UK Shareholders' Association

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EU Corporate Governance Framework — COM 164 (2011)
Response on behalf of UK Shareholders' Association ('UKSA')

In the UK a great deal of work has been carried out in the field of Governance and Stewardship in recent years and the review process is ongoing. The UK Corporate Governance Code has existed since 1992 (although under a different name) and a new version was issued in June 2010. Legislation about Limited Liability companies goes back to the middle of the 19th century and the latest Companies Act (2006) includes many governance provisions. Nevertheless the UK is still struggling to get this right. In the light of this experience we suggest that the Commission should be moderate in its ambitions to achieve common practices across 27 member states.

We believe that economic drivers operating in free markets are more effective and cheaper as a control tool than regulation. Regulation must be regarded as a second-best instrument to cover deficiencies in the market mechanism.

Many problems of corporate governance arise from either (a) too many links in the governance chain between directors and the beneficial owners; or (b) the fact that legal shareholders — those who actually have rights to control the company — are not necessarily the beneficial owners who carry the economic risks and rewards of ownership. A weakness in the drafting is that it fails to acknowledge this. The use of the ambiguous word 'shareholder' throughout fails to distinguish between legal and beneficial owners.

The dominance of share registers by institutional holders who are not beneficial owners is at the heart of governance weaknesses in the EU corporate sector. The reasons why the interests of institutional owners are not aligned with those of the beneficial owners are touched on in our answer to Q13. A fuller analysis is contained in UKSA's booklet 'Responsible Investing — for the Individual and Society' Part 2 — 'Removing Obstacles and Constraints' (January 2009, pages 13–28).

We suggest that in championing the cause of good governance the EU should take a lead in pressing for a mechanism whereby beneficial owners can exercise their rights. UKSA supports the introduction of Shareholder Committees — bodies elected by the beneficial owners only to represent their rights.

We are also surprised at the omission from the Green Paper of any discussion of the functions of auditors. Auditors should be appointed by, and report to, the beneficial owners.

Preliminary Questions

1. *Should EU corporate governance measures take into account the size of listed companies? How? Should a differentiated and proportionate regime for small and medium-sized listed companies be established? If so, are there any appropriate definitions or thresholds? If so, please suggest ways of adapting them for SMEs where appropriate when answering the questions below.*

   We agree that one set of measures cannot be appropriate to all sizes of companies. However, the differentiator should be by the market on which the company is listed. Thus stakeholders in companies trading on main markets are entitled to know that full governance requirements apply. If they choose to invest on secondary markets they will understand that less stringent provisions apply.

2. *Should any corporate governance measures be taken at EU level for unlisted companies? Should the EU focus on promoting development and application of voluntary codes for non-listed companies?*

   No mandatory measures at EU level for unlisted companies.

Boards of directors

3. *Should the EU seek to ensure that the functions and duties of the chairperson of the board of directors and the chief executive officer are clearly divided?*

   This is highly desirable, but should not be mandatory at any level.

4. *Should recruitment policies be more specific about the profile of directors, including the chairman, to ensure that they have the right skills and that the board is suitably diverse? If so, how could that be best achieved and at what level of governance, i.e. at national, EU or international level?*

   This may be desirable in principle but is a matter for national governments or company stakeholders to decide: so definitely not mandatory at EU level.

5. *Should listed companies be required to disclose whether they have a diversity policy and, if so, describe its objectives and main content and regularly report on progress?*

   Certainly not at EU level.

6. *Should listed companies be required to ensure a better gender balance on boards? If so, how?*

   Certainly not at EU level.

7. *Do you believe there should be a measure at EU level limiting the number of mandates a non-executive director may hold? If so, how should it be formulated?*

   No, it's for the beneficial owners to decide what 'limitations' to their directors' ability to act they will accept. But the number and burden of the mandates of each director and director-elect should be disclosed. If national governments wish to impose limits they should be free to do so.

8. *Should listed companies be encouraged to conduct an external evaluation regularly (e.g. every three years)? If so, how could this be done?*

   Yes, but not mandatory. Listed companies should disclose non-compliance or describe how the evaluation was done. Probably more important is to insist on directors being reviewed by their fellows.

9. *Should disclosure of remuneration policy, the annual remuneration report (a report on how the remuneration policy was implemented in the past year) and individual remuneration of executive and non-executive directors be mandatory?*

   Please note first our response to Q10. Disclosure of individual remuneration has been completely ineffective in achieving moderation but instead has encouraged a ratchet effect since no company wants to be seen to be paying below the average. Disclosure rules should have a bias towards transparency but a shareholders committee could be a medium for beneficial owner approval of terms without public disclosure.

10. *Should it be mandatory to put the remuneration policy and the remuneration report to a vote by shareholders?*

    The only prospect that we can see for restraint in the remuneration of directors and their employment contracts (including severance terms) is to give control of these matters to the beneficial owners. At the very least this means a binding vote but the owners need to be involved before the packages are final. Remuneration consultants, if any, should be engaged by, and report to, the beneficial owners.

