TUC Response: A Long-Term Focus for Corporate Britain

TUC response to BIS call for evidence

Introduction

1.1 The TUC very much welcomes this opportunity to respond to the BIS call for evidence on A Long-Term Focus for Corporate Britain. The consultation raises some of the most important issues and challenges facing the UK economy today, with major implications for our competitiveness and economic success as a country and for the different interests and stakeholder groups involved. The TUC represents over six million members in 58 trade unions. Many of our members work in companies, and are directly affected by the practices and performance of their employers. They are also, through their pension funds, the beneficiaries of investment in UK (and global) companies, with a stake in the long-term success of the corporate sector as a whole. And they, along with the whole of the UK population, are affected by the UK's overall economic performance, to which the corporate sector is such a major contributor.

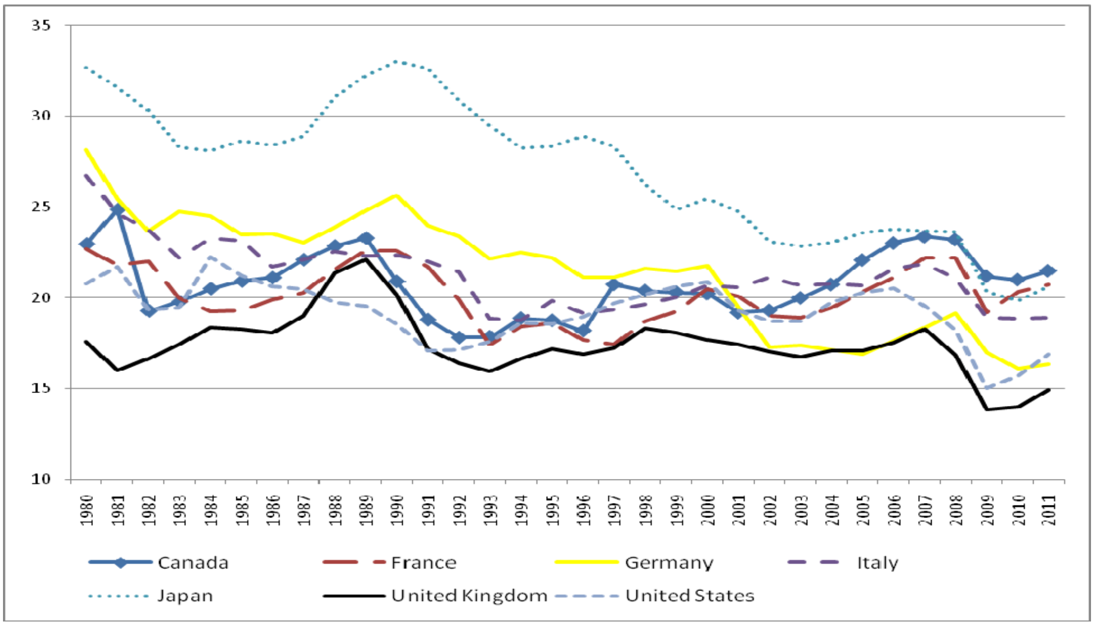
1.2 The TUC has for many years been raising concerns around many issues raised in the consultation document and we believe that this consultation is timely and apposite. We hope that the Government will have the courage to face down vested interests and take effective action to address the important issues it has raised.

1.3 This response answers most of the questions raised in the consultation, but we have altered the order of some answers in order to fit the narrative of our submission.

The Board of Directors

Do UK boards have a long-term focus – if not, why not?

Chart: Business Investment as a percentage of GDP 1980 – 2010



Source: IMF World Economic Outlook Database, April 2010

2.1 The chart above compares UK business investment as a percentage of GDP with that of Canada, Italy, the US, France, Japan and Germany. It shows that the UK constantly lags behind our main competitors in terms of business investment. This is a key indicator of the way in which UK companies are failing to take a long-term approach to their future success. The reasons behind short-term approach to business are explored in the rest of this submission.

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?

2.2 The TUC is aware of anecdotal evidence suggesting that company boards have at time experienced difficulties through not having sufficient information on who is buying, selling and holding their shares. We believe that the major role ascribed to shareholder engagement in the UK's corporate governance system makes is essential that companies are able find out this information in a way that is not too costly and time-consuming.

Shareholders and equity markets

What are the implications of the changing nature of UK share ownership for corporate governance and equity markets?

3.1 The changing nature of UK share ownership poses major challenges for corporate governance in the UK. The nature of the problem is two-fold.

3.2 As the consultation document briefly refers to, shareholders are ascribed a privileged and significant role in UK corporate governance. It is ultimately their interests that company directors are required to serve. In addition, shareholders have important governance rights, including electing all board directors, voting on directors' pay, voting on the annual report and accounts and deciding the outcome of merger and takeover bids (which will be discussed more fully below). A frequent response from governments of different political persuasions to public demand for action to address corporate behaviour of one sort or another is that 'it is a matter for the company and its shareholders'.

3.3 As the consultation document sets out, directors' duties were codified in the Companies Act 2006 and are set out in Section 172. Directors are required to act in good faith 'to promote the success of the company for the benefit of its members as a whole', and in doing so are required to have regard to the long-term implications of decisions, employee interests, customer, supplier and community relationships and environmental impacts.

3.4 There are two important assumptions that underpin the UK's system of corporate governance with its combination of shareholder primacy and shareholder-dominated governance structures. The first, which is reflected in the thinking behind Section 172 of the Companies Act, is that in the long-term the interests of shareholders and other stakeholder groups – and indeed, the company itself – will converge. This belief was clearly articulated by the Company Law Review, which, as the consultation document notes, carried out a fundamental review of company law between 1998 and 2001. Section 172 was designed to ensure that directors took what could be called the ‘high road’ to success, based on investing in R&D and training, developing long-term, committed relationships with employees, suppliers and customers and managing environmental impacts responsibly, rather than the ‘low-road’, based on low-skill, low wage employment, low investment levels and a short-term approach to financial returns. The idea that shareholder relationships will generally be long-term is critical to the basis of this analysis.

