THE KAY REVIEW OF UK EQUITY MARKETS & LONG-TERM DECISION-MAKING

CALL FOR EVIDENCE

SUBMISSION BY STANDARD LIFE INVESTMENTS LIMITED

Introduction

Standard Life Investments is a major UK institutional investor, with assets under management of £150 billion as at 30 September 2011. A significant proportion of our assets under management are invested in UK listed equities. Importantly, we also invest in bonds, including corporate bonds issued by UK listed companies, private equity and property. Our clients are generally long-term investors, who seek attractive returns that will enable them to meet their liabilities or other investment objectives.

In fulfilling our responsibilities, we engage regularly with the boards and senior management of companies to discuss a wide range of issues including strategy, corporate governance, corporate social responsibility and risk management. This performance provides us with unique insights of the approach taken by boards and management in respect of decision-taking over various time horizons. The relationship that we enjoy with many of our investee companies places us in a position where we can exercise constructive long-term influence consistent with the interests of our clients.

<u>Summary of Standard Life Investments Key Views & Recommendations</u>

- We recommend that regulations be introduced to impose an appropriate health warning in respect of communications to beneficiaries that offer and recommend index tracking investment funds and strategies so that the beneficiaries are on notice that such funds and strategies do not take into consideration the underlying competitive strengths of the individual companies to which the beneficiary is exposed.

- The increased incidence of listed companies providing quarterly updates on their trading and financial position, and the behavioural consequences thereof, do not encourage boards to focus on the long-term development of their business. Whilst we recognise the importance of keeping the market properly informed, we should like to see the Government taking steps that would encourage companies to consider the usefulness of providing quarterly updates to the markets, especially in the light of proposed revisions to the Transparency Directive.

- It is the role and responsibility of boards and their remuneration committees to determine the remuneration policies and practices that are used in their businesses. However, we should like to see the Government give leadership by lending its support to those that seek significant improvement in remuneration practices that will achieve a much improved alignment of interest between executives, boards and the long-term shareholders of publicly listed companies. Therefore, we recommend that the Government set up an independent standing

committee to monitor progress and undertake other market initiatives to stimulate change with a view to achieving the improved alignment.

- It is self-evident that investment bankers and other professional advisers are not rewarded in a manner that is designed to align their interests with the long-term development of their clients' business. We suggest that consideration be given to developing a code of conduct for investment bankers and other advisers, which would operate on a comply or explain basis and serve to condition the interaction between investment bankers and professional advisers and their clients in a manner that is consistent with the long-term development of the client's business. In addition, there should be an additional Code Provision in the UK Corporate Governance Code that provides that the company should have policies for paying professional advisers and investment bankers on terms that are aligned with the long-term success of the company.

- We recommend that BIS consult to determine what needs to be done to bring greater clarity to the legal and fiduciary responsibilities of institutional asset owners and trustees in order that they can have greater confidence as to what is required and expected from them in fulfilling their responsibilities.

- We believe there is scope to extend the time horizons which performance based fees for investment managers are calculated, with a view to strengthening the alignment of the interests throughout the investment chain.

- We have no evidence to suggest that international investment trends have adversely affected the quality of engagement between shareholders and quoted companies. Nevertheless, we recommend that BIS ask the Financial Reporting Council to commit to publishing an annual review of stewardship in the UK, which should include not only recommendations to improve best practice but also provide an appropriate commentary on the geographic ownership of UK companies and its implications.

The Review's Terms of Reference

The Review's terms of reference focus solely on UK listed equity markets. We believe that the terms of reference should have encompassed all types of long-term capital that are available to companies. In particular, it should have embraced private equity and bonds. The exclusion of these categories of long-term capital may undermine the cohesiveness of the recommendations made by the Review, bearing in mind that in practice companies seek to optimise their cost of capital and source it from a variety of providers. Also, it is relevant to note that evidence demonstrates that the exercise of the rights of bond holders is extremely influential in determining the long-term viability of the company, especially in times of distress, for example, when Marconi was restructuring in 2002, following its disastrous foray into telecom equipment.