11. *Do you agree that the board should approve and take responsibility for the company's 'risk appetite' and report it meaningfully to shareholders? Should these disclosure arrangements also include relevant key societal risks?*

    Risk management, and the balance of risk and reward, is a component of all business decisions. The need for the involvement of directors, management and stakeholders is self-evident. We are concerned that the framing of this and Q12 (following) exhibit a fundamental misunderstanding of this fact. The attempt to systematize a process that may be unique to each business, and the introduction of vague management-speak concepts such as 'risk appetite' and 'risk profile', will hamper real risk management and garble any meaningful reporting to stakeholders.

12. *Do you agree that the board should ensure that the company's risk management arrangements are effective and commensurate with the company's risk profile?*

    See Q11.

Shareholders

13. *Please point to any existing EU legal rules which, in your view, may contribute to inappropriate short-termism among investors and suggest how these rules could be changed to prevent such behaviour.*

    It is not EU rules that cause short-termism but the profit drivers of institutional shareholders. Hedge funds naturally are only interested in the short term. But other institutions that might be expected to take a long-term approach in fact judge and reward their investment managers on short term performance. Performance is judged against other comparable managers and on results over short periods.

    In addition, the economic interests of many institutions are served by the short-term approach since trading, broking and corporate takeovers and reconstructions generate fees, whereas inactivity does not. Informed private shareholders are likely to take a longer term view and provide a stable base of investors. They need to be given greater influence on market behaviour if this is to change.

14. *Are there measures to be taken, and if so, which ones, as regards the incentive structures for and performance evaluation of asset managers managing long-term institutional investors' portfolios?*

    No comment.

15. *Should EU law promote more effective monitoring of asset managers by institutional investors with regard to strategies, costs, trading and the extent to which asset managers engage with the investee companies? If so, how?*

    No comment.

16. *Should EU rules require a certain independence of the asset managers' governing body, for example from its parent company, or are other (legislative) measures needed to enhance disclosure and management of conflicts of interest?*

    No comment.

17. *What would be the best way for the EU to facilitate shareholder cooperation?*

    Enfranchise beneficial owners and disenfranchise non-beneficial owners. Groups with a common interest do not need further help to find ways of cooperating effectively.

18. *Should EU law require proxy advisors to be more transparent, e.g. about their analytical methods, conflicts of interest and their policy for managing them and/or whether they apply a code of conduct? If so, how can this best be achieved?*

As far as we can see the system of proxy advisers works satisfactorily in the UK although, since their recommendations are not normally public it is not easy to be sure. The system relies on the institutions using only advisers who are professional, competent and in whom they can have full confidence. Possibly it would be helpful if more of their recommendations were made public, particularly for those private investors who need help with controversial issues.

19. *Do you believe that other (legislative) measures are necessary, e.g. restrictions on the ability of proxy advisors to provide consulting services to investee companies?*

    No comment.

20. *Do you see a need for a technical and/or legal European mechanism to help issuers identify their shareholders in order to facilitate dialogue on corporate governance issues? If so, do you believe this would also benefit cooperation between investors? Please provide details (e.g. objective(s) pursued, preferred instrument, frequency, level of detail and cost allocation).*

    Issuers must be able to communicate with beneficial owners and should easily be able to establish who they are. Beneficial owners often have a need to know the identity of the other beneficial owners. In the UK this used to exist through accessibility of share registers but this has been lost through the use of nominee holdings. We hope that the Securities Law Directive will lead to requirements for full transparency.

21. *Do you think that minority shareholders need additional rights to represent their interests effectively in companies with controlling or dominant shareholders?*

    UK law gives some protection to minority shareholders but, in our opinion, not enough. It can be argued that those putting themselves in a minority position do so knowingly and should accept the consequences. Even so we would like to see increased protection. One point that particularly deserves attention is the issue of new shares to a new or preferred group of shareholders at below market price or intrinsic value. This gives them a financial advantage at the direct expense of the other shareholders.

22. *Do you think that minority shareholders need more protection against related party transactions? If so, what measures could be taken?*

    In general YES. However, in the UK this is covered by the Listing Rules which work quite well.

23. *Are there measures to be taken, and is so, which ones, to promote at EU level employee share ownership?*

    No comment.

Monitoring and implementation of Corporate Governance Codes

24. *Do you agree that companies departing from the recommendations of corporate governance codes should be required to provide detailed explanations for such departures and describe the alternative solutions adopted?*

    This suggestion is effectively for the adoption of the 'comply or explain' principle that is widely favoured in the UK. We agree with the comment about informative quality on page 3 of the Green Paper because this has led to the 'explain' alternative often being expressed in a standard wording that gives no useful information and is not challenged. The insidious increase in prescriptive content in Annual Reports has hindered real communication by replacing considered comment with meaningless boilerplate. What a company chooses to say, or not say, is far more instructive to the stakeholder than observing how it obeys reporting rules.

    We favour mandatory statements of departure from codes, leaving the company to decide on what further information to give.

25. *Do you agree that monitoring bodies should be authorised to check the informative quality of the explanations in the corporate governance statements and require companies to complete the explanations where necessary? If yes, what exactly should be their role?*

    If there are rules, in any situation, then of course monitoring bodies must be able to check they are being followed. As noted above we do not necessarily support the need for explanations for non-compliance.

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