3.5 The second assumption that underpins the UK’s corporate governance system and relates specifically to the role ascribed to shareholders in monitoring corporate governance standards and corporate performance, is that shareholders are willing and able to carry out the monitoring and engagement role that this requires. Both of these assumptions are challenged by the changing nature of UK share ownership.

3.6 There are a number of elements relating to the nature of share ownership and shareholder strategies that present severe challenges to the UK’s shareholder-oriented corporate governance system. As the consultation document sets out, share ownership of UK companies has changed dramatically over the last fifty years. In the 1960s, the majority of shares in UK companies were owned by individuals, many of whom took a reasonable level of interest in the companies whose shares they owned. By the 1980s, the majority of shares were owned by UK institutional investors such as pension funds and insurance companies. Today, this has changed. The IMA’s most recent figures suggest that pension funds and insurance companies now hold around 13% of UK equities each, with an additional 14% held by other UK institutional investors[1]. ONS figures show that at the end of 2008, 41.5 per cent of UK-listed shares were owned by investors from outside the UK, and individuals held just over ten per cent, the lowest percentage since the survey started in 1963[2].

3.7 It will by definition be harder for investors from outside the UK to develop the kind of engaged relationships with UK companies that are envisaged by the UK’s corporate governance system. Language, culture, proximity and availability of information all make engagement much more straightforward within a national context in comparison with engaging with companies abroad. This is reflected in responses to the TUC’s Fund Manager Voting Survey: in the most recent survey, 21 respondents said they voted all their UK shares (with a couple of minor qualifications), while nine voted all their overseas shares (with a further six saying they voted where practical or in certain markets or a significant proportion of their overseas shares)[3]. The UK’s corporate governance system was not designed on the basis that the largest single share ownership block would be investors from outside the UK.

[1] IMA, Asset Management in the UK 2009 – 2010, July 2010

[2] Available at http://www.statistics.gov.uk/cci/nugget.asp?id=107

[3] TUC Fund Manager Voting Survey 2010, p 68

3.8 In contrast with individuals who own shares in a limited number of companies whose progress they follow closely, institutional investors generally own shares in hundreds or even thousands of companies. Just as an increasing proportion of UK shares are held by investors from outside the UK, an increasing proportion of equity holdings of UK institutional investors are global, rather than UK equities. The sheer number of companies whose shares they hold poses major practical challenges to the ability of institutional investors to carry out their corporate governance responsibilities effectively. If UK institutional investors are to engage effectively on an informed and consistent basis with all the companies whose shares they own, this would require a very significant deployment of resources, considerably above the levels that most currently devote to engagement. As Sir David Walker pointed out in his report on UK bank governance, competition between institutional investors and the fact that the gains generated by effective engagement are enjoyed by investors across the board rather than flowing directly to the investors who have carried out the engagement, reduce the incentives for institutional investors to devote sufficient resources to enable them to engage effectively with all the companies whose shares they hold.

3.9 The IMA's survey makes it clear that its members are wary of too weighty expectations being placed on their governance role: 'The fact that UK investors now own a smaller proportion of UK companies has implications for the corporate engagement role that investment managers play in the governance of companies. There is concern amongst investment managers that there should not be unrealistic expectations of what they can achieve through engagement.'[4]

3.10 To conclude on this point, equity markets have become increasingly global. This means that over 40 per cent of the shares of UK companies are now owned by investors overseas. At the same time, UK institutional investors hold increasingly diversified portfolios, with a smaller proportion of total assets being held in equities and an increasing proportion of the equities they do hold being in overseas markets. The geographical and numerical spread of their company's shareholders creates significant challenges for a board's ability to engage effectively across their shareholder base. At the same time, UK institutional investors have increasingly diversified equity holdings, which creates challenges for their ability to engage effectively with the companies whose shares they own. Shareholdings are simply spread to thinly to facilitate committed, engaged relationships between institutional investors and companies. This challenges the basis of the UK's corporate governance system and the monitoring role ascribed to shareholder therein.

3.11 In addition to the practical difficulties that diversified shareholding present for both investors and companies in terms of developing long-term, engaged relationships, there is a still more fundamental challenge created by the changing nature of share ownership to the UK's corporate governance system. The convergence of interests between shareholders and other stakeholders and also, crucially, between the interests of shareholders and the long-term success of the company itself, breaks down if shareholders are taking a short-term perspective.

---

[4] ibid

The interests of short-term shareholders cannot be taken as a proxy for the long-term success of the company and its other stakeholders, as if the long-term impact is discounted it is possible to slash investment, lower wages and squeeze suppliers in a way that may generate short-term returns, although it will undermine the company's potential for future success. This issue is explored in more detail below.

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

What action, if any, should be taken to encourage a long-term focus in UK equity investment decisions? What the benefits and costs of possible actions to encourage longer holding periods?

3.12 Alongside the diversification of share holdings described above, increasing proportions of shares are owned by alternative investment managers with short time horizons and investment practices based on share trading rather than long-term share ownership. While the proportion of shares owned by alternative investment managers across the stock market as a whole remains fairly low, the ability of alternative investment managers to buy and sell large numbers of shares in a particular company over a short period of time magnifies their influence in the market. In addition, seeking to increase the value of a portfolio by buying and selling shares at an advantageous time has also become an important part of portfolio management of traditional institutional investors.

3.13 The influence of alternative investment managers, notably hedge funds, in issues relating to mergers and takeovers is a particular problem, and this will be returned to in the relevant section below.

3.14 The interests of investors who are short-term share traders do not equate with the long-term interests of the companies whose shares they hold. Nor do they equate with the interests of other company stakeholders such as employees, suppliers and customers. The growth of alternative asset managers and the increasing use of share trading as an investment strategy across all investor groups cuts right across the basis of Section 172 of the Companies Act, with major implications for corporate governance and company performance. Directors are required to 'act fairly between the different members of the company', but it is not possible to do this if some shareholders have bet on the company's share price falling and will therefore benefit from the company doing badly, while this will clearly hurt other shareholders, along with other company stakeholders and the company itself.

