Business, Innovation and Skills Committee
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House of Commons
London
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18 January 2013

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Dear Sirs,

The Kay Review of UK Equity Markets and Long-Term Decision making – The Business, Innovation and Skills Committee's call for evidence, 12 December 2012

Our attached submission is on behalf of the Association of General Counsel and Company Secretaries of the FTSE 100, generally known as the GC100.

If you have any queries concerning the submission, please contact Hilary Owens using the contact details above.

Yours sincerely,

Mary Mullally
Secretary, GC100

GC100 Group
The Association of General Counsel and Company Secretaries of the FTSE 100
The GC100 Group is an unincorporated members' association administered by the Practical Law Company Limited

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This submission is on behalf of the Association of General Counsel and Company Secretaries in the FTSE 100, generally known as the GC100. There are currently 131 members of the group, representing more than 82 companies.

The GC100 is grateful for the opportunity to respond to the call for evidence referred to above. Our response on the matters on which you are seeking views is set out below. Please note, as a matter of formality, that the views expressed in this letter do not necessarily reflect those of each and every individual member of the GC100 or their employing companies.

We hope you will find our comments useful and would be happy to meet with you to discuss them.

If you have any queries concerning this submission, please contact Hilary Owens on 020 3423 6627 or at hilary.owens@practicallaw.com.

1. **Executive summary**

We broadly support the Kay Review and the Government's response as an overarching framework of aspirations for how the UK equity markets should operate. Likewise, we believe that the general principles are, in the main, useful high level statements of best practice. The key challenge will be how these concepts are understood and implemented within the complex legal and regulatory matrices in which the UK equity markets operate. This will require careful and detailed examination and discussion.

In addition to the domestic framework, the UK equity markets are subject to regulation at the European and international level. This is particularly the case for the significant number of companies with dual or multiple listings. These, and many other UK companies whose only listing is in London, have businesses and teams located in and/or recruited from other jurisdictions. Their businesses and management (including board) recruitment and retention arrangements are therefore structured and run to reflect both UK and international demands. Furthermore, the importance of international investment in London-listed companies means that the UK market is inextricably linked to the commercial and governance requirements and expectations of market participants in other jurisdictions. Although we believe that many of the recommendations in the Kay Review and the Government's response are commendable, it is imperative that any specific proposals flowing from the Kay Review be formulated and implemented in this context.

In particular, care needs to be taken to ensure that UK companies:

- are able to compete effectively with their peers in other jurisdictions;
- are not subject to requirements which deter international investment; and
- can recruit and retain the best management teams, including directors, for their companies and businesses.

2. **Detailed submission**

2.1 **Directions for Market Participants – paragraph 3**

Paragraph 3 of the Directions for Market Participants recommends that there should be more opportunity for collective action by asset managers who should have more freedom to act collectively without fear of regulatory consequences. We agree with this, and in particular, the need for people to be able to collaborate without fear of being deemed to be acting in concert under the UK Takeover Code. However, we believe that the Takeover Code, as interpreted in light of Practice Statement 26, already confers on asset managers the necessary freedom to take collective action and that they do not need any greater regulatory exemptions or dispensations to facilitate this.

2.2 **Recommendation 1:** *The Stewardship Code should be developed to incorporate a more expansive form of stewardship, focussing on strategic issues as well as questions of corporate governance.*

We support this Recommendation and believe that discussion and debate on remuneration and other governance issues is far more productive when placed in the context of a company's long-term strategy rather than, as so often appears to be the case, being conducted in isolation. Some of our members have reported that where a broader view is taken, for example, where fund managers and corporate governance or remuneration analysts are both represented at the same meetings, this can be more productive than meetings which are attended only by those responsible for corporate governance.

2.3 **Recommendation 2:** *Company directors, asset managers and asset holders should adopt Good Practice Statements that promote stewardship and long-term decision making. Regulators and industry groups should take steps to align existing standards, guidance and codes of practice with the Review's Good Practice Statements.*

We support this Recommendation in principle.

Please also see our specific comments on Annex A – Good Practice Statement for Directors, at paragraph 2.14 below.

