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The Kay Review
Department of Business, Innovation and Skills
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Via email to: kayreview@bis.gsi.gov.uk

04 November 2011

Response to The Kay Review

Dear Sirs,

Our submission in response to the Kay Review "Call for Evidence" is given below.

Please note we would welcome the opportunity to visit you to discuss this matter as clearly these are very complex issues. Please suggest some convenient dates if you are agreeable to that suggestion.

Bearing in mind that we represent individual investors who invest directly in UK stock markets, and who typically have wide experience of how the market operates, we certainly have serious concerns about many aspects of UK corporate control and accountability.

There is surely an excessive emphasis on short term speculation versus long-term investment returns to the disadvantage of the UK economy and this has been encouraged by changes over the years to the way investments are held, the way the markets operate and by legal, regulatory and taxation changes.

To summarise our conclusions, the Government needs to encourage more responsible share ownership among investors. It can do this in many ways so as to reverse the recent historic trends to growing "intermediation" which takes information and control out of the hands of the beneficial owners of shares.

The Government has the power to discourage speculation and encourage shareholders to view their holdings as medium to long-term investment by changes to the regulatory environment and by changes in tax regulations. It needs to act decisively to promote the interests of the real investors rather than the intermediaries who dominate the financial scene at present.

We have responded to each of the questions/issues raised in the Review "call for evidence" below, and our specific proposals are highlighted in red. In addition we have given the results of a survey of our 1,500 members on the issues in an Appendix.

1. Whether the timescales considered by boards and senior management in evaluating corporate risks and opportunities, and by institutional shareholders and asset managers in making investment and governance decisions, match the time horizons of the underlying beneficiaries.

We can only comment on the views of individual equity investors in relation to this topic. Most such investors are looking for a long-term gain in the overall value of their portfolio of investments. The majority realise that the stock-market suffers from short-term volatility and is also cyclical in nature. Stock market prices often seem to reflect in an exaggerated manner the general trends in the UK and world economies. So when the outlook is bleak, the market falls excessively and when the outlook is good, the market rises to an unsustainable level. So any experienced investor accepts that they may have to ride out both short term and medium term fluctuations in general market sentiment and the random walk of particular stock prices.

However, that does not mean that any knowledgeable investor will buy and hold a stock regardless of news flow. If the initial reason for investment in a particular stock is no longer arguable due to a change in a company's circumstances, or the revelation to the investor of more knowledge about a company than they were previously aware of, then they may choose to sell a holding. This could take place in years, months, weeks or even days after making the initial investment. A simple change in the prospects for a particular company due to technology, market or management changes may be sufficient to result in a reduction in investment, or of course, and increase in investment.

The market should act as an efficient barometer of the changes perceived by investors in the long-term financial return and risks attached to a particular company, and in general it probably does so. A key function of the market is to reallocate capital over time to meet new demands and enable the development of successful companies. However there are no doubt quite a lot of exceptions to that general rule, particularly in respect of smaller companies, and where circumstances are abnormal.

Obviously some investors are more sensitive by reason of personality, experience and investment style to others. Some investors will trade more frequently, and hold stocks for shorter periods than others. The cost of trading (which can vary a great deal depending on their broking arrangements), how much time they wish to spend on their investment activities, the structure of their portfolio (and the kind of companies held within it), and other factors affect these decisions.

We do not believe that there should be any discrimination (e.g. via taxation) against short term trading or in favour of longer term investment. There is no clear dividing line between one or the other, and it would be wrong to try to affect the rational decisions of investors in any way.

Very short term speculators simply provide market liquidity but have little influence on the management of companies, and would not wish to have such influence. The key is to engage those who are actually beneficial owners with longer term horizons and ensure that they make appropriate and informed decisions.

One of the issues to bear in mind here is whether stock market investors consider themselves "part-owners" of the company or not. They obviously legally are if they are on the share register of the company, but changes in recent years have tended to encourage investors to see their shareholdings otherwise (see below for more on this topic). If a shareholder views him or herself as an owner of the business, when the company gets into temporary difficulties they may be more likely to hold on to their shares.

But if a shareholder simply views their holding as a gambling chip in a giant casino, they will dispose of their shares at the first sight of problems and not tackle the company directors about the problem or encourage them to resolve the issues. This is very damaging to the health of the UK corporate scene.

In the case of institutional investors who may be running tracker funds, or pseudo tracker funds where they don't wish to diverge significantly from market indices, obviously they have little sense of ownership because they will be forced to buy and sell stocks without consideration of the merits or prospects of a company. The growth of index tracking funds in recent years has been very damaging to the corporate scene in that it discourages "engagement" with boards of directors.