3.15 The TUC believes that directors' duties should be amended to put promoting the long-term success of the company at their heart, and making serving the interests of shareholders and the different stakeholder groups included in Section 172 secondary to this central aim. This would be closer to the original intention of how the new directors' duties set out in the Companies Act 2006 would operate. A possible formulation would be:

3.16 'The directors of the company are required to act in good faith to promote the long-term success of the company, and in so doing, should have regard to the need to:

i) deliver fair and sustainable returns to investors

ii) promote the interests of the company's employees

iii) foster the company's relationships with suppliers, customers, local communities and others, and

iv) take a responsible approach to the impact of the company's operations on the environment.'

3.17 This reformulation of directors' duties would bring significant benefits, but would still leave the role of shareholders regarding governance intact. As Sir David Walker noted in his review of bank governance,

'Fund managers whose management strategies substantially relate to active trading in stocks may have little interest in engagement with the boards of investee companies. If they dislike a stock they can sell it…

As a matter of public interest, a situation in which the influence of major shareholders in their companies is principally executed through market transactions in the stock market cannot be regarded as a satisfactory ownership model…'

3.18 Even more problematic than the issue of the incentive to engage, referred to in the quote from Sir David Walker above, is the issue of the divergence of interests of short-term share traders from the long-term interests of the company whose shares they hold. It is highly destructive for UK companies and for the UK economy and all those who depend upon it for short-term traders to be able to influence corporate behaviour and decisions to serve the traders' short-term interests rather than the long-term interests of the company. The TUC believes that governance rights and responsibilities should be restricted to long-term shareholders, and proposes that all voting rights in UK companies should be dependent on holding shares in the company for a minimum of two years.

3.19 Even with these reforms, the TUC believes that it may be necessary to revise and significantly reduce the role of investors in corporate governance. Investors' privileged corporate governance position is in the last chance saloon. If investors do not rise to the challenge of playing the responsible corporate governance role that has been ascribed to them, this will be clear and irrefutable evidence that the system itself needs to change.

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

3.20 Taking the case of a pension fund, the investment chain stretches between pension fund members or beneficiaries, pension fund trustees and/or managers, fund managers and the directors of the companies in which the pension fund's money is invested. In theory, there should be a good fit between the long-term nature of pension fund investments and a long-term focus in terms of corporate strategy and performance. In practice, relationships within the investment chain often contribute to short-term pressure on companies, which ultimately acts against the long-term interests of the pension fund beneficiaries.

3.21 Starting at the end-point of the investment chain, fund managers and institutional investors tend to put considerable store by short-term company financial indicators, such as share price movements and quarterly earnings. The introduction of a requirement in the Companies Act 2006 for directors to produce a Business Review including forward-looking information as part of their annual report was clearly intended to help investors assess companies' long-term strategies and plans. However, as has been highlighted in discussions surrounding the Governments' recent consultation into the future of narrative reporting, forward-looking information is often one of the weakest elements of narrative reporting. Whether because of the quality of forward-looking reports or because of a lack of demand for them on the part of investors, the introduction of the Business Review requirements does not seem to have led to a decreased emphasis being put on short-term financial reporting by investors.

3.22 The interest from fund managers in company share prices and quarterly reporting can undoubtedly put pressure on directors to take short-term measures to boost their company's share price rather than developing strategies for long-term organic growth. This is exacerbated by the fact that directors' pay is often linked in part to company share prices and/or short-term financial indicators, which creates a direct incentive for directors to boost these measures regardless of what is in the long-term strategic interest of the company. In addition, a low share price can leave a company vulnerable to a hostile takeover bid, even if the company if perfectly well-managed and successful. This was a feature of Kraft's successful hostile takeover bid for Cadbury: although Cadbury was generally regarded as a well-managed company with good prospects, its share price did not reflect what many commentators thought the company was really worth. This made it a relatively 'cheap' target for takeover. Commentary in the financial press surrounding the takeover noted that this was a feature of the UK stock markets at the time, and that many solidly performing companies were valued relatively cheap according to their share price, making them vulnerable to takeover bids. No wonder, then, that directors will take measures to raise their share price, even when such measures are not the best way to boost long-term company performance.

3.23 The difficulty of carrying out major corporate development programmes with the support of institutional investors has been given as a reason for some private equity buyouts of major UK household names. While the main reasons for private equity buyouts have nothing to do with development plans, it is true that it can be difficult for a listed company to undertake radical investment plans that would deplete short-term earnings per share, even if in the longer-term such investment will boost organic growth.

3.24 Fund managers accused of putting companies under short-term pressure will point to the fact that they are under pressure from their clients to maximise short-term financial returns. Fund managers are generally required to report to clients on a quarterly basis. In addition, pension funds are encouraged to consider information comparing the performance of their fund manager with other fund managers. This makes it harder for fund managers to break away from the 'herd' approach, for fear that following a different strategy that does not shadow the performance profile of other fund managers will lead to them losing clients. Research has shown that this tendency towards institutional 'herding' does indeed protect short-term returns, but does so at the expense of long-term returns[5].

3.25 The TUC believes that the point raised in the consultation document about excessive share trading activity taking place at the expense of long-term investment gains is an extremely important issue. It is relates closely to the points made above about the increasing use of share trading strategies by institutional investors as well as alternative assets such as hedge funds (see 3.12). As Dr Paul Woolley has argued, heavy trading has come at a high costs to long-term investors, and pension funds are having their assets exchanged and traded on average 25 times over their lifetime, even though in the long-term this drains pension funds of 30% of their value[6]. The TUC believes that the Government should initiate work on proposals to cap share turnover, looking at proposals to be adopted by pension funds and other long-term investors as well as the role that Government and regulators can play in encouraging long-term shareholding.