We would also draw attention to proposals by the Independent Commission on Banking and others whereby banks would issue bonds or other similar instruments that have loss

absorption characteristics. The significance of these bonds in times of stress, and their implications for long-term decision making as well as their potential to influence the terms of any restructuring, including the rights of long-term capital providers, should not be underestimated.

It is notable that private equity funds are typically financed by commitment from limited partners over a period of at least 10 years. These funds tend to provide companies with stable ownership. Furthermore, private equity companies have different corporate control mechanisms relative to listed companies. For example, it is common for private equity investors to enter into a shareholders' agreement with the company. Such agreements typically set out in some detail the way in which the private equity investors will exercise appropriate controls over the company's strategy, governance and business activities. The control mechanisms used by private equity providers have enabled the boards of many privately backed companies to take long-term capital allocation decisions confident that such decisions are aligned with the interests of the private equity shareholders. In contrast, the boards of listed companies have to meet the perceived needs of a large number of diverse shareholders, who often have different time horizons for investment. This is not always conducive to long-term decision-making by the companies. It is clear that there are some important lessons to be learned from the substance and form of the relations that subsist between private equity investors and their investee companies.

Therefore, accepting that the Review's terms of reference have been determined, we recommend that the review team host a small and appropriate number of round-table meetings with private equity and bond investors with a view to gaining a useful understanding, supported by evidence, of the approach that they take with a view to achieving attractive long-term returns on their clients' investments. Such round-tables will help to inform the Review's recommendations.

The Review's Questions

1. **Whether the timescales considered by boards and senior management in evaluating corporate risks and opportunities, and by institutional shareholders and asset managers in making investment and governance decisions, match the time horizons of underlying beneficiaries.**

   <u>Time horizons</u>

   The time horizon of an investment decision is determined by the return that is required from it. The required return will take account of the risks, such as inflation, associated with achieving it. For the boards and senior management of companies, the threshold return on an investment will be set by reference to the cost of capital. For institutional investors, the return on corporate investment will be determined by the price that is put upon it in the capital markets. This price reflects the aggregation of the time horizons of investors and the returns they expect. Underlying beneficiaries also have access to these returns although they frequently bear agency costs in doing so.

   For companies, the perpetuity nature of equity capital gives considerable flexibility when framing investment decisions, although such capital will typically bear a risk premium over other parts of the capital structure. For institutional investors, the

markets for equity capital give opportunities to invest in companies at various stages of their development. They also give the opportunity to invest in such a way that the risk of investment in any one company is mitigated by the inclusion of others in the portfolio.

Investment management mandates and benchmarks

Given the perpetuity nature of equity capital, the linkage between the time horizon of the company and the underlying beneficiary of that equity ought to be irrelevant. In reality, the relationship is more complex and frequently intermediated. It is often driven by the need to match liabilities. These liabilities are typically referenced to a deferred payment, such as a pension. In the past twenty years, changes in regulation and accounting standards have coincided with a rapid increase in the use of asset-liability modelling techniques by pension fund trustees. Typically such models allow for re-calibration every three years. This time frame corresponds with the requirement for company sponsored schemes to conduct triennial valuations. The mandates that are given to investment managers often dovetail with this horizon. The investment manager is responsible for building an investment portfolio that is consistent with the risk appetite and objectives of the trustees. It is the responsibility of the latter to determine the required return and the structure of the mandate. But the way that a mandate is so structured, particularly in the selection of the benchmark, will have a decisive effect on the way the assets are invested. For beneficiaries, the risk is that such a mandate will not deliver the returns that at least match the liability. For the investment manager however, the risk is underperformance against the selected benchmark, which could lead to the investment management contract being terminated. This fundamental mis-alignment is behind many disappointments between beneficiaries and their agents and advisers. Where these benchmarks are equity market indices, there is also the potential for capital to be mis-allocated in the marketplace, to the detriment of those companies that can most profitably use it. This can be seen most clearly in mandates that passively track an index, where the allocation of capital is determined by market weight rather than by opportunity cost. Such mandates are not consistent with efficient capital allocation. Similarly, a mandate that is unreferenced to corporate governance criteria means that beneficiaries do not have the assurance that their interests as beneficial owners are being managed in a manner consistent with delivering attractive long-term returns.

