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Corporate Law & Governance
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Dear Mr Gray

A long-term focus for corporate Britain

We thank the Secretary of State for his invitation to examine whether the ways in which listed companies and their shareholders interact either promotes or undermines long-term growth. Standard Life Investments is one of the UK's leading institutional investors and providers of equity capital to UK companies. As at 30th September 2010 it had £153bn under management, a large proportion of which is invested, on behalf of our clients, in the listed securities of UK companies. As an agent for clients with long-term liabilities, Standard Life Investments has a strong incentive to ensure that the wealth generated by companies grows so as to ensure that these liabilities are at least met. We also understand the importance of capital markets in providing resources that allow companies to grow sustainably.

The environment for the promotion of high standards of corporate governance has received a heightened level of attention over the past eighteen months. In the UK, there has been the Walker Review of BOFIs and the promulgation of an updated governance code by the FRC, the UK Corporate Governance Code. The Takeover Panel has reviewed and updated certain aspects of the regulation of takeover bids. The ISC also brought forward proposals that were crystallised in the UK Stewardship Code. Standard Life Investments played an active part in the development of these initiatives, particularly the UK Stewardship Code. We hope that this submission will both inform the Secretary of State and help to promote corporate behaviours that focus on those long term drivers that sustain business success. We answer the questions as follows:

Do UK Boards have a long-term focus – if not, why not?
That UK boards exhibit a focus on the long term should be self evident, as they are specifically required to do by section 172 of the Companies Act 2006 (CA 2006). The providers of share capital also have this focus as equity, by its very nature, is a resource provided in perpetuity. However, there are certain features of the corporate and market environments that arguably undermine this focus. For example, the general increase in reporting intervals may cause boards and their executive teams to be diverted from the achievement of longer term objectives in order to present the progress achieved in shorter periods in the best possible light. The role of corporate advisors can also contribute short-termism. These advisors provide a valuable service, fundamentally in the process of raising capital, but they are also businesses in their own right. It is in their best interest to encourage corporate activity, although the correlation

between capital market based activity and the achievement of wealth by their corporate clients is uncertain. However, one of the most important determinants of board behaviours is the process by which their executive members are incentivised. The link between executive remuneration and the measures by which shareholders evaluate corporate success is sub-optimal. Arguably, there is a disproportionate focus on incentives based on share prices. However, a share price merely represents the consensus of investor expectations about the future performance of a company – its correlation with the achievement of real corporate performance is far from axiomatic. Nonetheless, if this is the primary element by which wealth is shared with executive board members then it would be logical to suppose that more time and energy will be spent on the management of expectations than on the business as a whole. The problem is compounded by the relatively short time horizons over which such awards crystallise compared with those of the providers of the share capital. It is right that executive incentives should be aligned with the achievement of shareholder value as executives are the day-to-day stewards of the equity capital provided by those shareholders; but non executive members of the board should select more sophisticated and diverse measures of value to provide the right incentives for the longer term and to ensure that the corporate strategy, for which the whole board is responsible, is successfully and sustainably executed.

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?
CA 2006 empowers companies to discover the identity of the interests in their equity at whatever level of ownership. Similar powers of discovery are mandated in, for example, the provisions of the Takeover Code. Collectively, these allow companies a level of forensic examination that is greater than that provided by the EU Transparency Directive. Corporate brokers can also provide intelligence to companies as to movements in their shareholder base on a day-to-day basis. In short, we believe the legal framework in this regard is adequate.

In this context, it is also worth observing that the fostering of a long-term focus could be enhanced by boards paying closer attention to the alignment of their share register with providers of equity that share this outlook.

What are the implications of the changing nature of UK share ownership for corporate governance and equity markets?
We agree that the increasing globalisation of investment opportunities has allowed UK companies to access a larger pool of capital. This and the increased diversity of the shareholder base have also greatly improved the liquidity of markets for equity investors. This diversification has also placed UK equity in the hands of owners who are domiciled in jurisdictions where legal frameworks are different from that of the UK. For this reason, it is important that the governance environment for owners of UK equity is based on best practice rather than regulation. To expect and require overseas investors to conform to a system of statutory governance regulation which has little correspondence with their own legal frameworks of equity ownership risks diminishing the attractions of UK share ownership and a consequential rise in the cost of capital. It is also worth noting that the spread of the private equity model of ownership has also changed the degree of influence that can be exercised over corporate behaviours by more traditional market based models of ownership.