3.26 Some within the investment industry have recognised that short-termism is hampering long-term performance. Rathbone Unit Trust Management Income fund manager Carl Stick, commenting on the reduction in the average holding period for stocks in the UK and US falling from 10 years in the 1940s to nine months recently in 2010, said "much of my industry is only interested in taking a bet on the next two quarters of news reporting [from companies], which is absolutely crazy. We are all turning to quarterly reporting, that is why the industry is so short term."[7] And the work of the Marathon Club has sought to highlight and address the inefficiencies caused by short-termism in the investment process: "Amongst corporates, for example, the performance of companies, and thus their underlying listed securities, is significantly influenced by the actions and statements of directors, who are ever mindful of a need to satisfy the earnings expectations of watching analysts. Indeed their own remuneration is often closely tied to these numbers. On the investment side, active fund managers, when selecting potential investments for their portfolios, are also keenly aware that their clients – not least the pension funds of the companies that are being so evaluated in this short-term manner – are assessing their performance on a quarterly basis. This obsession with short-term performance measurement is, therefore, deep rooted in the investment system and is reflected in a fixation with a narrow set of earnings-based performance statistics."[8]

---

[5] The Price Impact of Institutional Herding, Amil Dasgupta, Andrea Prat and Michela Verardo, The Paul Woolley Centre Working Paper Series No 11, FMG Discussion Paper 652, April 2010

[6] The Future of Finance: the LSE Report, Paul Woolley, Sept 2010

[7] Investment Week, February 2010

[8] Marathon Club, Long-Term, Long-Only Investing A Consultation Paper, 2006

3.27 Clearly, the importance of pension funds and their trustees monitoring the performance of their fund carefully is paramount. However, it far from clear that the balance between short-term and long-term investment performance in the information given by fund managers to pension fund trustees is currently optimal, and the TUC believes that fund managers tend to put more emphasis on short-term investment returns than long-term when reporting to clients.

3.28 The problem of short-term investment horizons of fund managers and pension fund trustees was highlighted in 2001 by Paul Myners in his seminal report on institutional investment in the UK.[9] In its 2007 review of the Myners principles, the NAPF concluded that while pension funds had made progress on setting explicit mandates, including timescales, less progress had been made on the issue of timescales, with some pension scheme respondents commenting on the short termist nature of mandates[10].

3.29 The TUC recognises that tackling this situation is challenging and complex. The Pensions Regulator has made it clear that pension fund trustees should monitor the funding situation of their pension funds carefully, and requires pension funds to undergo a full funding analysis every three years. In this context, pension fund trustees, especially those tackling deficits, cannot focus only on long-term financial trends to the exclusion of short and medium-term information. However, the TUC believes that the balance of timescales within financial reports from fund managers to clients such as pension funds does need to change, and that a greater emphasis should be put on long and medium-term returns and less on short-term returns that is generally the case at present. We propose that fund managers' should be required to report to clients on returns over the past twenty, ten and five years on an annual basis, and that the Government consults with both asset owners and asset managers as well with wider stakeholders on guidance on the form that such reporting should take. The TUC believes that it is particularly important that comparative data in which a fund's performance is measured against a chosen benchmark is looked at on a long to medium timescale, rather than a short-term basis, to avoid the worst pitfalls of herding behaviour and the consequent devaluation of assets that this creates. In addition, the TUC believes that fund managers should be required to report clearly to clients on the extent and costs of share trading in their portfolios on an annual basis.

3.30 The TUC fully recognises the importance of pension fund solvency, and commends the work of the Pension Regulator (TPR) in drawing up standards designed to boost pension fund governance and performance and the Pension Protection Fund (PPF) in providing a safety net for pension fund members whose pension funds have collapsed. Nonetheless, the TUC is concerned that the thrust of some of TPR's work promoting pension fund solvency may encourage pension fund to focus on the short-term performance of their assets. As the PPF levy assessment starts to include investments, there will be the potential for this to

[9] Institutional Investment in the UK: a review, HMT, 2001

[10] Institutional Investment in the UK: six years on, NAPF, November 2007, page 25

have an impact on the investment time horizons of pension funds. The TUC recommends that the Government should work with TPR and the PPF to set in train an investigation into the impact of TPR guidance and PPF assessments on the timescales on which assets and asset managers are assessed by pension funds, and to see whether additional guidance for trustees on the issue of timescales in fund performance would be beneficial. It may be beneficial to commission this work externally.

3.31 There is also evidence that fund managers' individual pay is often linked to short-term financial targets and that they are frequently employed on short-term contracts, with renewal subject to short-term financial performance. This is an important area that requires further investigation and proposals for reform. Efforts to build longer-time horizons into fund manager mandates need to go hand in hand with addressing the issue of short-term pay targets and contracts for individual fund managers.

3.32 In the case of retail investment funds, DC pension funds, and other forms of investment funds such as insurance policies, the problems of asymmetric information and the potential for conflicts of interests and agency problems are still more pronounced. It is extremely difficult for individual consumers of retail products and, unless the fund is trust based, which is rare, for a DC pension fund member, to exert influence on the investment strategies of their asset managers. Information and product 'choice' in the retail sector do not facilitate consumers putting pressure on fund managers to take a long-term approach to investment through their purchasing power. There is not the space to do justice to these issues here, but it is important that in its follow up to this consultation, the Government addresses the full range of participants in the investment chain, including those pertaining to different investment products and vehicles.

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

3.33 More transparency in the role of fund managers and their mandates and pay would make an important contribution towards addressing the agency problems and short-termism that have been discussed above. As discussed above, there is recognition, including from within the industry, that the pay incentives for individual fund managers can encourage short-term investment behaviour that works against the long-term interest of their clients. It is essential that this problem is addressed as a matter of urgency. Transparency on fund managers' remuneration packages including all incentive targets and their timescales is a step towards tackling this problem, and the TUC believes that the Government should require fund managers to publish information that shows the level of fund managers' pay and the basis on which it is assessed.