The impact of legislation and regulation

To the extent that laws act as an incentive or disincentive to invest, they can have a decisive impact on equity returns and hence the time horizon of investors. Such laws are themselves often driven by the short term requirements of the electoral cycle and the funding needs of the public sector. For example, much has been written about the detrimental effects on the attractiveness of equity resulting from the changes in the Advanced Corporation Tax (ACT) regime in 1997, which had the effect of removing the tax credit available to a significant proportion of the investment community. Arguably a greater impact was made by the requirements of the 1986 Finance Act which had the effect of limiting the build up of surpluses in corporate sponsored occupational pension schemes to 5% of a scheme's liabilities. The Act proved to be a significant dis-incentive to what had hitherto been one of the main providers of long-term equity

capital to UK companies. The last decade has seen changes to savings and pension regulation on an almost annual basis; indeed the volume of the exhortation to citizens to invest for their retirement often rises in inverse proportion to the availability of incentives to do so. The uncertainty associated with such changes means that the time horizon of investors must also shorten, so contributing to the rise in the cost of capital to companies and an increase of the return required by investors from it.

Management incentives[1]

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 investors 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 ultimately with the achievement of shareholder value as executives are the day-to-day stewards of the equity capital provided by those investors; but there is a case for the adoption of more sophisticated and diverse measures of value - intangible as well as tangible - in order to provide the right incentives to sustain the returns from the corporate strategy over a longer time-scale. We commend to the review team the new management incentive arrangements approved by the shareholders of HSBC Group at its AGM earlier this year. They incorporate a number of interesting features in the context aligning the interests of management with achieving sustainable long-term returns.

Whilst there are no specific recommendations we wish to make arising from the above evidence, it nevertheless serves to provide context for our other evidence and contains certain strands that the review team may want to examine in more detail. For example, the absence of any reference to corporate governance in investment management mandates, and the time horizons over which management tends to be incentivised. The latter aspect will no doubt be the subject of comment from respondents to the current BIS consultation on directors' remuneration.

2. How to ensure that shareholders and their agents give sufficient emphasis to the underlying competitive strengths of the individual companies in which they invest.

An understanding of the underlying competitive strength of a company is fundamental to the appraisal of the opportunity cost of investing in it. However, the period over which returns to shareholders from a company's product or service can be competitively sustained is almost impossible to predict. Typical investment analysis will

[1] See also our evidence in response to Question 3.

take account of factors such as a company's ability to lower its cost of capital and other costs as evidence of a company's potential to replicate or enhance returns. However, to the extent that these advantages are competed away in the marketplace, they are often of short duration. This is one of the reasons why the forecasts provided by equity analysts rarely extend beyond two-to-three years or, where they do, is why a lower level of reliance is placed upon them by those making stock selection decisions. This focus on the short-term might contribute to the excessive discounting of future returns that was identified by a recent Bank of England study. However, other evidence suggests that it is factors outside a company's control, such as the general level of inflation, which are far more powerful determinants of the discount rate. Another factor is the discount required to take account of regulatory intervention. This discount particularly manifests itself during periods such as 2000-2003, when equity markets are trading downwards and there is a co-incident regulatory requirement for relevant asset managers to switch from equities to bonds.

Equity selection by Standard Life Investments on behalf of its clients is informed by its investment philosophy "Focus on Change". This recognises that different factors drive markets at different times in the investment cycle. Its application helps us to analyse the key factors driving the market price of an investment and to identify the drivers that the wider market may have missed. Our investment process also focuses on underlying measures of long-term corporate performance, such as cash returns on invested capital, growth of shareholder equity and the governance framework in which these returns are achieved. This provides a basis of comparison with other investment opportunities. Very little reliance is placed upon short term market trends, except where this has some relevance to the determination of change at the company level.