2.4 **Recommendation 3:** *An investors' forum should be established to facilitate collective engagement by investors in UK companies.*

We would express a cautious interest in the concept of investors' forums. There is, of course, nothing to prevent interested parties from establishing such forums now, which leads us to question whether there is really a need for this type of body – if there is, would they not already be widely in existence?

If investors felt that such a body would help them to engage more effectively with investee companies, then we think that this proposal should be pursued but a number of aspects would warrant further development as noted below.

We assume that the plan would be for a specific forum to be created for an individual company, as we do not think that it would be workable for a forum to cover multiple companies. The success of such a forum would depend on its having well defined parameters (objectives, attendees, frequency etc), yet retaining the flexibility to meet the circumstances of individual companies. For such a forum to add value there would need to be a commitment to candid discussion.

The composition of the forum would be very important. Whilst the idea is termed an "investors' forum" we would not wish such forums to comprise solely of investors who set the agenda and provide the company with their views. It would have to be a collaborative exercise with the company being properly represented and conduct of the meeting being effectively regulated. We would also be interested in understanding more about the criteria that would be recommended to ascertain which investors could attend – would it, for example, be based on a qualifying percentage of share ownership or open to any shareholder? How would significant shareholders based overseas be encouraged to participate? It will be key to ensure that the eligibility criteria for participation in the forum (and any guidelines as to how the forum operates) are such that stability and consistency are promoted. For engagement to be meaningful over the longer-term, the forum will need to be consistent in its approach and focus even if there are changes in the company's investor base. A framework that encourages the represented shareholders to provide an indication of their voting intentions on specific matters would be helpful for companies and increase genuine engagement.

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Greater clarity about the intended purpose of the investor forum would be welcome. If the intention is to foster longer-term engagement between the forum and the company, we believe that it would be preferable for a forum to meet with the company on a regular, perhaps annual, basis, rather than convening meetings in response to particular events or crises. This latter approach would not foster continuity and may adversely impact on management's ability to manage such events successfully. We would not, in any event, wish to see such meetings having to be scheduled too often, as there will be an associated cost as well as time and administration involved in convening and attending them, both for the company and investors. We also consider that there must be doubts as to the practicalities of events-driven meetings because of the difficulties there would be in setting the criteria to establish when a relevant event has occurred and ascertaining when such criteria are met so as to require a meeting. There may also be difficulty in arranging meetings on short notice to canvas views on events which are of an urgent nature. It is also not wholly clear whether the forum would be intended to replace or be in addition to the frequent and regular meetings which many companies' senior executives typically already have with fund managers and others at major institutional shareholders as part of companies' regular "investor roadshows" in the weeks following results announcements.

The agenda for any such forum would have to be carefully considered and, in particular, it would have to take account of the difficulties around disclosing confidential and/or inside information. This may also hinder the practicality of holding meetings in response to certain events rather than as regular fixtures.

Furthermore, it is important from the point of view of shareholder democracy that engagement with such forums is not seen as a substitute for putting matters to shareholders generally and that these proposals do not result in a conflict with Principle 5 of the UKLA Listing Rules which requires a listed company to ensure that it treats all holders of the same class of listed equity securities that are in the same position equally. As a related point and, as highlighted above, the composition of a forum would require careful consideration to avoid the consequence of concentrating influence in a small number of represented shareholders.

2.5 **Recommendation 4:** *The scale and effectiveness of merger activity of and by UK companies should be kept under careful review by BIS and by companies themselves.*

We are not sure what is meant by the comments at paragraph 3.26 of the Government's response, and, in particular, the point that "the Government believes it would be appropriate for government to take a greater interest in mergers and acquisitions". We also consider that reference in the Kay review to the Government and regulatory authorities using "informal authority" to be particularly unhelpful. We believe that all parties should be able to rely on a clear and transparent set of rules without having to be concerned about possible Government intervention based on evanescent political considerations which happen to be relevant at the time.

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We believe that it is right that the Government should impose rules and regulations to regulate properly the conduct of mergers and acquisitions, but we believe that the current provisions of the Takeover Code as enforced and interpreted by the Takeover Panel, together with the merger control regime, do this job very well.