3.34 The TUC does not believe that any costs associated with greater transparency in this area would be significant, and believes that they would easily be outweighed by the benefits.

3.35 The TUC also believes that the Government should convene a working group that should include pension funds, TPR and asset managers, to work on best practice guidance on the issue of performance and timescales in mandates.

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?

3.36 The TUC believes that voting is an extremely important part of the engagement process. However, voting also serves an important legal function in its own right that goes beyond engagement. It is through voting that shareholders elect the company's directors, including the Chair of the board, who will have a major influence on the company's direction and prospects. Shareholders also vote to approve the company report and accounts on an annual basis. Alongside the advisory vote on the remuneration reports, there are other votes on specific aspects of remuneration where shareholder approval is required. And, very importantly, shareholders votes on shareholder resolutions, which often raise important strategic issues at particular companies.

3.37 In most of these instances, investors' voting strategies will go hand in hand with and be influenced by their engagement with companies through letters, telephone calls and meetings. In the TUC's most recent Fund Manager Voting Survey, respondents reported that engagement influenced voting outcomes, illustrating that voting and engagement are strongly related[11].

3.38 Important though they are, engagement activities are generally piecemeal and carried out by investors on an individual or small group basis. Voting allows investors to express their voice collectively and provides an opportunity for investors as a whole to give or withdraw their support for individual directors, a company's remuneration policy and so on. As such, votes are an asset of the fund, and should be treated accordingly.

3.39 The TUC has been carrying out an annual Fund Manager Voting Survey since 2003 in order to inform our network of over 1,000 trade union member nominated pension fund trustees. The Survey provides important information on how fund managers have voted on significant votes at company AGMs. For anyone, whether a pension fund trustee, pension fund member or member of the public, who is interested in the voting record of fund managers in general and their own fund manager/s in particular, the Survey is an invaluable source of information. The most recent TUC Fund Manager Voting Survey is attached as an appendix to this consultation response.

3.40 Although there has been a welcome increase in the numbers of fund managers who are reporting some information on voting, it would currently be impossible to compile the Fund Manager Voting Survey from publicly available sources. That is because only a minority of fund managers provide comprehensive voting data that includes records of all votes for, against and abstentions. Some fund managers report just headline voting statistics, while others report on votes

[11] TUC Fund Manager Voting Survey 2010, TUC, November 2010, p 70

against and abstentions, but not votes for, which means that unless you know categorically what shares were held by a fund manager at a given point in time, it is impossible to work out their full voting record. In the most recent Fund Manager Voting Survey, respondents were asked what information on voting they disclosed publicly, how frequently it was updated and how long such information was left on company websites. The Survey found that nine out of 22 respondents reported their full voting record, with six reporting just no votes and abstentions and three reporting headline statistics. There was considerable variation in the frequency with which data is updated and left on websites. The TUC is concerned that some fund managers report data only for a limited time, as this hampers longitudinal analysis[12].

3.41 The fact that nine respondents already publicly disclose their full voting record shows that the costs of disclosure are not prohibitive.

3.42 In terms of the benefits, there has been increasing recognition from market participants and policy makers of the need for asset owners to engage more fully with their asset managers about the engagement and monitoring activity undertaken by asset managers on asset owners' behalf. Greater transparency about voting records is an important part of this; it should be possible for all asset owners to compare the voting record of their fund managers with others, which, were it not for the TUC Survey, would not currently be possible. The TUC believes that the Government should make use of the reserve power taken in the Companies Act 2006 and make it mandatory for fund managers to publicly disclose their voting records. In addition, the TUC believes that it is essential that a standard voting disclosure template is developed to ensure comparability of the data provided. The TUC believes that given its responsibility for the Stewardships Code, the Financial Reporting Council (FRC) would be an appropriate body to consult on and design such a template.

Directors' Remuneration

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

4.1 In the TUC's view, the main reasons for the increase in directors' remuneration are set out below.

- Public policy has led to an increasing proportion of directors' remuneration being incentive-related, yet the performance criteria for incentive-related pay have been insufficiently stretching, so that directors' remuneration has risen dramatically regardless of company and individual performance and in the face of low overall stock market returns (as clearly set out in the consultation document).
- Despite the Combined Code of Corporate Governance explicitly warning

[12] Ibid, pp 71 - 72

against this[13], remuneration committees frequently use comparisons with other companies to set pay for directors in the upper median or upper quartile. This leads to a continual upwards ratchet in executive pay which is entirely self-generating and bares no relation to performance or any other factor that the Combined Code asks remuneration committees to consider.

- Remuneration committees do not pay regard to the impact on employee motivation and morale of awarding pay increases for directors that are much higher in percentage terms than those awarded to other staff. Supporting principle D.1 in the Combined Code that requires remuneration committees to 'be sensitive to pay and employment conditions elsewhere in the group', is routinely ignored. In addition, there is no evidence that remuneration committees see themselves as having any responsibility for the wider social and economic impacts of increased inequality that their decisions are fuelling, so the increased awareness in recent years of the destructive impact of rising inequality do not appear to have affected remuneration committee discussions.
- There is no evidence that it is necessary to pay UK directors require such high levels of remuneration in order to keep them in their jobs. The brain-drain argument, so often used, has been widely discredited[14]. The only country that pays its directors higher levels than in the UK is the US, but trans-Atlantic traffic in executives has been mainly from the US to the UK, which has had the effect of pulling up executive pay levels in particular companies but cannot be used as a plausible rationale for executive pay increases across the board. There is no evidence whatsoever of a high demand for UK executives in the US. There is, however, anecdotal evidence that some directors are concerned to ensure that their remuneration keeps pace with that of their peers in other companies. This has encouraged the continued use of pay comparators with the pay ratcheting consequences already noted.
- Both remuneration committees and shareholders have been supremely ineffective in ensuring appropriate levels, rate of increase and performance criteria for executive pay. This is returned to below.
- The role of remuneration consultants is of great concern to the TUC. It appears that some remuneration committees rely heavily on the advice given to them by remuneration consultants. However, remuneration consultants are frequently part of wider business consultancy organisations, which gives rise to conflicts of interests, as they may be seeking other contracts from the same executives whose pay they have been asked to advise on. There are real questions to be asked about why the experience that remuneration consultants should surely have accumulated over the last fifteen years has not led to a better match between pay and performance, and why remuneration performance targets remain insufficiently challenging.