Likewise, institutional investors are usually managing funds on behalf of other people who are actually the beneficial owners. So they tend to suffer from the "Principal-agent" problem in that they in essence have no proprietary interest in a company and will not necessarily be rewarded for spending effort on engaging with a company. Again the growth of indirect investment by retail investors in the stock market via funds as opposed to direct holdings has exacerbated this situation.

We now have the situation where the vast majority of shares in public companies are held by investors who are not the beneficial owners.

At the end of 2008, and based on "beneficial" ownership, the Office of National Statistics indicated that individuals held 10.2% of shares listed on the LSE. That compares with 26.2% held by pension funds and insurance companies. But 41.5% of shares were held by foreign investors, which presumably would also be mainly held by institutions.

Some people have questioned the 10.2% figure and believe it is substantially higher if shares held in nominee accounts (such as ISAs) were properly taken into account. However, assuming the measures were consistent, it is worth pointing out that this fell from 12.8% in 2006, 14.0% in 2004 and 20% in 1994. There is clearly a trend for more holdings via mutual funds and other institutional structures, and less direct shareholding in individual companies. Some of this trend is accounted for by the sale of the holdings of demutualisation and privatisation shares that individuals acquired when former building societies became public companies and the Government sold off nationalised industries. But that does not account for most of it.

These changes have surely encouraged more investors with a short-term outlook on their holdings, and also ensured that the directors of companies will bear that in mind when making strategic decisions.

We would like to see the Government much more actively promoting direct investment in the stock market by retail investors (effectively they are discouraged rather than encouraged at present by regulation and the way intermediation has grown up). This could be done in a variety of ways, some of which are covered below.

2. How to ensure that shareholders and their agents give sufficient emphasis to the underlying competitive strengths of the individual companies in which they invest.

Our members generally make their own investment decisions, although they may rely on advice from their stockbroker, on advice from other sources, and on analysts published reports.

The question of how equity analysts and asset managers assess the competitive advantage of companies is such a broadly based question, that analysts might study this question for years and numerous books have been written on this subject, so we do not think it is practical to try and answer that question within the timeframe required for a response to this Review.

Likewise separating out judgements on underlying corporate performance from short-term market trends is not a very practical proposition. Investors might make judgements on that issue in particular companies but market trends are often signals for the fundamental basis of a company's prospects. For example, if store-based retailers are suffering at present in terms of their share prices, as we know they are, is this a reflection of the economic environment and resulting falls in profits, or the fact that sales are moving to the internet?

As regards the question on "how have technological advances such as automated trading affected investment decisions in equity markets", it is certainly obvious that the market is becoming more driven by "momentum". This arises because automated trading systems are clearly a substantial influence on share price trends in the short term as one can see from examining trading patterns in stocks. This then encourages investors who are making individual investment decisions to follow the market trend. This has been shown in recent years to be a very successful investment technique and hence of the growth in this approach.

Of course the impact of these systems is encouraged if investors have no proprietary interest in their investment and are willing to buy or sell shares simply on pricing trends rather than fundamental value.

Another reason why "momentum" effects are growing is the growth in indexing tracking funds (including ETFs). These are proving more popular as a people realise that active managed fund management costs are generally too high, whereas they are lower in such funds.

The mechanisms used by such funds tend to provide positive feedback to existing price trends. As a stock price falls (perhaps from some random item of news), the market cap of the company will fall and hence index tracking funds will sell it. That induces further price falls, generating more sales by the same or other index tracking funds, and so the process continues until some more fundamentally based investors realise that the price is becoming totally out of line with reality. This whole process can take some time though, resulting in increased volatility.

So it comes back to the issue of how to encourage investors to view their ownership of shares as a partial ownership of the company and adopt a proprietary interest.

We cover the particular issue of the rampant spread of nominee accounts in our response to question 9 below. Nominee accounts destroy the relationship between companies and investors. It stops companies from communicating with their shareholders and vice-versa (or shareholders with other shareholders which is the basis for shareholder democracy).

Another problem is that legislation and regulations have encouraged individual investors to move into collective investment vehicles (unit trusts, OEICs, ETFs, pension funds, insurance policies, etc). For example if you wish to obtain the tax benefits of an ISA, then you have to do it via a nominee account, and typically those are promoted as fund investment vehicles. Likewise apart from SIPPs, all pensions are collective vehicles, and even in the case of SIPPs most of the assets are held in managed funds. This approach distances investors from the companies in which they invest and leads to high intermediation costs (most of the tax relief benefits that investors should gain from end up in the pockets of financial intermediaries). It destroys personal engagement between investors and companies. So our recommendation would be:

To remove the requirement for ISAs, pension funds and other investment with tax benefits to be managed by financial institutions and allow retail investors to manage these themselves.

