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SOCIETY OF CONSERVATIVE LAWYERS

Responsible Capitalism – Corporate Investing

FOREWORD

It has been possible to produce this pamphlet due to the work of Natalie Etchells who is the Society's first Lyell Scholar. The Lyell Scholarship is named after the late Right Honourable Lord Lyell of Markyate QC who was Solicitor General between 1987 and 1992 and Attorney General between 1992 and 1997 becoming the longest continuously serving law officer for more than 100 years. Lord Lyell was Chairman of the Society of Conservative Lawyers at the time of his death in 2010. The Scholarship is funded by the legacy left to the Society by the late Pamela Thomas OBE who was closely involved with the Society for many years and served as its Secretary for more than twenty years. The Society would like to thank Jonathan Fisher QC for the huge contribution he has made through his hard work in leading the selection process for the first Lyell Scholar and also for the guidance and editing assistance he gave the author during the production of this pamphlet.

The pamphlet is very timely. Shareholders have been ignored by the management of companies for far too long. This has been a significant factor contributing to a form of short-termism which has been damaging not only to individual companies but to the financial situation as a whole. There are a number of reasons for the lack of shareholder participation as the pamphlet explains. What is important is that long-term investment should be incentivised. Companies have been too concerned with the remuneration of management in the short-term and fund managers, whose financial welfare is often linked with short-term performance, have failed to challenge such a corporate strategy.

The pamphlet discusses a number of ways in which a more long-term approach can be achieved. These include giving greater weight to the voting rights of shareholders, various tax incentives encouraging long-term holding and the setting up of shareholder committees to oversee the board of management. It is also proposed that there should be some extension of fiduciary duties so that these extend to fund managers and clients together with the setting up of a new reporting obligation which will be designed better to reflect the long-term health of a company as opposed to existing arrangements which put pressure on management to meet quarterly targets.

There is undoubtedly an acceptance by the Government that companies must embrace the long-term perspective. The ideas in this pamphlet will contribute to the debate on this important issue and is consistent with the Society's objectives in helping to focus attention on current political issues.

The Lord Faulks QC
Chairman of Research, Society of Conservative Lawyers
October 2012

Corporate Investing: examining the role of shareholders within the corporation and the encouragement of long-term investment

By Natalie Etchells, Society of Conservative Lawyers Lyell Scholar 2012

Introduction

This paper discusses contemporary problems in the corporate investing process and suggests a range of options for improvement, with a focus on encouraging long-term investment and promoting shareholder participation.

This report focuses on two issues: the desirability to do more to encourage long-term investment and the encouragement of shareholder participation in the running of the company. Numerous problems faced when attempting to promote long-term investment and the involvement of shareholders in the company are the result of 'short-termism'. Short-termism has been given many definitions within academic commentary. In this paper, short termism denotes an attitude focusing solely on immediate results, overlooking as yet unappreciable future events. Definitions of 'long-term' and 'short-term' will vary according to each company and their specific circumstances.

Why is it desirable to encourage long-term investment?

A company's value depends on its long-term ability to generate income to fund value, which creates growth and pays dividends to shareholders. The Bank of England has stated that in an efficient capital market, savings are the basis for investment which in the long term promotes growth. Short-termism damages the ability of many companies to engage in long-duration projects (for example infrastructure projects) which are believed to yield the greatest long-term private and social returns and offer most potential for future growth.

In response to the recent publication of the Kay Review Interim Report the Business Secretary, Vince Cable, welcomed the report saying that economic policies had to embrace a long term perspective. Without a long-term perspective firms fail to innovate and add little value, effectively stagnating.

Why is it desirable to encourage shareholder participation?

The British model of corporate governance attributes greater importance to the ability of shareholders to hold directors accountable than many other countries. The views of shareholders and their level of engagement in the company have great significance in the UK. Shareholders can be highly influential within a business, and can act as a valuable check on the decisions of directors. Conversely, shareholders can easily become passive and fail to exercise their rights in contributing to and influencing company policy which compounds the problems associated with short termism. Many measures designed to increase long-term investment will concurrently promote active participation by shareholders.