---

[13] Supporting Principle D.1 of the Combined Code includes: 'The remuneration committee should judge where to position their company relative to other companies. But they should use such comparisons with caution in view of the risk of an upward ratchet of remuneration levels with no corresponding improvement in performance.'

[14] Eg, Life at the Top The Labour Market for FTSE 250 Chief Executives, Nick Isles, Work Foundation, 2003

4.2 The TUC believes that the emphasis in public policy on performance-related pay over the last fifteen years has been mistaken. In particular, the TUC believes that the incentive-related element of remuneration should not dominate the total package, and should be a much lower proportion of total pay than is generally the case at present. The reasons for this are set out below.

- There is no evidence that performance-related pay works in terms of generating better performance. There is, however, convincing academic evidence that performance-related pay does not generate higher levels of motivation or performance[15].
- The TUC believes that the assumption that directors are motivated primarily by financial incentives is neither true nor desirable. Surely it is desirable that those running Britain's companies should be motivated by a commitment to their company and a desire to do a good job, and to be fairly rewarded for doing so, rather than motivated by money alone. Most people in many walks of life are expected to, and indeed do, do their best at work for a fixed salary, and the TUC can see no reason why directors should be any different in this regard. There is a danger that the emphasis on incentive-related pay for directors will become self-fulfilling, and will attract to the role people who are motivated primarily by individual greed rather than a commitment to their company and dedication to their role. While the TUC does not believe that individual greed is the prime motivation of most directors across UK industry at present, it could be argued that within the financial sector remuneration design has affected both behaviour and the type of person attracted to the industry, with disastrous consequences for the sector and the wider economy.
- It has proved extremely difficult for remuneration committees to set performance targets that are sufficiently challenging to ensure that incentive-related elements of remuneration are paid out only for good and exceptional performance; the vast majority pay out for mediocre and in some instances poor performance. While this may in part reflect a lack of motivation to set challenging targets on the part of remuneration committees and consultants, the TUC believes that is also reflects the fact that it is genuinely difficult to predict what will be a 'good' future result, which indicators should be used and so on. The difficulty with finding one indicator that encapsulates 'good' performance has led to incentive schemes becoming more and more complicated, which in turn has had the effect of creating so many different incentives that directors regard them as neither aligned with business strategy nor within their control[16].
- Because of the failure of incentive-related pay to link remuneration to performance, it is the incentive related elements of pay that have contributed

---

[15]See, for example, The False Promise of Pay for Performance: Embracing a Positive Model of the Company Executive, James McConvill, 2005; The Upside of Irrationality: The Unexpected Benefits of Defying Logic at Work and at Home, Dan Ariely, 2010; Not Just for the Money: Economic Theory of Motivation, Bruno Frey, 1997; The Hidden Costs of Reward: New Perspectives on the Psychology of Human Motivation, Mark R. Lepper & David Greene, 1979

[16] See Executive Compensation Review of the Year, PWC 2009

most to the massive rise in the gap between directors' pay and average employee pay over recent years.

4.3 The TUC is particularly concerned that the gap between directors' pay and average employee pay has grown so sharply in recent years. While the TUC accepts that there will be a differential between the pay of directors and the average pay of other employees within their company, what the TUC cannot accept is that these differentials should rise year upon year upon year. As Will Hutton's Fair Pay Review showed, by 2009 median pay for FTSE 100 chief executives had risen to 88 times UK median earning, up from 47 times in 2000, and to 202 times the national minimum wage, up from 124 times in 2000[17]. The rate of increase in UK executive pay has been higher even than in the US, and while the US ratio of executive to average employee pay is still higher than in the UK, the gap is closing.

4.4 Differentials of this scale and differential pay increases over-value the contribution of executives in relation to that of other staff, and devalue the importance of team working. They send a signal to staff that there is one rule for the board and another for the rest. This is bad for employee morale and motivation, both of which have been shown to be key determinants of future success[18]. Evidence shows that there is a strong correlation between narrower pay dispersion within an organisation and improved organisational performance[19]. This is mainly because of the impact on employees.

4.5 Awarding higher pay increases to directors than to the rest of the workforce can lead directly to difficulties in reaching agreement on pay settlements, as last year's dispute over pay at BT showed. BT offered its workforce a pay rise of 2%, while some of BT's senior managers had been awarded salary increases (not including the increases to the incentive elements of remuneration) which were significantly higher. This led to a ballot for strike action, and the CWU to comment; "Staff are comparing this offer with the larger salary rises and bonuses for senior executives, which expose the blatant double standards being adopted by the company when it comes to remuneration". The dispute was eventually settled without a strike taking place when the company increased its offer to staff.

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

4.6 At present, remuneration committees are made up of 'independent' non-executive directors. However, the majority of non-executive directors are, or have been, executive directors of other company boards. If they are currently executive directors, they stand to benefit indirectly from high remuneration packages because of the effect of comparators described above. Perhaps more importantly, past or current executive directors will be steeped in the same culture and

[17] Hutton Review of Fair Pay in the public sector: interim report, December 2010

[18] Engaging for success: enhancing performance through employee engagement A report to Government, David MacLeod & Nita Clarke, 2009

[19] Hutton Review of Fair Pay in the public sector: interim report, December 2010, page 22

assumptions about directors' pay. Unless the membership of remuneration committees is widened, their effectiveness is unlikely to improve.

4.7 The TUC believes that employees should be represented on remuneration committees through their trade unions. This would bring a common sense perspective to decisions on executive pay and would bring the issue of pay and conditions elsewhere in the company that remuneration committees are required by the Combined Code to consider directly to their attention. It would prevent remuneration committees from ignoring the impact of their decisions on other staff.