2.6 **Recommendation 5:** *Companies should consult their major long-term investors over major board appointments.*

Unlike the other recommendations, this seems to be a very specific new requirement and we would welcome greater clarity on what might be proposed. For instance, it is not apparent to us what the Government would regard as major board appointments for this purpose. The Kay Report envisages that the chairman and "important non-executive appointments" would fall within this category. However, “major board appointments” could include executive director appointments.

Information about individual appointments, particularly for senior or executive directors, may constitute price-sensitive information about a company. The disclosure (or delay in disclosure) and the dissemination of such information is therefore subject to significant regulatory constraints (for example, pursuant to DTR 2). If the information is considered to be inside information, the investor would need to be wall-crossed prior to any discussions. This may be problematic as, in our experience, institutional investors are unlikely to agree to this if discussions are continuing for any period of weeks, as they would be prevented from dealing for a prolonged period of time. In addition, consulting with a number of investors may also increase the risk of a leak, even if confidentiality arrangements are imposed. We note that it is suggested that an investor forum may be an appropriate venue for these discussions. For the reasons set out previously, we doubt whether this is workable in practice.

As a more general point, confidentiality is vital for prospective board appointments, not only from the company's perspective but also, in many cases, for the candidate and for any other company of which the candidate is already a director. We think that there would be a risk that sensitive negotiations could be jeopardised if the company had to share information with investors before or during the process.

The existing legal and corporate governance framework applicable to UK companies already provides shareholders with significant influence over board appointments and it is not clear to us what “consultation” means in this context.

In addition, there may be circumstances where a requirement to consult shareholders could undermine a board’s ability to act in the best interests of shareholders as a whole – for example, where a board is seeking to appoint a new independent non-executive director in order to bolster the independence of a board in the face of a significant or founding shareholder with its own agenda, the requirement to consult might lead the shareholder to take action to frustrate the board’s choice of independent director. Rules requiring consultation would in our view run the risk of being too prescriptive and

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interfering with the board's ability to act in the interests of all shareholders.

We would welcome more specificity on the proposals, in particular, as to the level and nature of discussions envisaged by this recommendation.

In conclusion, we do not believe that this recommendation would work in relation to the proposed appointment of individuals to specific posts. We do, however, think that there would be merit in there being dialogue between companies and investors, as there currently often is, regarding the general composition of the board, succession planning, and whether there is a need for additional skills or experience to be represented.

2.7 **Recommendation 6:** *Companies should seek to disengage from the process of managing short-term earnings expectations and announcements.*

Whilst we welcome Recommendation 6 and, in particular, the changes that will see an end to the mandatory requirement for UK companies to produce quarterly reports, we believe it is important to note that for many international companies the position is not necessarily that simple. For UK companies with international businesses, notably those with operations or listings in the US, there may still be a legal or regulatory requirement to report more frequently and/or in a way that engenders a short-term view. Even in the absence of a formal requirement, where UK companies have a sizeable international investor base, there may be an expectation on the part of non-UK investors of more frequent reporting than may be required in the UK. While changes to EU or UK laws and regulations are, therefore, to be welcomed, it may be that for many companies, the changes will not alleviate the situation and/or lead to the shift in focus that is desired.

We also believe that to give real effect to this proposal changes in UK/EU regulation may be required. At present, UK listed companies are under obligations to disclose inside information to the market as soon as possible. This means that any information which may have a significant impact on share price (however short-term) has to be disclosed and, indeed, recent pronouncements by the FSA appear to demonstrate the FSA's belief that disclosure (under DTR 2) is required in respect of any information which may be relevant to a reasonable investor, even where this would not be likely to be price-sensitive, though others argue that this is an incorrect interpretation of FSMA. So the Disclosure and Transparency Rules are themselves straight-jacketing companies into announcing short-term information and, in our view, this is bound to lead to companies seeking to manage short-term expectations. Therefore, whilst we consider the Kay review proposals for companies to focus on the long-term rather than to expend energy about managing short-term expectations to be laudable, we have doubts about the ability to effect changes in this connection without a change in the Disclosure and Transparency Rules, which themselves reflect EU law.

2.8 **Recommendation 11:** *Mandatory IMS (quarterly reporting) obligations should be removed.*

See our comments on Recommendation 6 above.