Technological advances in the way an equity market operates, such as automated trading, also have little relevance to an appraisal of the fundamental attractiveness of a company's shares. Where these changes facilitate investment, they are only of value if they lower the cost of doing so. Much has been made of the increased incidence of high frequency trading on exchanges and the disruption caused by the sudden withdrawal of the pools of capital associated with it. However, to the extent that these strategies rely on the minute arbitrage opportunity between rapidly moving bid and offer prices, they should logically be competed away over time. The same holds true for other so-called "black box" investment techniques. In the meantime, these techniques can be beneficial to the extent that they provide market liquidity and enable rapid price formation. Such strategies and techniques are often used for index tracking funds.

Standard Life Investments Recommendation

We recommend that regulations be introduced to impose an appropriate health warning in respect of communications to beneficiaries by investment managers and advisers in respect of index tracking investment funds and strategies so that they are on notice that such funds and strategies do not take into consideration the underlying competitive strengths of the individual companies, which comprise the risk assets to which the beneficiary is exposed.

3. Whether the current functioning of equity markets gives sufficient encouragement to boards to focus on long-term development of their business.

Interim Management Statements (IMS)

The increased incidence of listed companies providing quarterly updates on their trading and financial position, and the behavioural consequences thereof, do not encourage boards to focus on the long-term development of their business. This is because the market reaction to such statements, often fuelled by comments by sell side analysts who are incentivised to generate commission from their clients, is reflective of the frequency of these reporting intervals. These comments frequently focus on short term targets being either met or missed, which of itself is unrelated to the execution of long-term strategy by a company's board and management. The 'noise' - positive or negative - arising in response to quarterly IMS is an unwelcome distraction in the context of encouraging boards to focus on the long-term development of their business.

We understand that on 25 October 2011 the European Commission published in draft its proposed revisions to the Transparency Directive. These would abolish the requirement to publish IMS 'in order to reduce the administrative burden linked to listing on regulated markets and encourage long-term investment'. These proposed revisions are very welcome.

Whilst we recognise the importance of keeping the market properly informed the evidence associated with the consequences of quarterly market updates is not consistent with providing encouragement to boards to focus on long-term development aspects. Accordingly, we should like to see the Government giving its support to the proposed revision to the Transparency Directive and to otherwise take steps that would encourage companies to consider the usefulness of providing quarterly updates to the markets, in favour of reports that focus on the long-term development of the business. These could be produced at intervals at the discretion of the reporting entity.

Performance Conditions used to Incentivise the Executives of Publicly Traded Companies

Most publicly traded companies have incentive schemes that comprise an annual bonus and a long-term incentive scheme based on 3 year performance. Furthermore, it is not uncommon for the performance measure to be the total shareholder return (TSR) or some other measure based on share price performance. These attributes are evidenced in the remuneration reports of listed companies. Whilst we are strong supporters of pay for performance, we believe that there is a need to break the mould so that the time horizons used to reward executives is much more demonstrably aligned with the time horizons used by long-term investors, such as Standard Life Investments. We commend to you work done by Professor Brian Main, of the University of Edinburgh. His recent paper entitled 'Executive Pay - a career perspective'[2] contains some very interesting ideas. In particular, with the benefit of

[2] Executive Pay - a career perspective' by Brian G M Main, Hume Occasional Paper No 89, June 2011

supporting evidence, he recommends that executives should be required to hold shares in the company for a period of time after they leave it. This proposal would provide encouragement to executive directors to focus on the long-term development of their business.

It is the role and responsibility of boards and their remuneration committees to determine the remuneration policies and practices that are used in their businesses. However, it is in the gift of the Government to give leadership by lending its support to the encouragement of significant improvements that will achieve an alignment of interest between executives, boards and the long-term shareholders in publicly listed companies.

