



Professor John Kay
The Kay Review
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The Kay Review of UK Equity Markets and Long-Term Decision Making

Dear Professor Kay,

Thank you for giving the Institute of Directors (IoD) the opportunity to comment on your consultative document, published in September 2011. Issues surrounding corporate governance are of considerable interest to the IoD and its membership. We are therefore pleased to present our views in respect of your examination of the effect of UK equity markets on the competitiveness of UK business.

About the IoD

Founded in 1903, and granted a Royal charter in 1906, the IoD is an independent, non-party political organisation of 40,000 individual members. Its aim is to serve, support, represent and set standards for directors to enable them to fulfil their leadership responsibilities in creating wealth for the benefit of business and society as a whole. The membership is drawn from right across the business spectrum. 92% of FTSE 100 companies have IoD members on their boards, but the majority of members, some 70%, comprise directors of small and medium-sized enterprises, ranging from long-established businesses to start-up companies.

Overall perspective

The IoD's perception is that a stockmarket listing can, in some cases, increase the short-term pressures experienced by the CEOs and executive management of quoted companies.

The underlying purpose of a secondary equity market is to provide investors with a mechanism of buying and selling shares in a speedy manner. Consequently, it is unsurprising that many investors in quoted companies have a shorter-term investment approach than the typical shareholders of privately-held companies.

In a business environment of impatient capital, the board of directors has a key role to play in defining the long-term interests of the company, and ensuring that management (particularly the CEO) is not excessively distracted by the short-term pressures emanating from the equity market. As long as the board remains convinced of the viability of the company's chosen strategy, it should support management in the face of external market pressures. Furthermore, the board (particularly the chairman) should play an active role in justifying the company's long-term orientation to markets and seek to attract investors to the company that share a similar investment time horizon.

However, in order to be credible in this role, it is essential that boards are trusted by the market and society at large. Boards must be seen as bodies that are capable of monitoring the activities of

management (particularly the CEO) with a high degree of expertise and objectivity. They should not be viewed as apologists for management, and should possess a clearly-defined vision of the best interests of the company.

The IoD believes that the best way to achieve this objective is by means of a concerted effort to improve the induction, training and ongoing education of directors. A director of a quoted company should clearly understand the implications of his/her governance duties as a director, including the duty to act in the interests of all of the shareholders (not just those with a short-term investment orientation) and the duty to consider the longer-term implications of decision-making¹. Regular use of external board evaluation would also raise the board's awareness of its distinctive governance role.

In addition, greater diversity on boards – particularly in terms of professional background – would serve to increase confidence in the board's ability to independently define the best interests of the company vis-à-vis both executive management and the stockmarket.

In contrast, policy measures designed to reshape the time horizons of institutional investors - such as capital-gains taxes or loyalty dividends – face major difficulties. Alongside the market distortions and unintended consequences that could arise, unilateral policy measures from UK regulators are likely to be largely impotent in a world of global capital markets.

Detailed remarks

This section of our response presents our detailed views on various aspects of the relationship between equity markets and long-term decision-making.

1) The diverse time horizons of a company

When considering the issue of short-termism, it is important to recognise that the company is a legal vehicle that may be used to pursue a variety of commercial activities. The time horizon of these activities can vary considerably. In some sectors of the economy, e.g. pharmaceuticals or technology, it may be important to take a long term investment approach. However, in other circumstances, a shorter-term horizon may be essential for the company's survival and prosperity.

Ultimately, the company's relevant time horizon can only be determined with regard to the specific circumstances of the company. It cannot be assumed that the adoption of a long-term approach is always optimal. This is an issue that is best determined by boards of directors – in consultation with shareholders - in the light of a company's distinctive strategy and business environment.

The most important feature of governance for any company is not whether it adopts a short or long-term management perspective. Rather, it is whether its management is properly accountable (to the board and shareholders) for the implementation of the agreed strategy. Company management that fails to achieve short-term goals defined by the strategy is just as guilty of poor performance as management that pays inadequate attention to the longer term.

2) Evidence of short-termism amongst UK-quoted companies

Our perception – based on the anecdotal experiences of our members – is that quoted companies can be subject to short-termist pressure from equity markets. This may arise due to fluctuations in share prices or as a result of pressure from sell-side analysts or activist investors (e.g. hedge funds).

We are also aware of the following research studies which are suggestive of some degree of short-termism in the behaviour of equity markets:

¹ Companies Act 2006, Section 172.

- A study by Graham, Harvey and Rajgopal (2005)² found that managers avoided implementing a value-creating (positive-NPV) investment project if such a project caused quarterly earnings to decline below market expectations. In addition, over 75% of executives admitted to sacrificing value-added in order to smooth reported earnings. Both of these behaviours were driven by a desire to satisfy the expectations of stockmarket investors and analysts.
- A PwC survey (2011)³ of FTSE 350 companies found that that a majority of executives preferred a low return investment option which delivered in the short term (£250,000 tomorrow) over a higher return option which delivered over a longer timescale (£450,000 in 3 years). These investment preferences implied annual discount rates of over 20%.
- A Bank of England study (2011)⁴ relating to UK and US companies found that future corporate cash-flows were excessively discounted by equity markets. Company cash-flows more than 30 years ahead were scarcely valued by capital markets at all.

However, although these studies are interesting, there is still a shortage of empirical evidence concerning short-termism and the magnitude of its impact on the real economy. Consequently, although the IoD welcomes the Kay Review's investigation of this important topic, there is a need for Government to exercise caution in respect of any subsequent policy responses.