Notwithstanding, the recent financial crisis has led to pressures for a more prescriptive governance regime despite the increasing plurality of interest in shareholder bases. These calls have also come despite there being little evidence to suggest that the failure of a number of financial companies was due to systemic governance failure, given the diversity of the governance models in the countries in which these corporations were based. If a more rules-based approach is adopted, it is clear is that more attention will need to be given to the way that regulations cause the type of corporate behaviours that generate the instability the regulators are trying to avoid in the first place. In response to the crisis, institutional investors in the UK have come forward with qualitative improvements to the governance environment under the aegis of the FRC. The principle of "comply or explain" has been preserved and Standard Life Investments would strongly urge companies to improve and augment the detail and quality of their governance disclosures. Such disclosures, by providing a cogent and credible degree of assurance, should logically contribute towards a lowering of the cost of equity capital.

The principle of "comply or explain" also captures the reality of the influence that shareholders can bring to bear on corporate governance and behaviours. Some commentators have suggested that the financial crisis was due to deficiencies in the engagement process, a shortcoming that Lord Myners characterised by reference to shareholders behaving like "absentee landlords". Yet this is to fundamentally misunderstand the relationship of shareholders to listed UK companies. It assumes that shareholders have the same access to information as company insiders, which is manifestly not the case. It also overstates the rights which shareholders enjoy over the companies in which they invest. They have neither right to the utilisation of a company's assets nor preferential access to its products and services. They are simply entitled to the residual assets of a company once all its other obligations have been met.

What are the most effective forms of engagement?
For shareholders, the purpose of engagement is to protect their interests and to gain assurance that the stewardship of a company will ensure that their reasonable expectations, as providers of equity, are met. They also have rights to vote on matters that may have an impact on the long-term performance of a company.

Standard Life Investments has a well developed process of investment and engagement in addition to the exercise of its voting rights. We believe that the main component of engagement is a purposeful dialogue on strategy, performance and management of risk as well as on matters subject to a vote. We seek to gain insights and assurance about the stewardship of a company from all levels of the board and have a clear process of escalation to ensure that our expectations as shareholders are given a fair hearing. In certain circumstances, we are also prepared to share insights with other investors to help inform their own engagement and to act collectively with them as appropriate. While we encourage boards to be pro-active in their engagement with shareholders, we also recognise that the process of engagement can be very time-consuming for them. Boards should also have a reasonable expectation that the duties of stewardship that are delegated to them by shareholders can be exercised without interference. Shareholders in publicly quoted companies have neither a right to set the strategic direction of a company nor a role in the processes by which a company gives effect to that strategy – indeed, to attempt to do would risk de-stabilising the business. The key to successful engagement is to behave in a way that is supportive, fosters good relations and ensures that legitimate concerns are addressed.

Is there sufficient dialogue within investment firms between managers with different functions?
Standard Life Investments has an investment process where the governance and investment functions are linked. Both teams participate in formal company engagements and hold regular meetings with each other where information and insights are shared. There are also well-established procedures for the ring-fencing of price sensitive information. This allows representatives of listed companies to communicate with the appropriate team member on matters of confidentiality or market sensitivity.

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 the primary method by which Standard Life Investments exercises its rights as a shareholder. While a resort to legal process is always an option, voting is the means by which boards can formally be held accountable to shareholders. In that sense, the exercise of a vote is the outcome of the process of engagement; it is not merely an administrative function of ownership The UK Corporate Governance Code 2010 increased the instances by which these rights are exercised with the provision for the annual

re-election of directors. There is however, never a guarantee that the exercise of these rights will produce the desired outcome and owners of equity should not, for example, be held accountable for deficiencies in the wider regulatory framework.

