of bringing about effective and lasting change to our systems of law and

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governance. We also believe that this is a timely review for the UK coming as it does ahead of the planned European Commission Green Paper on Corporate Governance due in 2011. However, we believe that it is important when undertaking a review, particularly one covering diverse areas, to support positions taken in a call for evidence with sufficient factual and research-based material to ensure that the review is built on firm foundations. Despite the fact that the paper contains many footnote references to other documents, we feel that this call for evidence lacks a proper basis in fact and fails to provide a balanced review of relevant research. This is a pity as the subject areas are of vital economic significance.

The call for evidence paper appears to be based on a presumption that a focus on the short-term is always bad. This is not substantiated and may be a false presumption. We know of no studies which indicate that short-termism in itself erodes value. Sometimes short-term measures, including regulatory actions, are required to make necessary changes in order to preserve a business for the long-term. Therefore, we would be apprehensive of BIS initiating any measures that were designed to curtail the ability of boards and shareholders to take speedy short-term actions in the best interests of the businesses that they manage and own. We believe that BIS should only embark on policy making to address UK short-termism on the basis of a more thorough analysis of the concept of short-termism than is presented in this call for evidence paper and a far more rigorous understanding of current UK practice than is likely to result solely from responses to this call for evidence.

We are also concerned that in other respects this call for evidence goes over much ground that has already been covered by other recent public consultations and that will be covered again by the EC Green Paper. There is a real danger of consultation fatigue which will be counter-productive in the long-term. In addition, we feel that there is a disproportionate focus on executive remuneration to the detriment of other aspects of governance, such as risk management, which are of more fundamental and pressing importance to growth and future prosperity.

RESPONSES TO CONSULTATION QUESTIONS

The board of directors

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

We have not undertaken any detailed research in this area but our perception based on feedback from our members and others is that, on the whole, boards do have a long-term focus. The directors' duties contained in the Companies Act 2006 have assisted in highlighting the importance of having a longer-term view and boards have responded to this by taking wider considerations into account. However, many market and regulatory mechanisms are short-term and both boards and shareholders are surrounded by short-term external imperatives which can make longer-term focus more challenging. Most boards seem to accept the need to manage the resulting tensions for the benefit of shareholders and society as a whole.

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?**

The UK has two effective mechanisms to 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. Together with the section 793 process the FSA Disclosure and Transparency Rules (DTRs) establish an operating framework for shareholder identity which is well established by requiring 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 some well voiced limitations to the current section 793 procedure in relation to timing issues, costs and territoriality. Notwithstanding the section 793 procedure, it is still easy for shareholders who wish to remain anonymous on any corporate register to do so. The June 2009 rule changes extending Chapter 5 of the DTRs and requiring disclosure of long contracts for difference and other derivative products having similar economic effect were useful in giving companies and investors a clearer picture of who has significant economic control over listed shares.

The section 793 right applies to companies domiciled in the UK and to their shareholders all over the world. In practice investors may challenge that right where there are local banking secrecy rules but companies have certain powers to force disclosure and these powers if used effectively can render the shares worthless.

While companies have faced many new disclosure requirements over recent years, investors with hidden identities (and sometimes hidden intentions) can still remain hidden on the register. Whether shifts in share price caused by unidentified shareholdings are deliberate or unintentional, the effects of lack of disclosure affect all market participants. This is an area where we believe it would be beneficial to make minor changes to ensure speedy and effective shareholder identification but we believe that such changes should be part of a wider review at EU level which could form the basis for wider international harmonisation.

Nevertheless, there are risks in a European review of these issues. Recent EC proposals to align notification of major shareholdings under the Transparency Directive pose a serious risk if they move to a maximum harmonisation approach which would mean watering down existing UK requirements.

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 and equity markets are huge and potentially threaten the existing system of corporate governance in the UK which has traditionally operated on the assumption that ownership of capital is dispersed yet control is concentrated in the hands of boards. This assumption is not necessarily true in modern capital markets. In addition, the increasing diversity of share ownership has meant that accessing capital through equity markets has become a more complex exercise.

Modern listed companies no longer operate in a world where an identifiable and homogenous group of domestic shareholders can be seen as representative of the markets. The capital markets exercise their power over boards through a host of market participants many of whom are not accountable or particularly transparent. These include not just institutional investors, but also hedge and private equity funds, sovereign wealth funds, activist investors and others who can intermediate between companies and the investing public.