Promoting shareholder participation is an element of long-term investment; therefore many of the options discussed to support shareholder involvement will reinforce the options proposed to encourage long-term investment generally.

Listed companies, rather than private limited companies are examined in this report. The latter tend to be owned and controlled by smaller groups of shareholders who are much more closely involved in the running of the business and more likely to have established long term objectives.

Awareness of corporate short termism has been growing in the US since 2006 but the problem of short-termism is not perceived as prevalent to the same extent in the UK as in the US. The lack of basic data in the UK on information as fundamental as holding periods has meant that differentiation between types of shareholder is, for the most part, speculative or anecdotal.

Conclusions

This report concludes that incentivising market participants, rather than regulating them, may produce the most effective results. The UK should be an attractive place from which to operate a business and a corporate governance scheme in which there is a great deal of flexibility will provide best for all participants. It is not possible to force investors to engage in a meaningful way with the companies in which they are invested. The use of regulation to do so could be costly and counterproductive. Incentivising market participants is therefore the key strategy. Flexibility permits the greatest number of company-specific solutions and the aim of this report is to discuss a variety of options.

Many of the options discussed will be suitable for implementation through either statements of best practice or through additions to the Corporate Governance Code. Its ‘comply or explain’ enforcement maximises the options available to companies without necessitating legislative changes.

The current situation

Following the Financial Crisis of 2007-2008 (the ‘Financial Crisis’) it is important to re-evaluate accepted or neglected areas within the governance of the corporation to ensure that the most suitable approach is taken. For decades there has been academic discussion over the role of shareholders within the corporation and the issue of increasing shareholder participation in company management.

As a result of the responses to the Department for Business Innovation and Skills’ consultation ‘A long-term focus for corporate Britain’ the Kay Review of UK Equity Markets and Long-Term Decision Making launched a call for evidence on 15th September 2011. These responses will be discussed in relation to the perceived causes of short-termism and the options for improvement.

In recent years there has been a marked increase in short-term attitudes due to technological advances and the ease with which data can be accessed. These changes in technology facilitate the reduction of barriers to short-term investment by reducing trading time and costs.

Causes of short-termism

The causes of short-termism (relevant to this report) relate directly to each of the main participants in the investment process and any recommendations may be relevant solely to that participant. It is for this reason that the majority of the analysis of both causes and possible options will be structured by market participants.

Investors: investor pressure on management

Prior to the dot-com boom the priority for most investors was long-term value creation and an accompanying loyalty to the company in which they invested. Since the dot-com boom, investment on a mass-scale has increased, particularly through the use of funds and asset managers. Boards of directors and other executives took their lead from investors, who increasingly focused on short-term returns (Aspen Institute). Jensen (2005) notes that many managers used overvalued equity to meet growth expectations, which was damaging to the core value of the company. Investors are regularly criticised as over-valuing short-term payoffs, rather than taking advantage of the full long-term benefits of their shareholdings.

The modern mistrust of corporate leaders is an aggravating feature of investor pressure on companies for short-term profits. This lack of trust has come about partly as a result of a series of corporate scandals such as Enron. Investors will be very cautious in investing their long-term interests in companies that fail to demonstrate commitment to long-term value creation. This increases interest in short term investment.

The trend towards investor short-termism is significant since the shorter term the investment, the shorter term the wider interest in the company. This equates to a lack of participation and influence on issues with a long-term focus as the shareholders have little concern beyond their own short-term horizons of investment.

Asset/Fund Managers: lack of transparency and conflicts of interest

The compensation of fund managers is linked to current performance of the fund. Fund managers who focus on short-term trading gains are unlikely to promote business policies which are beneficial to a company on a different timescale. Many respondents to the Department for Business, Innovation and Skills' consultation 'A Long-term Focus for Corporate Britain' felt that there is insufficient transparency in fund manager pay and the mandates they are given.

Whilst many respondents acknowledged that conflicts of interest exist, there was no consensus as regards the extent to which agency problems and conflicts of interest are problematic. An important conclusion is that more information is needed.