Standard Life Investments Recommendation

We recommend that the Government not only provide such encouragement but set up an independent standing committee to monitor progress and undertake other market initiatives to stimulate change in respect of performance conditions and other relevant remuneration issues. The approach taken by the Government in respect of gender diversity on boards and the impact that this is having provides a template for action.

Transaction led Advice from Investment Bankers

It is the usual practice for investment bankers who act for companies in respect of specific transactions, which generally includes the provision of advice to boards, to be paid in cash for their services. In respect of listed companies, shareholders have, in effect, little or no say in respect of the quantum and other aspects of payments made to investment bankers. Although there is usually some degree of transparency in respect of the fees paid, shareholders have to accept it as ‘part of the deal’ and there is no effective accountability in respect thereof. This also applies to the fees paid to other professional advisers, such as lawyers and accountants. The evidence for this is set out in shareholder circulars. In addition, the evidence of a number of respected academic studies calls into serious question the sustainability of strategies of growth by acquisition for many companies. In these instances, investment bankers and other advisers are generally rewarded handsomely and boards fail to focus effectively on the long-term development of their business with significant adverse consequences for the financial returns to shareholders.

It is self-evident that the investment bankers and other advisors are not rewarded in a manner that is designed to align their interests with the long-term development of their client’s business. Therefore, with a view to strengthening alignment of the advisers with the interests of boards in focussing on long-development of their business, we should like to see investment bankers and other professional advisers receiving a significant proportion of their remuneration on a deferred basis and which is linked to the success of their clients business or the transaction that was the subject of the advice. Once again, this is not a change that can be imposed through legislation or regulation.

Standard Life Investments Recommendation

Accordingly, we recommend that

(i) Consideration be given to developing a code of conduct for investment bankers and other advisers, which would operate on a comply or explain basis and serve to condition the interaction between investment bankers and professional advisers and their clients in a manner that is consistent with the long-term development of the client's business. Such a code should provide that as a matter of principle, investment bankers and other professional advisers will take a significant proportion of their fees on terms aligned with the long-term success of the company.

(ii) There should be an additional Code Provision in the UK Corporate Governance Code that provides that the company should have policies for paying professional advisers and investment bankers on terms that are aligned with the long-term success of the company.[3]

4. Whether Government policies directly relevant to individual quoted companies (such as regulation and procurement) sufficiently encourage boards to focus on the long-term development of their businesses.

As an institutional investor we do not have reliable information about the consequences of such Government policies. Accordingly, we do not submit any evidence in respect of this question.

5. Whether Government policies directly relevant to institutional shareholders and fund managers promote long-term time horizons and effective collective engagement.

In our experience, there are no specific Government policies which impede effective collective engagement. We also note the regulation of contact between companies and individual investors is not an obstacle to effective engagement. However, there is a notable absence of Government policy initiatives to promote long-term time horizons that are directly relevant to institutional shareholders and fund managers.

Over the years, serious consideration has been given by policy makers and others to a number of possible initiatives, such as enhanced voting rights for long-term investors. Whilst superficially attractive, these initiatives have generally failed because of the significant practical shortcomings and the risks associated with a higher cost of capital arising from differential rights of ownership. We see little or no merit in revisiting such initiatives.

[3] Principle A.1 of the UK Corporate Governance Code states that 'Every company should be headed by an effective board which is collectively responsible for the long-term success of the company'.

Standard Life Investments Recommendation

In the light of the UK Stewardship Code for Institutional Investors, which is consistent with the promotion of long-term horizons, the Government should encourage reference to the provisions of this Code in the mandates given by beneficiaries to their fund managers.

6. Whether the current legal duties and responsibilities of asset owners and fund managers, and the fee and pay structures in the investment chain, are consistent with these long-term objectives.