For example, shorting has been a feature of exchange trading in shares and is the foundation of hedge funds. Concerns have been raised that those who invest in the hope of making a profit from a downturn in a company’s fortune are somehow less legitimate investors than those who invest in a company’s success. There is clearly a responsibility on the long-term owners of a company’s shares to consider carefully the costs and benefits of their stock lending activities that support short selling. Although it is important to recognise the benefits of increased liquidity and enhanced price discovery, directors often feel aggrieved by the short selling of their company’s shares. Giving directors the information to enable them to influence long-term share owners lending stock would ensure that lenders were fully cognisant of the potential effect of their actions on their assets.

If investors were required to disclose to a company any lending this would allow directors who believe that the short selling that it enables is detrimental to the long-term stability of the company to address their concerns to institutional investors and even request a recall of the lent stock. If nothing else this would promote a more open dialogue with shareholders. This is an example of where small changes could have significant benefits to market efficiency. This could be an area that would merit review when initial experience of applying the UK Stewardship Code is considered.

Recent substantial investment by sovereign wealth funds and governments is a mark of the new capital markets. Many of these investors disclose little about their goals and operations which raises questions about their intention to vote their shares and be active owners although some have made it clear that they do not intend to vote their shares. This poses a threat to existing systems of corporate governance and could give rise to the following risks:

- Boards may not be fully held to account. Holding to account in this context means obtaining explanations at the time that they are needed and objectively validating them for fairness and completeness. This not only provides useful information for shareholders but also has a beneficial self-regulating influence on the decisions of boards and the quality of disclosure.
- Boards may find it increasingly hard to establish a dialogue with shareholders who do not want to engage with them or remain hidden on the share register. In this scenario, boards who want to have a dialogue with their shareholders would be unable to do so.
- An increasing trend towards silent and invisible shareholders may mean that activist shareholders have a disproportionate effect. This shift in power could ultimately lead to loss of value.

4. What are the most effective forms of positive engagement?

We view all engagement as positive. The most effective form of engagement has to be the face-to-face meetings and presentations which already take place with most institutional investors although we do appreciate the time limitations on many investors. We believe more use could be made of web and electronic media to facilitate more engagement with a broader group of investors and that in this respect the corporate community could do much to open up a wider platform on which to engage. This may also have the benefit of enabling overseas investors including sovereign wealth funds to be more actively engaged.

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

There is concern about how well governance teams are linked to fund managers within investment firms and how far companies act upon engagement messages from investors. The Stewardship Code in the UK will be helpful in this area but it is by its very nature limited to a relatively small percentage of UK listed stocks. This is a challenge for the investment community but one which they are well aware of and are working hard to address.

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 extremely important form of engagement. Voting however should not be viewed as only an engagement issue as it is more fundamental than that.

The costs to institutional shareholders and fund managers of disclosing publicly how they have voted should be minimal. In our view, they would be outweighed by the benefits to underlying beneficiaries and society more broadly. There has been long-standing pressure for more accountability in this area, and a remedy is needed both in the UK and across Europe.

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

There are practices in equity markets that cause governance problems but these are not necessarily linked to short-termism. We are not aware of any research that has indicated that short-termism in itself is a problem. A better way of looking at this may be to identify the problems that short-termism is believed to create and to highlight what steps can be taken to address those problems. There is a real danger of tackling a perceived issue of short-termism in isolation without properly understanding the role that short-term considerations play in the capital markets and thereby creating a new set of problems through unintended consequences.

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?

This question assumes that a long-term focus is intrinsically better for UK equity investment and also that a long-term focus is not already prevalent. We are not convinced that a case has been made to support this contention.

We would be apprehensive about any regulatory measures that seek to distinguish between short- and long-term holdings and that penalise short-term holdings. In particular, we would be against placing voting restrictions on shares held short-term or increasing shareholder rights for long-term holders.

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

Among the most neglected areas in current corporate governance research are the role of reputational intermediaries and the structure of financial institutions. Research is needed to understand better how lack of competition and high barriers to entry, as well as current market practices, are frustrating the operation of existing mechanisms that are meant to address agency problems in the investment chain.

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 end users in the investment chain. Transparency of roles and mandates is more important than pay disclosures which may have the unintended consequence of increasing overall remuneration through a ratchet effect. Nevertheless, we accept that there is a need to address widespread concern among ultimate beneficial share owners about how their returns are reduced by fees.

Directors’ remuneration

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

The latest IDS Executive Compensation Review does indicate an increase in boardroom pay in the listed sector. Salaries have been rising over the past two decades. This contrasts with the latest Institute of Directors survey on smaller companies which covered salary alone excluding share incentives and bonuses and indicated that smaller company directors’ pay has not increased dramatically.