Directors/Board Members: executive compensation

Executive compensation has become a controversial issue between managers and shareholders. Underpinning managerial incentives is the desire to create a long-term interest in the company; therefore ensuring the executive takes a long-term perspective, whilst simultaneously rewarding them.

Coates et al (1995) have classified executive compensation measures as either long-term or short-term focused. Long-term measures included marketing, sales and profit margin. The short-term measures included share and equity options, asset returns and residual income. Share and equity options are contentious because if properly used they may be considered as long-term incentives. Often the situation occurs whereby the options may be exercised as soon as gains are realised, rather than at a fixed point in the future. A manager may maximise the value of a short-term incentive plan by making shorter-term decisions, thereby inflating the share price (for example) in the shorter-term. The average time-scale for a long-term incentive plan is three years, which is a relatively brief time frame. While each case differs from company to company, the effects of such decisions may not be appreciable in such a short period of time.

Shareholders, Fund Managers and Directors: focus on quarterly reporting

This problem affects all market participants, rather than a single group. The concepts of transparency and regular reporting on company finances are highly appealing from an investor's perspective. The ability to monitor the performance of a company in which you have a vested interest is, for obvious reasons, very important. Well informed investors make better investments. However, criticisms of quarterly reporting or earnings guidance are extensive and increasingly ferocious.

Quarterly reporting is a widespread practice in the UK. Focusing on quarterly results encourages managers to concentrate their efforts on "meeting the numbers" as opposed to creating long-term value. The constant pressure to demonstrate good results has been attributed to pressure from investors, company boards and fund managers. Internally, there may be pressure from different levels of management to meet quarterly targets. The result is a mutually reinforcing obsession with short-term performance. A US survey of more than 400 financial executives revealed that more than 80 per cent of respondents would decrease spending on research and development, advertising, maintenance and hiring to meet short term targets. Short- term perspectives are not problematic, when combined with longer-term focus but frequently the long-term focus is sacrificed for short-term gains, reducing innovation and damaging the company's future prospects.

There was a wide consensus amongst respondents to the Kay Review's consultation that quarterly reporting has an adverse effect on both companies and investors which is reflected in European Commission proposals to review the reporting obligations in the Transparency Directive.

Incentivising market participants: improvement options

Shareholders

Voting weight

Increasing the weight of shares proportionately with the duration of shareholding may persuade shareholders to retain their shares for longer to maximise their influence within the company. The issuing of shares with differing voting weights is already utilised by some companies to promote the interests of select shareholders above the general body of shareholders, thus these measures would not represent a substantial change. This measure would be highly likely to attract investors committed to engaging meaningfully with the running of the company, who seek to increase their involvement and interest as time goes on. Longer-term shareholders would therefore accrue greater influence in the company, while short-term investors would have a smaller interest comparatively, in turn promoting long-term decisions. However this inequality may deter some investment. Nevertheless, a number of respondents to the Kay Review's call for evidence favoured this approach, suggesting that it could be mandated by legislation or implemented by individual companies through the articles of association.

Tax incentives

Introducing tax reforms may be a useful method of either discouraging short-term investment, or encouraging long-term investment. Capital gains tax may be used to either end. The introduction of a higher rate of capital gains tax to be paid on the sale of shares (or any security) held for less than a specified period of time could be used to discourage short term investment or excessive trading. The success of a company rests on both its long term and short-term policies.

The use of capital gains tax on a descending scale proportionate to the length of time a security is held could be used to encourage long term investment. The longer the security is held, the greater the tax reduction. This measure is akin to taper relief, previously abolished in 2008. Whilst recommending its reintroduction is beyond the scope of this report, application of taper relief in this select way will provide an invaluable incentive to retain shares and encourage longer-term investment. Respondents to the Kay Review felt that taper relief or similar tax advantages should be introduced and the impact of such measures is fertile ground for further research.

Shareholder committees

A selection of shareholders forming a committee to advise or supervise a company's directors is not a novel concept. The German system of co-determination has been used in various forms since the Second World War. Co-determination is the system in which both shareholders and employees of the company form part of the company's supervisory board and oversee the board of management. The supervisory board has little responsibility in terms of the management of the company; however they do appoint the members of the board of management.