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2.9 **Recommendation 12:** *High quality, succinct narrative reporting should be strongly encouraged.*

We endorse this recommendation. However, in order to ensure its success, we believe it will be important to ensure that there is a “joined-up" approach between all legislative and regulatory bodies as, although in the UK there is an attempt to "de-clutter" annual reports, this principle needs to be consistently applied.

As noted in paragraph 2.8 above, we would also note that for UK companies with international investors and/or operations there may still be a strong expectation, if not actual legal or regulatory requirements, for more discursive reporting. In this respect, we particularly feel that it would be useful for the Government to liaise with the US Securities and Exchange Commission (SEC) in relation to the level of reporting that is required for SEC registered UK companies. If not, any streamlining of the UK position would be undermined by US regulation which, generally, requires more detailed reporting.

2.10 **Recommendation 14:** *Regulators should avoid the implicit or explicit prescription of a specific model in valuation or risk assessment and instead encourage the exercise of informed judgment.*

We endorse this recommendation. However, we would again make the point set out in paragraphs 2.8 and 2.9, that the international nature of many UK companies may mean that such companies may still be required, or be expected, to comply with regimes which do prescribe specific models.

2.11 **Recommendation 15:** *Companies should structure directors’ remuneration to relate incentives to sustainable long-term business performance. Long-term performance incentives should be provided only in the form of company shares to be held at least until after the executive has retired from the business.*

We support the principle set out in the first sentence. We do not agree with the principle in the second sentence for the following reasons;

- in any remuneration structure it is important to preserve an element of flexibility. Different businesses operate in different ways and the nature of their operations can mean that different reward structures suit different businesses. Any changes to the executive remuneration regime need to preserve such an element of flexibility. For companies whose business model and cycles make it appropriate to structure compensation in this way, then they can already do so. But it is unlikely that there can be a "one size fits all" type of policy;

- such a policy is likely to make it considerably harder to attract good candidates. This is likely to be a particular issue for the many London-listed companies’ which have some or all of their operations and/or directors located outside the UK in jurisdictions where there is no equivalent policy. In such circumstances, exporting such a UK standard could make it very difficult to attract and retain talent;

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- in many cases, performance related pay has become a significant part of the remuneration package relative to basic pay. In these cases, directors will have come to rely on the performance related pay and deferral for the length of time envisaged by the Recommendation may be impractical;

- such a policy may simply shift the emphasis from performance related pay to basic pay (see the point above) which could possibly mean that there is less incentive for management to pursue performance enhancing strategies; and

- such a policy may also be counter-productive, and encourage the early resignation of successful executives (to trigger release of their long-term incentive gains), leading to an increased 'churn' of executives, and thereby reducing the long-term strategic focus that is being sought by implementing such a policy.

If it is concluded that an obligation to hold shares in the longer-term is required, we wonder if there may be better ways to achieve this. For example, many companies already have a requirement for executive directors to hold a significant number of shares in the company (for example, calculated by reference to a percentage of their base salary). Many companies are also introducing longer vesting periods. We believe these approaches are already being more effectively used to achieve the same objective.

2.12 **Recommendation 16:** *Asset management firms should similarly structure managers' remuneration so as to align the interests of asset managers with the interests and timescales of their clients. Pay should therefore not be related to short-term performance of the investment fund or asset management firm. Rather a long-term performance incentive should be provided in the form of an interest in the fund (either directly or via the firm) to be held at least until the manager is no longer responsible for that fund.*

Whilst we do not consider that this recommendation is directly relevant to the GC100, many of our members have pension schemes which rely on the performance of asset managers to enhance the returns to their employees and pensioners and, therefore, have an interest in this recommendation. We, therefore, support the recommendation in principle and, in particular, the notion that it is long-term performance which should be incentivised and rewarded, although again we do not believe that it is necessarily the case that a fund manager should be required to retain his entire interest in the fund for the whole of his period of employment or responsibility for the fund, as opposed to a specified minimum level of interest.