We believe that the fiduciary responsibilities of institutional asset owners, such as pension fund trustees, are insufficiently understood, and trustees often do not have a good grasp of these responsibilities and how they should be fulfilled. This belief is informed by regular conversations in the normal course of business with pension fund trustees and other institutional asset owners. The consequences of the uncertainties are illustrated, for example, in the approach taken by institutional asset owners to stock lending. In this regard, some believe that they have a responsibility to maximise the financial returns on their assets and thereby lend them to third parties, whose identity is often unknown, in return for a short-term fee. Since however, the voting right 'goes with the stock' when shareholder meetings arise, it is the borrower and not the beneficial owner who exercises the voting right, which frequently relate to resolutions relevant to the long-term governance of the company. If the resolutions being considered at the shareholder meeting are controversial, the demand to borrow stock increases significantly, with the consequence that the fee charged by the lenders increases commensurately, making the short-term financial returns to the institutional asset owners more attractive. In effect, such owners are 'absentee owners' and are not behaving as responsible long-term investors in respect of the companies in which they invest. Over the last decade there have been a number of studies and reviews of stock lending practices, both globally and within the UK. These reviews have stimulated a better understanding of the issues involved. However, they have failed to address satisfactorily the issues of fiduciary responsibility.

Standard Life Investments Recommendation

We recommend that BIS consult to determine the extent of the problem with a view to making informed decisions as to what needs to be done to bring greater clarity to the legal and fiduciary responsibilities of institutional asset owners in order that they can have greater confidence as to what is required and expected from them in fulfilling their responsibilities.

With respect to the fee arrangements between the institutional asset owners and their fund managers, we have seen a progressive move over the last decade from fixed fees to performance based fees, which are designed to incentivise and reward fund managers for outperforming the relevant benchmark. This is evidenced in the mandates we have with many of our clients. Such performance based fees are typically determined on an annual basis, taking into account the relative performance

over the previous year. We believe there is scope to extend the time horizons over which such performance based fees are calculated with a view to strengthening the alignment of interests throughout the investment chain in a manner that is consistent not only with the long-term objectives of the institutional asset owners but also by the giving of encouragement to boards to focus on the long-term development of their business.

With respect to how individual asset managers are rewarded, we can only speak for the approach taken by Standard Life Investments. Our fund managers typically have bonus arrangements which blend the short-term (one year) and medium-term performance (three years) of the funds which they manage. There are appropriate investment governance checks and balances in place to ensure that these bonus arrangements do not give rise to inappropriate risk taking and otherwise are generally consistent with the objectives of our clients. As a practical matter, our individual fund managers typically manage portfolios for several clients, each with their own specification. Furthermore, although we seek to achieve continuity of responsibility, it is necessary from time to time to rebalance client responsibilities between individual fund managers in order to ensure a high standard of service is maintained, which has inevitable consequences for bonus arrangements. Whilst we are not complacent, and recognise the need to continually evaluate the basis by which individual fund managers are rewarded in a competitive environment, we believe our current policies and practices are aligned with our clients' requirements. It is relevant to note that in the wake of the banking crisis, the FSA undertook a review of pay policies and practices within the fund management industry. In the circumstances, this was appropriate and the recommendations were generally accepted by industry practitioners.

7. Whether there is sufficient transparency in the activities of fund managers, clients and their advisers and companies themselves, and in the relationships between them.

The 2006 Companies Act empowers corporations 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 and regulatory framework in this regard is adequate.

One of the principal roles of investment consultants is to advise clients on the costs associated with their investment managers. The transparency of these costs will further increase when the terms of the Retail Distribution Review come into force in 2013. This should allow disaggregation of costs in the intermediary chain, allowing better informed decisions about which parts of the chain add value.

The investment consultant industry also provides useful insights into the sort of costs that beneficiaries are prepared to bear in meeting their investment objectives. For company-sponsored pension schemes where benefits are defined, the priority of trustees is generally to minimise the chances that the scheme's assets fall short of its liabilities. Matters such as governance and engagement with investee companies will

typically be lower down the hierarchy of their concerns. For company-sponsored schemes where the investment risk is borne entirely by the recipient, trustees may be unwilling to pay for anything other than manager selection. However, there is a growing body of empirical evidence (identified in the 2010 Walker Review) that governance standards have a critical impact on the sustainability of investment returns as well as being integral to the mitigation of risk. Trustees therefore need to pay more attention to the corporate governance standards that are being applied at both the portfolio level and at the level of the investee companies. This will give trustees not only a greater insight into the investment processes of their managers and their effectiveness as good stewards but also a better understanding of the governance and stewardship risks inherent in the investment portfolios managed on their behalf.