3. Whether the current functioning of equity markets gives sufficient encouragement to boards to focus on the long term development of their business.

These questions seem primarily aimed at the directors of companies so we will only comment briefly. However, one of the reasons why directors and senior managers of companies probably have been influenced more by short-term performance is the increasing use of performance related pay schemes. The use of bonus schemes and LTIPs that focus on short term measures such as "total shareholder return" or "earnings per share", particularly the former which is partly share price based, have tended to motivate executives in the wrong way. So it is widely acknowledged that in banks, where bonus schemes got totally out of hand, this led to the use of more risky business strategies. Little attention was paid to the risks that were being run, for example by gearing up of the balance sheet or the use of funding that was susceptible to withdrawal. In essence by doing so, executives could achieve bonuses in a year or two that would set them up for life so the risks were clearly acceptable to them when any failure of their strategies might not be known for some years and after the executives concerned have long departed.

We have covered this issue more extensively in our response to the concurrent consultation on Executive Pay run by the BIS.

In summary we would like to see a cap on the maximum amount of total remuneration that is made up by bonus or share option schemes, with more reliance on base salary as the primary remuneration element. We don't think performance related pay actually provides much in the way of incentives and a high performance element certainly encourages short-term thinking.

Any experienced manager knows that it is easy to make a company more profitable within a one or two year period by cutting costs, reducing sales and marketing expenditure, reducing R&D, halting new product releases, reducing customer service and other such measures. But the long term effect is a weakening of the competitive position of a company. Unfortunately long-term incentive schemes rarely provide the right incentives and linking them to simplistic measures of company performance are not likely to assist.

4. Whether Government policies directly relevant to individual quoted companies (such as regulation and procurement) sufficiently encourage boards to focus on the long term development of their businesses.

We have few comments on this as this is probably more a question for boards of companies to answer, but we are wary of any policies that Government might introduce to encourage long term investment versus short-term expenditure – for example by taxation policy and the use of capital allowances. Artificially distorting investment or expenditure decisions is not likely to be helpful.

But there is one area where Government policy could have a substantial impact on improving the stewardship of companies and that is in the area of law. Apart from the problem of incompetent management, directors in smaller companies (such as AIM stocks) often seem to be "ethically challenged", and if they do not actually break the law they may well mislead shareholders about the affairs of their companies, sell shares at opportune times based on inside information, issue large numbers of shares, options or warrants that are in their interest but not shareholders and prejudice minority shareholders by doing placings to their favoured institutions (or to themselves).

Regulations are ineffective in controlling such activity, and even when the law is broken, they are unlikely to be pursued. The law and market regulations are too weak and the regulators are not forceful enough and are under-resourced to pursue many of the issues that arise.

In particular, we suggest the AIM market should be brought under the control of the FSA and harmonised with that of the main market to stop abuses.

Indeed even if shareholders wish to pursue an issue in law, they have little ability to do so because shareholders have no contract with the directors and there is no concept of "fraud on the market" in UK law. Actions for "breach of duty" by directors are generally impractical. Even if actions are practical, the costs of litigation are now so high that only the wealthiest institutions could risk an action against a public company, and most fund managers have no incentive to pursue such claims. Similarly, if the financial accounts of a company have been misleading to shareholders due to failures by the company auditors, the shareholders have no claims that can be pursued in law and more and more obstructions to possible claims against auditors have been put in place over the last few years. Likewise other professionals involved in promoting or regulating companies (brokers, AIM Nomads, etc) are ever more protected from their own failings.

In essence the legal system which acts as the framework for companies has been watered down in the interests of company directors and their professional advisors over the last 50 years, to the detriment of shareholders interests.

Major reforms of the legal framework within which companies and directors operate are required.

One solution to some of these problems (although not to all) would be to have strong shareholder democracy where shareholders could easily change matters if they saw it necessary. But the migration of most shareholders into nominee accounts has effectively destroyed this. One can no longer easily communicate with your fellow shareholders, or indeed know who they are.

Shareholders in nominee accounts have difficulty voting and receiving corporate information, and most private shareholders are in practice disenfranchised totally (the last Companies Act did not significantly change this). See later in our response for more on this subject.

A General Meeting of a company is no longer viewed as the forum where directors report on their stewardship of the company and are questioned by shareholders. It has become an archaic format where most shareholders (including almost all institutional holders) stay away.