Standard Life Investments discloses how it has voted in accordance with the agreements that it has with its clients. However, it makes public disclosure on its corporate web-site where it has voted by exception. It always uses best endeavours to engage with a company where a vote is likely to be contentious to our clients' interests. It will also inform the company of an intention to vote against where the matter is unresolved.

While it is important that such voting rights are preserved, it is also the case that there are legitimate investment processes operated by market participants that do not require their exercise. To the extent that voting and other forms of engagement produce positive outcomes for shareholder value, these participants and their clients can be said to derive an economic benefit for which they do not pay.

Is short-termism in equity markets a problem and if so, how should it be addressed?
It is a truism that different market participants have different investment requirements and time horizons. For institutional investors with third party businesses, these requirements and associated incentives are set by the clients and beneficial owners of the shares. There are a number of features of equity markets that contribute to a perception of short-termism on the part of market participants. For example, technological advances have permitted the increasing prevalence of high-frequency trading. The diminishing share of UK equity ownership by those whose liability-driven business model is consistent with long term investment horizons is also cited as a reason for increased short-termism. However, the idea that the investment return from a shareholding is determined by the conviction with which it is held in the first place is preposterous. The correlation between the return from share and the length of time over which it is held is also far from obvious. This is one of the reasons why investors adopt a portfolio approach to the management of their holdings of equity.

The main determinants of the attractiveness of a company's equity relative to other opportunities are not the time horizons of its individual shareholders but changes in those shareholders' expectations about future returns and perceptions of risk. Given the asymmetries of information between corporate insiders and shareholders, these changes in expectation are logically driven by the companies themselves. Holding periods may also be effected by changes in a shareholder's tolerance of investment risk and the need to diversify it. Nonetheless, a number of commentators have suggested that the shortening time frames over which shares are held is somehow evidence of the deficient exercise of the responsibilities of ownership. Yet this is to confuse activities associated with ownership of equity (voting and engagement) with those associated with investment, which are to do with the evaluation of risk and of opportunity cost.

More consideration also needs to be given to the impact of regulation on the time horizons of market participants. Investors need to be able to take a long term view of the attractiveness of equity as a distinct asset class. Yet almost constant change to pension legislation, the imposition of tariffs (such as "windfall" taxes) to correct perceived political problems, differential treatment of equity and associated derivatives, multiple changes in the taxation of equity returns to investors and the application of solvency regulations have all contributed to a diminution of the attractiveness of share ownership and volatility in the marketplace.

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?
Investors will focus on the long term if they are given an incentive so to do. The most important external incentive is provided by the tax system and the impact that this has on the opportunity cost of owning

equity as opposed to an alternative. The increasing cost of the regulatory burden on UK companies also needs to be balanced by measures that foster investor confidence in the capital structure of the companies so regulated. As providers of loss bearing capital, equity investors require assurance that regulatory structures will be clear, consistently applied and drafted with a view that encourages the provision of equity for the longer term. Government should also do more to ensure that investment mandates awarded by the public sector are given to those agents that take stewardship seriously. Whatever method is chosen to foster a long term focus, equity investors need to be given assurance as to the persistency of such arrangements if they are to plan for the longer term with confidence.

Are there agency problems in the investment chain and, if so, how should they be addressed?
Agency is a common function of a market economy and of the investment processes associated with it. Its cost is also responsive to competitive forces in a free market. However, agency processes also need to be properly accountable. The most serious strains occur where the agency function distorts the risks being borne by market principals. An example is the way that the markets for securitisation encouraged excessive risk taking by the originators of mortgages in the USA in the lead up to the so-called "sub-prime" crisis. The only remedy for this is carefully targeted regulation and the operation of "caveat emptor".