In addition, we are witnessing a progressive improvement in transparency and accountability of fund managers to their clients in respect of how the fund managers fulfil their responsibilities under the Stewardship Code. By way of evidence, we are currently taking steps to improve how we report to clients about our corporate engagement activities. Such improvement is welcome and it is important that momentum is maintained as the Stewardship Code evolves. Over time it will result in better aligned corporate engagement and a better understanding by clients of how fund managers fulfil their Stewardship Code responsibilities.

8. The quality of engagement between institutional investors and fund managers and UK quoted companies, and the importance attached to such engagement, building on the success of the Stewardship Code.

The jury is still out as to whether the Stewardship Code and the activities it encourages to stimulate engagement by investors with companies has been sufficiently effective. The 2011 AGM season was characterised by an increased level of voting opposition by shareholders to resolutions recommended by corporate boards, especially in relation to remuneration of directors. However, the evidence suggests that the overall levels of votes cast was little changed, year on year. This is reflected in the announcements by companies of the results of their AGMs. However, it would be wrong to equate voting with ‘effective engagement’. It is incumbent on institutional investors to explain to companies why they have voted against a board’s recommendation. We seek to do this and have done so for many years, as has been the case with a number of other leading UK institutional investors. It will be interesting to see whether or not the evidence submitted to the review by companies suggest that there has been any improvement in engagement around voting decisions.

There is evidence to suggest that a number of UK fund managers are investing more resource to improve the governance service provided to their clients. It is likely that this increased investment will lead to increased engagement by investors with companies over the next few years.

As has been the case for many years, a significant proportion of engagement is focussed on remuneration issues. Whilst we ourselves encourage a more broadly based agenda for our engagement with companies, we accept the importance of engaging effectively on remuneration. That said, BIS and the FRC should encourage both companies and investors to engage across the range of issues that are relevant

to enhancing the long-term competitiveness of UK companies with a view to achieving the best long-term return.

When the Review was announced, it was explained that 'shareholders have a primary role in promoting the accountability of management and boards for the performance of their businesses'. In this regard, it is important to highlight that there is a notable blind spot in the engagement agenda between most companies and their investors. This concerns a willingness by institutional investors to engage with companies about the quality of their corporate reporting and the assurance provided thereby. In practice, as was noted in the recent House of Lords Economic Affairs Committee report on the audit market, there are only a very few institutional investors, including Standard Life Investments, who are engaged on this subject. We fully support the recommendation made by the Institute of Chartered Accountants of Scotland in its report entitled 'The Future of Assurance' that an additional principle should be included in the Stewardship Code to address this significant shortcoming. We recommend that BIS engage with the FRC to address this.

Annual general meetings are a key mechanism that enable companies to provide accountability, and enable shareholders to hold boards to account. Yet the evidence demonstrates that attendance at AGMs is very low, that institutional investors rarely attend, and that they are costly. However, it is relevant to note that we do attend and speak at selected AGMs, and we have found them to be an effective means of interacting with boards of directors, especially when other avenues of constructive engagement have been pursued unsuccessfully.

Standard Life Investments Recommendation

We recommend that the Government introduces legislation that would make AGMs much more useful and less costly than is currently the case, taking due advantage of improvements to communication technology. In addition, the FRC should promote the usefulness and importance of AGMs in the UK Stewardship Code.

Regarding process integration of governance and stock selection, we can only speak for Standard Life Investments. We believe that our governance and stock selection processes are effectively integrated and we strive to make improvements on a continual basis. With a view to informing our clients and other interested parties about how we achieve process integration, we recently prepared the enclosed paper, which is designed to enable effective communication and transparency, and thereby accountability. We commend our process and its transparency to you as an example of good practice.