2.13 **Recommendation 17:** *The Government should explore the most cost effective means for individual investors to hold shares directly on an electronic register.*

We agree with the need to address this recommendation in the context of policy proposals relating to central securities depositories and securities law in the EU. We also think that it is necessary for any system to be able to cater to the wishes of shareholders – whilst some may wish to hold shares directly on an electronic register and take direct advantage of the rights and obligations of being a shareholder, there will be those who wish to hold shares

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through a nominee because they are happy to forego such direct involvement.

The cost and administrative burden for companies in moving to any new system and, in particular, where paper based shareholders have to be moved to any such system, need be borne in mind. It will be necessary to weigh up such factors with the benefits to be gained. We believe that there will, in any event, be a natural shift towards more technology driven systems and that companies will move in that direction at a time that best suits them. We doubt if it is worth obliging companies to adopt new systems which may mean they have to do so at a time which does not best suit their individual circumstances.

2.14 **Annex A – Good Practice Statement for Company Directors**

(a) **Paragraph 1**

The law relating to directors' duties has been codified in the Companies Act 2006 which sets out the factors which directors should consider in determining whether a decision will promote the success of the company. We believe that these provisions deal with the position adequately and consider that it would be unhelpful to include factors which overlap with the statutory factors but omit some and add others.

(b) **Paragraph 2**

Whilst we acknowledge that this principle may be correct for many companies, we believe that it may not suit all companies. Each company will have to act in the way that best suits its own business and strategies. There are, of course, companies whose business *is* the management of a portfolio of financial interests.

(c) **Paragraph 3**

Whilst we consider this point to be desirable, we believe that it is largely outside the control of directors - intermediation costs are set and controlled by third parties over whom directors have little or no control.

(d) **Paragraphs 4, 5, 6 and 7**

We support the principles underlying these paragraphs as we can see that they are consistent with the objective of promoting a long-term focus. We do, however, consider that there are laws and regulations which, if not amended, may hinder the achievement of such a focus and perpetuate a more short-term approach.

Companies in the UK have traditionally been more reluctant than in other markets to provide clear financial guidance on longer term prospects. We perceive that this is an ingrained cultural approach, which we believe may have its roots in, or at least is reinforced by, two aspects of the regulatory regime within which listed companies operate:

- the rules on profit forecasts (both under the Prospectus Rules and the Takeover Code) discourage companies from producing explicit forecasts, at least for the near term - listed companies are materially constrained in their willingness to provide meaningful forward-looking financial information because profit forecasts published as part of regular reporting may require to be repeated (in circumstances where the directors face personal liability without the benefit of the protections provided by section 463 of the Companies Act 2006) and reported on by independent accountants;

- the way the continuous disclosure obligations (for listed companies, under Chapter 2 of the Disclosure and Transparency Rules, implementing Article 6 of the Market Abuse Directive) are interpreted and enforced by the FSA tends to mean that if a company has provided financial guidance on its longer term prospects but there is a change in circumstances that makes achievement of that guidance more challenging it will be required to make early disclosure of that by issuing a profit warning. Generally, markets react adversely to such disclosures and companies may be reluctant to give guidance in order to reduce the risk of having to issue profit warnings.

If it is desirable to encourage UK companies to provide more specific forward-looking information, we think the rules require a major overhaul with a view to creating a climate in which efforts made in good faith by management to identify longer-term financial prospects are not perceived to expose the company concerned, and its management, to unacceptable regulatory risks. It may not be easy to achieve a balance between, on the one hand, the requirements of investor protection (given the risks associated with forward-looking statements that are inevitably to some extent speculative) and keeping the markets informed and, on the other hand, the need to facilitate better long term disclosure, but we think the effort should be made.

An appropriate safe-harbour regime that encourages companies to provide clear guidance on their financial prospects together with the companies' assumptions regarding external factors and risks that may prevent their achievement would provide a sounder basis for a focus on longer term performance.

(e) **Paragraph 10**

Please see our comments on Recommendation 15 at paragraph 2.12 above.

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(f) **Paragraph 11**

Please see our comments on Recommendation 5 at paragraph 2.7 above.

(g) **Paragraph 12**

Please see our comments on Recommendations 6 and 11 at paragraphs 2.8 and 2.9 above.

Yours sincerely,

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