The operation of good governance practice by agents within the investment chain has been addressed by the Stewardship Code which requires fund managers to disclose if and how they apply the principles of the Code. However, the development of certain types of investment model has undoubtedly contributed to weaknesses in the chain of accountability. An example is the growth of collective investment schemes that track equity indices. While these funds may have cost advantages for beneficial owners, they have no logical interest in the behaviour of corporate managements, long-term or otherwise. This is because the only criterion for investment in a company is its weight within the relevant index. As a result, index- tracking funds also allocate capital to companies that may not make the optimal use of it. Hedge funds and Exchange traded funds also share a similar characteristic of index tracking funds in that good governance is not central to their investment process. For this to be rectified, more attention needs to be given to the incentivising of beneficial owners to ensure that their agents follow best governance practice.

A particular area of concern to companies is the role of intermediaries in the voting process. The use of voting agencies is the logical consequence of the commonality and number of reporting and voting periods by listed companies around the world. While their use implies a delegation of responsibility by shareholders, this is preferable to those powers being delegated back to corporate officers themselves. Standard Life Investments makes use of these agencies as a cost effective way of voting our clients interests. However, we retain the right of discretion to vote otherwise if this is in the best long term interests of the company and its owners.

What would be the benefits and costs of more transparency in the role of fund managers their mandates and their pay?
In a free market economy, the role and mandate of the fund manager should be a matter between it and the client. It is also the client's prerogative to disclose such arrangements. One area where both regulation and the operation of market forces have been progressive is the increased level of transparency about the costs borne by beneficial owners of shares that use fund managers. Market participants are now much better informed about the impact of costs on investment returns. For example, investment consultants provide clients with a clear assessment of where value is being added or detracted in the various parts of the investment chain. Regulations have also served to minimise practices (e.g. "soft" commission) that may have given rise to conflicts of interest in the past.

More attention however, needs to be given to how greater transparency actually increases the costs of ownership of shares. It is sometimes the case that the active benchmarking of costs perversely leads to their increase. This can clearly be observed in the case of executive remuneration

What are the main reasons for the increase in directors' remuneration? Are these appropriate?
For companies, a successful remuneration policy should be one that is able to attract, retain and motivate directors who can enhance the value of the business as a whole. Shareholders also have this aim, with the added incentive that the dilutive aspects of remuneration on shareholder value should be minimised. Nonetheless, there has been an observable increase in the level of executive director remuneration over the past ten years that is not proportionate to that achieved by other economic participants. The simplistic explanation for this is that increased globalisation has led to a corresponding increase in the demand for directorial talent. While the impact of market forces is clearly important, it can also be observed that there have been very few instances of directors of leading UK publicly quoted companies being "poached" by competitors overseas. Two possible conclusions are that the demand for the sort of talent associated with the running of a UK listed company is not as strong as claimed or that UK remuneration practices have done too good a job in respect of the recruitment and retention of directors.

Another cause of the disproportionate rise in directors' compensation is the increased use made by boards of benchmarking. This has been facilitated by the increased transparency of remuneration practices at listed companies and the intervention of remuneration consultants. Compensation has risen inexorably because, as market- based compensation levels rise, the median to which many companies refer when setting their own arrangements also rises in a self-fulfilling spiral.

What would be the effect of widening the membership of the remuneration committee on directors' remuneration?
As remuneration committees are sub-committees of the main board, widening membership of the board begs the question as to whom these additional members would be accountable. Additionally, as board members act as stewards of the capital provided by shareholders, the company's ultimate owners, widening board membership would dilute their rights of ownership. This would lead to an increase in the cost of equity capital.

Are shareholders effective in holding companies to account over pay? Are there areas of pay it would be beneficial to subject to shareholder approval?
The mechanisms for holding companies to account over pay are adequate. Since 2002, shareholders have been able to exercise an advisory vote on the remuneration report and any share-based incentive schemes have to be approved at a General Meeting before they can be utilised. Additionally, the power to de-select directors by a vote at a General or Extraordinary Meeting reinforces the chain of accountability.

As significant investors in UK listed equity, Standard Life Investments does not require further powers over the setting of executive pay. Indeed interventions, such as the exercise of a binding vote, could act as a disincentive to company management. In specific instances (such as the use of "golden parachutes"), we think deficiencies can be rectified by an improvement in corporate processes for succession planning.