4.8 In addition, the TUC believes that there should be an additional independent member appointed to remuneration committees. This could be someone from a wide range of backgrounds who would bring a different perspective and experience to the discussions.

4.9 The TUC believes that reform of remuneration committee membership will be most effective if two independent appointments are made (one employee/trade union representative and one who could be from outside the company), as the difficulty of being one lone voice heavily outnumbered by incumbents may otherwise detract from the impact of widening membership.

Are shareholders effective in holding companies to account over pay? Are there further areas of pay, eg, golden parachutes, it would be beneficial to subject to shareholder approval?

4.10 Shareholders have presided over massive increases in executive pay that do not correlate with company or individual performance and that have taken no account of pay and conditions elsewhere in the company. It cannot plausibly be argued that shareholders have been effective in holding companies to account over pay.

4.11 The TUC Fund Manager Voting Survey has for several years asked respondents on what issue they are most likely to vote against management, and also over which issues they are most likely to engage with management. Remuneration always tops both lists[20]. Figures show that across the market as a whole, remuneration is the issue on which investors are most likely to vote against management.

4.12 Despite this, however, the number of occasions when remuneration reports have actually been defeated at an AGM remains very low.

4.13 The TUC would support a number of changes in this area. We believe that the vote on the remuneration report should be binding, rather than an advisory vote as at present.

4.14 We would also support the extension of shareholder approval to gold parachutes. In addition, we believes that directors should be on the same notice

[20] See TUC Fund Manager Voting Survey 2010; surveys from other years available via the TUC website

periods and conditions as ordinary staff within the company, and that any payments on departure that go beyond the terms of what ordinary company staff would receive should be subject to shareholder approval at the time of departure.

4.15 However, if done in isolation, we do not believe that extending shareholder supervision of executive pay will have much impact. Fund managers have not made good use of the powers that they already have to act on directors' remuneration. Fund managers are themselves often very highly paid, and the TUC believes many are out of touch with the stance that their clients would wish them to take on directors' pay, and that many clients and end-beneficiaries are unaware of how votes on remuneration are being used on their behalf.

4.16 The TUC believes that mandatory public disclosure of the voting records of institutional investors would support greater awareness of fund managers' positions. In addition, the TUC believes that fund managers should be strongly encouraged to carry out a rigorous consultation with their clients and beneficiaries about their policy positions on executive remuneration.

What would be the impact of greater transparency on the linkage between pay and meeting corporate objectives and performance criteria for annual bonuses?

4.17 As argued above, the TUC believes that a much smaller proportion of pay should be incentive-related and that the incentive-related element of remuneration should not dominate the total package.

4.18 We would, nonetheless, support improved disclosure in this area. Disclosure on the performance criteria attached to directors' pay is currently extremely complex, and it often requires specialist knowledge to understand how much and when a director will actually be paid. It would be beneficial if clearer information was presented on how the incentive-element of pay is linked (or not) to corporate objectives.

4.19 The TUC would strongly support a requirement for performance criteria for annual bonuses to be disclosed. Annual bonuses have risen significantly in recent years, both in absolute terms and as a proportion of total remuneration, and it is unacceptable that there should be such opacity about the basis on which they are awarded, especially when they have become such a significant element of total remuneration.

4.20 The TUC believes that all incentive-based remuneration should be truly long-term in nature in order to avoid fuelling short-termism, and for this reason supports the abolition of annual bonuses.

What would be the impact of greater transparency on the relationship between directors' pay and employees' pay?

4.21 The TUC believes that remuneration reports should be required to include information showing how directors' pay relates to the pay of other staff in the company so that shareholders and other stakeholders can judge whether remuneration committees are being sensitive to pay and conditions elsewhere in the company, as stipulated by the Combined Code.

4.22 The wording principle D.1 referred to above dates back to the recommendations of the Greenbury Committee in 1995. It was subsequently incorporated into what is now the Combined Code of Corporate Governance. Following the Companies Act 2006, regulations were passed to require remuneration committees to report on how they have fulfilled this stipulation. However, the regulations fell short of requiring concrete information on directors' pay in relation to pay elsewhere in the company to be disclosed, and companies continue to pay lip-service to the requirement, typically just saying that pay elsewhere in the group has been taken into account without saying how.

4.23 The TUC believes that more rigorous transparency on this important area is long overdue. A brief summary of our arguments for why growing pay disparity within companies should be tackled is set out above in 4.3, 4.4 and 4.5 above. The TUC believes that it should be mandatory for remuneration reports to include information on the average rate of increase for other staff, and the ratio of each director's total remuneration to the average pay of company employees below board level, and to the lowest pay rate in the company (expressed on a pro-rata basis). This is similar to the SEC proposal for disclosure on top to median pay ratios within companies to be disclosed.

4.24 Pensions is another area where companies often implement a two-tier policy, with too many companies having closed good quality defined-benefit pension schemes for staff while keeping them open for their directors. The information included in remuneration reports on pensions is poor and it is not possible currently to get a full picture of directors' retirement provisions, let alone how these compare with those offered to other staff. Given the costs of providing gold-plated pensions to directors over the entirely of their retirement is extremely high, the lack of disclosure on directors' pensions is unacceptable and out of kilter with the other disclosure requirements on directors' remuneration.

4.25 The TUC believes that remuneration reports should be required to include more detailed information on pensions, particularly on accrual rates, contribution rates, and arrangements relating to payments in lieu of contributions. In addition, companies should make clear any differential treatment for directors. The TUC believes that that directors and employees should be members of the same schemes, on the same terms. Where this is not the case, this should be made clear in remuneration reports.

4.26 In summary, the TUC believes it should be a requirement for the following information to be included in remuneration reports:

- For each director, the rate of increase in their basic salary and their total remuneration.
- The average pay increase for staff elsewhere in the company (it should be permissible, but not a requirement, for information about different groups of staff to be provided separately if this adds clarity).
- For each director, the ratio of their total remuneration to average non-director employee pay and the lowest rate of employee pay in the company (expressed on a pro-rata basis).