3) Institutional investors and short-termism

Short-termism in equity markets is likely to have its roots in the short-term investment horizon of many institutional shareholders. The investment strategy of a significant proportion of fund managers is oriented towards share trading rather than long-term company ownership.

The newly-introduced Stewardship Code is an attempt to encourage institutional shareholders in UK companies to adopt a longer-term and more engaged approach to company ownership. However, it is important to be realistic about the likely impact of the Stewardship Code. There are a number of reasons why its effect on investment behaviour is likely to be relatively limited.

- **Many active fund managers are subject to relatively short-term performance pressures.** In most cases, this leads them to concentrate their efforts (and human capital) on stock-picking and equity trading rather than long-term engagement with their companies under ownership.
- Engagement between shareholders and boards is often infeasible due to the diversified portfolio strategy of many institutional fund managers. Such institutions hold relatively small percentage stakes in large numbers of listed companies. **As a result, they lack the incentive to meaningful engage with any individual company.**
- Many institutional fund managers are deterred from devoting significant resources to engagement due to the costs involved and the “free-rider” benefits that competitor fund managers with stakes in the same company would gain as a result of such activities.

None of these underlying problems is overcome by the introduction of the Stewardship Code. Consequently, we are sceptical as to whether many fund managers will fundamentally change their investment behaviour in favour of a long-term ownership approach.

4) Short-termism and company ownership structure

² Graham, J R, Harvey, C R and Rajgopal, S (2005), “The Economic Implications of Corporate Financial Reporting”, Journal of Accounting and Economics, 2005.

³ PwC (2011), “PwC Valuation Index, Tracking the Market to Understand Value”, PwC.

⁴ “The short long”. Speech given by Andrew G Haldane, Executive Director, Financial Stability and Richard Davies. 29th Société Universitaire Européenne de Recherches Financières Colloquium, Brussels, 11 May 2011.

Short-termism is much less of an issue for unlisted companies. The management of privately-held companies are less exposed to fluctuations in company valuation, and can focus on achieving longer-term operational success. For this reason, many significant companies may choose, quite reasonably, to go private or forego a public listing.

The transmission of short-term pressures from stockmarkets is also reduced in listed companies with a controlling shareholder or blockholder. Although such companies have a market-determined share price, this will not necessarily influence management behaviour if the blockholder is willing to take a longer-term view.

A recent study of companies in the Nordic economies⁵ – where there exists significant variation in terms of the ownership structure of listed firms – found that companies with a significant blockholder or reference shareholder were less likely to be subject to short-term pressures on issues such as investment or R&D expenditure than companies with a large number of dispersed shareholders. Significant shareholders are in a position to shield companies from the short-term “noise” of capital markets, with positive implications for a longer-term corporate perspective.

Unfortunately, there are very few controlling or significant shareholders of large UK-listed companies. Ownership is dominated by institutional shareholders of various kinds – both domestic and foreign - with small percentage ownership stakes.

Given the key role of institutional investors in mobilising savings in the UK, it is hard to envisage any change to this situation (although sovereign wealth funds may be a new class of investor with a greater willingness to take significant ownership stakes in individual listed companies). This contrasts with corporate sectors in continental Europe and many other countries outside of the English-speaking world, where blockholders continue to dominate company ownership⁶.

5) Overcoming short-termism – the key role of the board

The IoD believes that the short-term pressures arising from a stockmarket listing can be most effectively addressed through the actions of boards rather than through regulatory changes or changes to the shareholder voting regime.

The board must be active in ensuring that the company adopts a time horizon that maximises corporate value creation. There are several ways in which it can do this.

Firstly, boards should actively seek to attract shareholders to the company that share the strategic time horizon of the company. Although many UK institutional shareholders do not have a long-term investment horizon, shareholders are not a homogeneous set of actors. Certain types of shareholders may be willing to adopt a longer-term oriented investment approach.

This is more likely to be the case if shareholders fully understand the company’s strategy and key performance indicators. **Boards should therefore place a high priority on clearly communicating the corporate mission and strategic timeframe of the company to potential investors and other stakeholders.**

Secondly, the board should ensure that the timeframe of executive remuneration policies is matched to the overall strategic timeframe of the company.

If corporate success is defined on a longer-term basis, the board should avoid incentivising the pursuit of short-term financial targets by executives. The remuneration committee should define financial and non-financial performance criteria that best align the time horizon of executives with that of the company.

⁵ Brunzell, Tor, Eva Liljebloom and Mika Vaihekoski. “Short-Term Expectations In Listed Firms: The Mitigating Impact Of Large Owners”. Available at SSRN: <http://ssrn.com/abstract=1400734>. July 2011.

⁶ Barker, Roger M. (2010). “Corporate Governance, Competition, and Political Parties: Explaining Corporate Governance Change in Europe”. Oxford University Press.

Thirdly, if short-term market pressures are brought to bear on management, e.g. through the volatility of the share price or the emergence of a hostile takeover bid, the board should play a key role in shielding management from these external pressures. They should continue to offer this support as long as they remain convinced that the existing management team is best placed to implement the long-term strategy.

During times of short-term uncertainty, the board should not allow the CEO and the executive team to become distracted from their operational management of the business. **Boards should support them by playing a significant role in communicating the existing business strategy to the market, and by building a supportive dialogue with investors.**

Thank you once again for inviting the Institute of Directors to participate in this consultation. We hope you find our comments useful.

Yours sincerely,

A handwritten signature in black ink that reads "R. Barker". The signature is written in a cursive style and is underlined with a single horizontal line.

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