The additional disclosure brought about by the Directors’ Remuneration Report Regulations (the Regulations) introduced in 2002 and subsequently amended and the increasing use of remuneration consultancies may have been factors in ratcheting up boardroom pay. We are not aware of any specific research into this but it also occurs to us that reduced tenure and changing practices over terms and conditions of employment, including shorter notice periods for directors, may have been factors in driving increases in basic and incentive remuneration. There is scope for research to help establish whether the benefits of increased disclosure in terms of improved performance have outweighed potential ratchet and other effects on costs.

The Regulations have provided a useful framework which assists users of annual reports to assess how well remuneration is governed. However, the Regulations are not and cannot be, in themselves, a substitute for good governance and best practice reporting. Most preparers of remuneration reports acknowledge that it is not always easy to disclose and explain all of the remuneration elements in a straightforward and easily understood way. This is compounded by the range of different practices which make it very difficult for users of annual reports to compare and comprehend remuneration practices. Some may say that the link between pay and performance is still not sufficiently clear and that companies and their advisors still have improvements to make in terms of remuneration disclosure. We comment further on this in responding to Question 14 below but do not believe that additional regulation is required in this area.

There needs to be fresh and innovative thinking when reviewing the ways in which market participants seek to incentivise boards, managers and each other to act in the interests of those that they are meant to serve. Fundamental areas that need to be looked at include:

- Why certain incentives have failed and are failing.
- Why new mechanisms are needed to link pay to value creation.
- How pay fits into broader issues of human capital governance such as the capabilities of people, internal processes and structures and related incentives.
- How people can be incentivised to achieve longer term strategic objectives.
- What existing mechanisms ensure that appropriate remuneration and incentives are in place and how those mechanisms are overseen.

These fundamental areas of review may call into question the effectiveness of pay structures and incentives in terms not only of rewarding failure but also of failing to reward which can be equally damaging.

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

We do not believe that widening remuneration committee membership would have a significant effect on the dynamics of setting remuneration. We do however believe that greater scrutiny of the activities of remuneration consultants could have a significant effect and that companies should give greater disclosure about the activities of consultants that advise remuneration committees including their fees and any other work that they undertake for the company.

At a minimum, companies should be disclosing which consultancy firms have been used and whether they comply with the voluntary code of the Remuneration Consultants Group (RCG). The RCG represents the majority of executive remuneration consultancy firms advising UK listed companies and its voluntary code of conduct clearly sets out the role of executive remuneration consultants and the standards by which they advise their clients.

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?

By and large we believe that shareholders have enough mechanisms at their disposal to ensure effective control and have the ability to vote down any remuneration report or intended share plan that they do not agree with. In particular, we do not think that a shareholder vote on golden parachutes is necessary. However, as noted in our answer to Question 3, there are threats to the effectiveness of shareholders in exercising their powers as a result of the changing nature of UK share ownership.

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?**

We do not think greater transparency in these areas is necessary or would be beneficial although in relation to performance and vesting criteria for incentive and bonus schemes, any variation or change in performance criteria or comparator group should be fully disclosed.

However, it may now be more important to emphasise clarity rather than transparency. If the disclosure of directors' pay arrangements in annual reports was expected to be clear, this would focus the attention of boards and consultants on effective communication and the need to avoid overly complex arrangements if these cannot be clearly communicated. It might then be possible to require all the details to be disclosed elsewhere, for example on the company's website, to meet the need for transparency.

Takeovers

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

We believe that, on the whole, boards do understand the long-term implications of bids and communicate effectively. In addition, we would expect shareholders following the UK Stewardship Code to monitor any takeover bid and engage fully with the company accordingly if there are areas of concern. This could also be an area that would merit review when initial experience of applying the Stewardship Code is considered.

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?

Any revision of existing Listing Rules requirements for circulars and shareholder approval based on size thresholds should be approached with caution. In particular, while the risks of value-destroying acquisitions need to be better understood and managed, UK corporate bidders should not be put at a competitive disadvantage compared with non-UK companies by imposing regulatory burdens designed to discourage legitimate commercial activity.

The Takeover Code is designed to ensure that the shareholders of an offeree company are treated fairly more than anything else and we believe that has to be the right area of focus. We have previously stated that we do not consider that offeror company shareholders should be afforded protections under the Takeover Code unless the relevant circumstances as set out in Rule 3.2 of the Takeover Code are applicable.

Other

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

Additional comments are set out under 'General observations' earlier in this letter.

Please contact me should you wish to discuss any of the points raised in our response.

Yours sincerely

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