- Where the average rise in basic pay for directors is significantly higher (say more than 1%) than the average rise for employees, an explanation for this differential from the remuneration committee should be included in their report.
- The type of pensions scheme (final salary or money purchase) offered to directors and the type of scheme offered to staff. Where these are not the same, an explanation should be given.
- The contribution rate for directors and the contribution rate for other employees; where these differ, an explanation should be given.
- For final salary schemes, the accrual rate for directors and the accrual rate for other employees; where these differ, an explanation should be given.

Takeovers

5.1 As the consultation document sets out, mergers and takeovers, especially hostile ones, have a poor record in terms of generating value. In addition, they are often associated with falls in employment. Takeover bids can have a major impact on the interests of a company's workforce, and the announcement of a possible or firm takeover bid generally results in a period of profound uncertainty and insecurity for a company's employees. The TUC's prime concern is with the impact of mergers and takeovers on employees. In addition, it is of great concern to the TUC that so many takeover bids result in the target company being saddled with heavy debt which blights its and its employees' future prospects, and that many takeovers destroy value in the medium-term.

5.2 The TUC believes that there are serious problems with the present decision-making procedures for mergers and takeovers. At the heart of this is the fact that the decision on whether or not a merger should go ahead is made by shareholders and shareholders alone; while the company board has an important role in assessing the bid and deciding whether or not to recommend it to shareholders, it is shareholders alone who have the final say.

5.3 The central problem with this system is that in the context of mergers and takeovers, the short-term interests of shareholders are frequently not aligned with the long-term interest of the target company or the wider economic interest of the country or locality. Shareholders generally consider that their interests and those of their beneficiaries are served by achieving a high offer price for their shares in takeover situations, and will generally sell if the offer price is high enough. Whether the merger makes good economic sense in the long-term and is likely to create value or destroy value is not their prime consideration, as once their shares are sold they will be free to redeploy the funds raised elsewhere and will no longer necessarily be invested in the merged company. While directors are required to set out to shareholders their opinion on the likely impact of the takeover on the company, there is no evidence that this has much impact on shareholders' decisions on whether or not to sell their shares, which, as already stated, rests very largely on the price they are offered.

5.4 The TUC believes that it is essential that the regulation of mergers and takeovers is reformed to ensure that takeover bids are subject to the long-term interests of the target company. This could be achieved through the establishment of a Mergers and Takeovers Commission that would operate at arm's length from Government and whose role would be to assess whether or not proposed takeovers were in the long-term interest of the target company. Alternatively, the remit and membership of the current Competition Commission could be adapted to encompass a wider role than its current focus on competition. In either scenario, an appropriate referral system would need to be developed.

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

5.5 Given that the academic evidence suggests that many bids destroy value and returns to shareholders in the acquiring are often negative, it seems far from clear that boards do fully understand the long-term implications of takeovers. What is absolutely clear is that they do not communicate them effectively.

5.6 In the Kraft takeover of Cadbury for example, neither Kraft nor Cadbury set out any in-depth information about the rationale or lack thereof for the takeover. Other elements of required disclosure, notably concerning the implications of the merger for employment, were given minimal (and in fact misleading) coverage.

5.7 The Takeover Panel consulted recently on a number of proposed changes to the Takeover Code, including the issue of disclosure. The TUC welcomes the proposals that the Panel put forward in relation to the right of employee representatives to have their views on the bid circulated to shareholders and its proposal to make clear that any plans that are set out in the offer documents will be expected to hold true for at least one year. However, the TUC is not clear how the latter will be enforced, and believes that this point needs clarification. In addition, the TUC is disappointed that the Panel, while apparently acknowledging that companies tend to disclose minimal information on the issue of its intentions for the offeror company and its employees, did not propose any action to address this poor quality.

5.8 The TUC believes that this weakness in compliance should be addressed through a combination of amendments to the Code and additional explanation as to what is expected under these requirements, perhaps in the form of a Practice Statement. The Code should be amended to make clear that explanation and justifications should be given for the statements made, and that a significant level of details is required. It should also make it absolutely clear that information should be given in relation to each one of the plants or locations of work of the target and offeror companies.

5.9 The TUC made a number of detailed proposals on disclosure in response to the Takeover Panel's consultation, and this document is attached as an appendix to this response.

Should the shareholders of an acquiring company in all cases be invited to vote on takeover bids, and what would be the benefits and costs of this?

5.10 The consultation document has noted the fact that the returns to shareholders in acquiring firms are often zero or negative. Given this, the TUC believes that it is important that shareholders in acquiring companies are given the right to vote on proposed takeover bids so that they can make their own decisions about the likely long-term impact of the bid. The concern expressed by Warren Buffet as a major Kraft shareholder about their hostile bid for Cadbury and the impact of its takeover of ABN Amro on RBS provide examples of why shareholders in acquiring companies would benefit from being invited to vote on proposed takeovers (although in the latter case, RBS shareholders did vote on the takeover and supported it).

5.11 In addition, the TUC believes that the proposal put forward above for voting rights to be subject to holding shares in the company for a minimum of two years, has particular resonance in the case of mergers and takeovers, and would prevent hedge funds and other from buying shares in a company that has been targeted for takeover with the express aim of selling them to make a quick buck.

Conflicts of interests

5.12 Conflicts of interests among board members in merger cases is an important area that the consultation document does not address. Company directors currently face major conflicts of interests in merger and takeover situations, frequently standing to gain millions of pounds from the sale of the companies they manage. Equally, because executive pay is correlated primarily with company size, directors in acquiring companies frequently stand to gain personally from a successful takeover bid. There is a strong risk that these conflicts of interest will distort the market for corporate control and it is essential that they are investigated and addressed. In particular, the TUC believes that there is no justification for managers gaining directly from the takeover of the company they work for, and that the law should be changed to prohibit company directors and senior managers from receiving direct benefits from takeovers.