To sum, when the FRC published the UK Stewardship Code for Institutional Investors last year, its Chairman emphasised the importance of the Code 'evolving'. She was right to do so. The early evidence of activities by institutional investors following the publication of the Code is moderately encouraging, taken as a whole. However, it is premature to judge whether the Code has been a success. When the time comes to make that judgement, we very much hope that it will be judged as a success and we

are determined to do our best to uphold the Code's principles and encourage other institutional investors and fund managers to do likewise. Therefore, we should like to see the Code continuing to evolve and be integrated into the investment processes of institutional investors and fund managers. The Government should give unambiguous encouragement to the Code's evolution and the principles of best practice it comprises.

9. The impact of greater fragmentation and internationalisation of UK share ownership and other developments in global equity markets on the quality of engagement between shareholders and quoted companies.

The increasing globalisation of investment opportunities has allowed UK companies to access a larger pool of capital. This and the increased number of market participants has, in aggregate, greatly improved the liquidity of the UK equity market. This diversification has also placed UK equity in the hands of more owners who are domiciled in jurisdictions where legal frameworks are different from that of the UK. From the viewpoint of Standard Life Investments, there is little evidence to suggest that this fragmentation has degraded the quality of our engagement with investee companies. However, it has highlighted the importance of well focussed and systematic engagement by shareholders, as the evidence shows that the voting process alone is an insufficient means of correcting governance shortcomings. It is relevant to note that in 2010 representatives of our Governance & Stewardship team had 185 meetings with senior representatives of companies to discuss matters of interest to our clients. For the year to date it has had 169 such meetings.

In the wake of the financial crisis, Standard Life Investments and other UK institutional investors came forward with qualitative improvements to the governance environment under the aegis of the FRC. These have been included in the UK Corporate Governance Code and the UK Stewardship Code. The latter specifically requires signatories to disclose how they engage with investee companies. Attention has also been paid to collective engagement and its harmonisation with the UK Takeover Code. The FRC has welcomed the significant number of overseas supporters of the UK Stewardship Code and signatories to it.

To summarise, we have no evidence to suggest that international investment trends have adversely affected the quality of engagement between shareholders and quoted companies. That said, there are inherent risks and it is important that the FRC is mindful of these as it oversees the development and evolution of the UK Corporate Governance Code and the UK Stewardship Code.

10. Likely trends in international investment and in the international regulatory framework and their possible long term impact on UK equity markets and UK business.

In the absence of a fundamental asset allocation switch in the existing global investment pool in favour of UK equities, marginal investment is likely to be driven by those countries generating an excess of savings over the resources needed for inward investment. To the extent that these excess savings will be looking for a diversification of returns, the UK equity market will present an opportunity. Presently, these pools of savings are mostly in the Middle and Far East and it is interesting to note that China

International Capital Corporation has recently become the Peoples Republic first member of the London Stock Exchange.

The increasing globalisation of investment opportunities is also creating pressure for the harmonisation of regulatory and governance standards. The benefits of the adoption of best practice for standards of customer care, consumer protection and property rights should go without saying. This is one of the reasons why Standard Life Investments fully supports the principle of “comply or explain” that is enshrined in the UK Corporate Governance Code, which of itself incorporates best practice standards. The benefit of this approach, as opposed to statutory regulation, is that it preserves the appeal of investment in the UK to overseas investors where the legal framework of ownership rights may be different. To the extent that such a regime encourages overseas investment, it will also lower the cost of capital for UK companies. That said, we recognise that the likely trends of investment suggest that an ever increasing portion of the UK equity markets will be owned and/or managed by investors whose approach to responsible investment may differ from those institutional investors who support the UK Stewardship Code.

Standard Life Investments Recommendation

We recommend that BIS ask the FRC to commit to publishing an annual review of stewardship in the UK (not of the UK Stewardship Code per se), which should include not only recommendations to improve best practice but also provide an appropriate commentary on the geographic ownership of UK companies and its implications.