However, there is certainly scope to question whether the metrics that are most commonly used for the setting of executive remuneration are effective. The evidence suggests that the use of share price or "total return" based measures of incentive that are unrelated to financial or other measures, provides a poor alignment with the long term generation of wealth for shareholders. They can also provide a poor incentive for their recipients where the reward given bears little relation to the effort put in. In short, there needs to be a wider debate about the replacement of stock-based compensation with incentives that are more reflective of underlying performance and of the drivers of corporate wealth creation. More use should be made of actual economic measures such as profitable sales growth, market share, customer satisfaction, return on capital and the fostering of employee skills that add value, rather than of a measure that is merely related to market expectations (i.e. share prices).

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?
Remuneration reports are frequently the largest part of the governance report of UK listed companies. But disclosures about remuneration policy and the design of compensation packages are of little value where these are unrelated to verifiable achievement. While there may be some commercial sensitivity to the disclosure of prospective corporate targets and incentives, there would appear to be few reasons not to include retrospective explanations. Clearer disclosure of the alignment of incentive with outcomes and of instances where boards have exercised discretion would significantly enhance the assurance given by current governance reporting.

However, it is not clear how disclosure of the relationship between executive director and employee pay would be of use to shareholders as an objective measure of corporate wealth creation. It would also create an instance of "moral hazard" which is of itself no guarantee that executive incentives would be better constructed. We believe that it is far more important that companies demonstrate a higher duty of care to their employees than merely the oversight of remuneration differentials between various parts of the workforce. We also believe that improvements in the construction of executive remuneration would address perceived inequalities.

Do boards understand the long term implications of takeovers and communicate the long term implications of bids effectively?
For the shareholders and boards of offeror companies, the decision to acquire should logically be based on whether or not the transaction will improve the long term competitive position of their company. For the shareholders and boards of companies that are acquired, the reasons why they might respond favourably to a takeover approach are different. Typically, these might include whether or not their company faces a strategic deficit, has financial weaknesses or has an underperforming management team. The response will also be determined by the extent to which the premium that is offered adequately discounts the future expected returns and the economic benefits of the business combination. In each case, shareholders and boards need to judge the opportunity costs associated with the transaction and whether or not it will create value.

While there is a body of strong empirical evidence that suggests that takeovers (particularly where they are contested) create little value for the acquiring company, the reason for this is less to do with ineffective governance than poor understanding of the economics of the transaction and its associated risks. What might appear superficially accretive in terms of the pro-forma earnings numbers is often far less so when other measures of wealth creation are considered. For acquiring boards, a particular difficulty is presented by the extent to which the payment of goodwill correctly captures the intangible economic values of the business acquired. In many cases, clear overpayment is observable. Acquiring companies also misjudge the difficulties of combining what are often very distinct business cultures. Mistakes are most prevalent where the corporate action is driven by an over-ambitious executive team where advice is dominated by the company's advisers at the expense of the wider board and shareholder base. Greater disclosure of the economic rationale for a takeover and high quality engagement with shareholders would give a much better chance of effective evaluation.

However, these deficiencies are properly the concerns of shareholders rather than regulators, as there is already a substantial body of law designed to address public interest issues such as employee rights and competition.

Should the shareholders of an acquiring company in all cases be invited to vote on takeover bids and what would be benefits and costs of this?
Regulatory provision for this would make little sense without similar provision in non-UK jurisdictions. The reason for this is that companies subject to UK law might be placed at a disadvantage when bidding competitively against a company of another jurisdiction. UKLA rules already make provision for a

shareholder vote when a proposed transaction crosses a certain threshold of materiality ("Class 1 transactions"). These arrangements operate satisfactorily.

In summary, a long term focus for corporate Britain can best be fostered by the provision of the appropriate incentives. The link between the nature and volatility of regulation and the impact that this has on the cost of equity needs serious attention. Shareholders can also do more to promote corporate incentives and practices that are better correlated to the drivers of wealth. The evolution of best governance practice has provided a credible market based response to the deficiencies highlighted by the financial crisis. As an important economic participant in its own right, the government needs to consider how it can generate a long term view for a free market.

Yours sincerely

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