It is important that in this model shareholders are involved at a high level and have a large degree of influence. It may also benefit the company as promoting share ownership amongst those with relevant industry knowledge or expertise could result in a supervisory board with many members able to make a considerable and useful contribution to the success of the business. The introduction of a supervisory board will encourage investment from those eager to participate in the company, rather than passive investors.

In the US shareholder committees are regularly utilised in the Chapter 11 bankruptcy context on the basis that shareholders must have a voice to represent their own interests, as they may differ from those of the directors. However, this may also be of application in the daily running of company, A small number of US companies have formed formal shareholder advisory committees as part of their internal structures.

Ideally a shareholder committee should liaise between the board of directors and the body of shareholders to ensure greater recognition for shareholders in the decision- making process. The composition of such committees can be categorised in a number of ways: the shareholder with the largest holding, the interested shareholders; a requirement of a specified percentage of shares held prior to eligibility for the committee; and a requirement of having held shares for a specified period of time. Ultimately, the fairest method of selection can be a company-specific choice.

The powers and function of such committees should be for the company to decide based on their individual need, but a general recommendation could be that the committee should take a predominantly advisory as opposed to a supervisory role. However, if shareholders are given extensive supervisory powers then they may owe fiduciary duties to other shareholders. This situation ought to be avoided as it excessively complicates the role of shareholders.

Some respondents to the Kay Review consultation favoured the establishment of shareholder committees. It was noted that this power is available to large shareholders at any time, but that 'explicit provision' for such an arrangement would encourage the participation of committed shareholders.

It has also been suggested that the Institutional Investor Committee, which comprises the Association of British Insurers, the Investment Management Association and the National Association of Pension Funds, might provide a foundation for collective shareholder action.

Implementation

The implementation of these options would be best achieved by additions to the Corporate Governance Code which, benefitting from the 'explain or comply' provisions would likely be the most flexible way in which to introduce shareholder committees or altering voting rights. Tax incentives would require legislative changes and the impact of this necessitates further research.

Executives

Executive compensation is an area of considerable friction between managers and shareholders. It is, however, possible to re-align the interests to focus on longer-term value creation. Some executives, particularly the board of directors, are already subject to fiduciary duties. Increasing or extending existing fiduciary duties may not necessarily be productive. Instead, incentivising executives at levels extending beyond the Board to concentrate on long-term objectives is an effective way of stimulating long-term perspectives and decision-making.

Companies are already able to create their own executive compensation plans, the most relevant in this context being the grant of stock options. Granting stock options only exercisable after a specified number of years or at a certain time re-aligns compensation with the company's long-term interests. For example, Coca-Cola utilises a compensation plan comprised of solely equity-based share units only payable after long-term performance goals of three years or more are met.

A further complementary measure could be the use of tax incentives on the exercising of stock options and other executive incentive plans. Tax incentives such as the longer the option is held prior to being exercised the greater the tax reduction, may be valuable in persuading managers to pursue long-term views.

Executives with a vested interest in the company they run have an incentive to create value within the company. Altering the timescale of the investment such that it is only exercisable or realisable after a substantial period of time will encourage long- term value creation as the interests of the executives are tied up for longer periods. The Kay Review Interim Report suggested use of share incentives was for the shares to be held up to or beyond the tenure of the executive, prompting long-term decisions which benefit the company's long-term interests. Furthermore, tying the executives (or their financial interests) to the company for extended periods of time promotes confidence in the company in terms of its business strategies and its competent management. In applying the incentive plans beyond the highest levels of management internal issues posed by short-term attitudes throughout the company may also be alleviated.

Since there is a pre-existing ability to create such plans, a form of official encouragement or statement of best practice may be useful in promoting the use of such incentives. It is important that such executive compensation measures be instated by the company, and that it is a corporate strategy as opposed to being a regulated issue. Legislating for tax incentives may be a way in which the government can very actively promote long-term views amongst executives in addition to publishing statements of best practice.

Asset/Fund Managers

There is much general criticism of the roles of fund and asset managers in the cycle of short-termism, and an investigation of the precise problems created by their involvement would be worthwhile as the extent of the problem is debatable.

Fiduciary duties

The Milstein Centre for Corporate Governance has recorded increasing awareness amongst investors in the USA that fiduciary duties must be redefined in scope to include responsibility for a longer horizon. The same could be applied in the UK. The Core Values Strategy Group of the Aspen Institute argues for increased disclosures on compensation, trades and policies on proxy voting.

There is support for resolving conflicts of interest through the extension of fiduciary duties to include the relationship between the fund manager and the client in the responses to the Kay Review's consultation. The growth of intermediation was also highlighted as a factor increasing conflicts and costs.

Other ways of dealing with conflicts of interest

Suggestions from the National Association of Pension Funds (NAPF) include the use of a best practice framework to monitor fund and asset managers and to deal particularly with the disclosure of conflicts of interest, and when the structural separation of two conflicted businesses may be appropriate.

It may also be useful to restructure the compensation of fund managers who are focused on the long-term to correspond with the fund's longer-term performance.

Role in educating investors

The importance of fully informed investors who understand the effects of short-term decisions on their part cannot be overstated. The role of intermediaries in ensuring that investors are aware of reforms or proposed reforms, for example to taxation or the introduction of shareholder committees, is vital.

Quarterly Reporting: issuing non-earnings guidance/annual reporting

Issuing qualitative statements about market conditions, industry-specific information, and qualitative statements about high-performance measures rather than quarterly reporting will significantly aid the transition from short-term to long-term corporate strategy. Alternatively it may be possible to promote reporting on an annual basis through a best practice structure. It is anticipated that such measures will relieve much of the pressure by investors and high-level management to meet quarterly targets. This should permit management the necessary freedom for longer-term decision-making.

The advantages of a Board with a long-term perspective, and fewer short-term pressures, may be that the company is able to encourage a longer-term stance in its decision-making, attracting long-term investment from shareholders drawn to the long-term strategies. The company may also be able to engage in activities which promote innovation and long-term value creation, such as research and development, which will in turn make the company more attractive to investors with long-term perspectives. Such investors may be keen to be actively involved in the running of the company as their interests are aligned in the longer-term, thus a further possible advantage is increased shareholder participation in the company. A company focused on the long-term will attract shareholders focused on the long- term, and perhaps also more likely that investors motivated by short-term returns will choose to invest elsewhere.

Education of Investors

A minor point that should be noted is the importance of clear, plain language free from jargon (legal or accounting) in statements issued by companies, analysts and funds.

Conclusion

Package of options

A package of options is recommended as it is important that multiple options are employed concurrently to tackle the inter-dependent contributions from various market participants to short-termism. The nature of short-termism means that merely reforming one area will not resolve the larger issue and may in fact increase the burden on the group affected. There is need for re-examination of all major participants and the role they have in encouraging long-term investment and shareholder participation. It would be self-defeating to recommend changes to executive compensation if directors still face pressures of producing quarterly results and if shareholders have no incentive to invest long-term.

The options recommended are therefore:

1. Shareholder tax incentives. This, along with complementary best practice guidance, could be implemented at a national level by the government to rapidly alter attitudes to long-term investing.

2. Shareholder committees. The implementation of compulsory shareholder committees with a minimum advisory function could be achieved through an addition to the Corporate Governance Code.

3. Executive incentives. The use of long-term incentives, such as stock options, which may only be exercised after a specific period of time could be adopted through issuing best practice guidance. It is important not to unduly restrict the ability of the company to reward its managers appropriately, but it is desirable to encourage a long-term interest in the business.

4. Extension of fiduciary duties to fund managers and clients. This option would remove some of the conflicts of interest currently inherent in the investment process.

5. Removal of quarterly reporting. New reporting obligation appears imminent on a European level. However, adopting changes or making additions now to encourage the production of non-earnings guidance would be a pro-active approach to the issue.

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