General Meetings of companies need significant reform.

5. Whether Government policies directly relevant to institutional shareholders and fund managers promote long-term time horizons and effective collective engagement.

We have no comments on questions a) and b), but as regards c), whether the regulation of contact between companies and investors is an obstacle to effective engagement, we certainly believe there are problems in this area.

At present we have the worst of all worlds where private briefings by companies to analysts takes place (so there is no level playing field for all investors) even though there are rules that restrict disclosure of price sensitive information without a public announcement, but where investors cannot discuss openly important issues for fear of being made an "insider" and hence being prohibited from trading the company's shares.

The requirement to limit disclosure, and yet the apparent need for more "engagement" are to some extent self-contradictory. No investor can participate in a meaningful discussion about the future strategy of a company, or even its short term tactics, with board directors without being made privy to important information about the position of a company. This issue does need to be resolved.

We suggest that a more open disclosure policy (along the lines of Regulation FD in the USA) would resolve some of these problems and stop the "private briefings" that now take place so regularly in the UK.

6. Whether the current legal duties and responsibilities of asset owners and fund managers, and the fee and pay structures in the investment chain, are consistent with these long-term objectives.

We have no comments on question a).

As regards question b), the same problem arises in regard to how individual asset managers are rewarded as happens in respect of executive remuneration. The increased use of performance based fees has not only led to a general rise in fund management fees, which were already high in the UK, but has also encouraged risky behaviour.

To quote Peter Hargreaves of Hargreaves Lansdown, a prominent UK retail broker, he recently said "there is little evidence that these fees actually improve performance. The people who seem to benefit most are the fund managers".

As evidence of the general rise in fund management fees, Lipper recently produced a report on this subject which was written up in an Article in the FT on the 9th October. It said that in the UK, of 196 funds that have made a change to their annual fee over the past decade, 80 per cent made an increase. It suggested the same growth is happening across Europe driven by the failure to reduce costs as fund sizes rise (as happens in the USA), rising costs of distribution, the growing power of "platforms", and more specialised funds charging higher fees (typically including performance based fees).

Fund management fees are now consuming a very large proportion of investors' real returns. For example Money Observer magazine reported in 2010 that fund management fees eat away an average of 43% of investors' returns over a 10 year period.

How can this happen? After all charges of 1.5% per annum (a common level of "management fees") don't sound much. But the problem is that the average dividend yield on the stock market might be around 3.0% (currently 3.5% on the FTSE-Allshare due to depressed stock prices), and capital growth can be minimal over long periods of time. So that's why half the returns may disappear into the bank accounts of fund managers. Not only that, the headline quoted management fee often understates the real charges incurred (trading costs and other charges are excluded).

Look at it another way, what is the real growth in the UK or Worldwide economies (excluding inflation)? In the long term it may be as low as 2% and is certainly of that order, or less, in the UK at present. Companies as a population cannot in essence grow faster than the economy as a whole. The proportion of that growth in real earnings that is taken by companies might vary, but is unlikely to be substantially higher than the overall growth rate even allowing for the fact that equities are somewhat a leveraged investment because companies are partly financed by debt. So if a fund manager takes 1.5%, he is already consuming a very large proportion of the real return on capital investment made by companies.

Indeed this has been a general trend in the last 50 years where the financial system is now basically run and organised in the interests of the intermediaries who operate the system. The real returns generated by companies do not get through to the end investors – whether they are retail investors, pension funds or other beneficial owners.

John Bogle has commented widely on the same situation in the USA, even though they have generally lower fund managed costs than in Europe. For example in his recently published book entitled "Don't Count On It!", he has this to say: "*The huge and widely recognised economies of scale entitled in managing other peoples' money have been largely arrogated by fund managers to their own benefit, rather than to the benefit of the fund shareholders*" (page xxii). In Chapter 4 he covers the explosion in "financial intermediation costs" in the USA in the past 60 years, which is exactly analogous to what has taken place in the UK. For example on page 77 he says: "*The argument that our financial system is costly because of the benefits it brings to investors belies the reality of our system, in that it does not operate under classic free market conditions. In fact, the system is a model of information asymmetry (which favours sellers over buyers), imperfect competition, and irrational choices driven by emotions rather than reason)*". He supports his arguments by facts and figures and shows for example that probably the share of the earnings of the S&P500 that were claimed by the financial sector rose from 5% in 1980 to about 30% in 2008 (page 79). He also argues that fund performance is strongly inversely correlated with fund management fees, i.e. the higher the fees, the worse overall return –in other words performance fees (which are often the reason for high charges) typically do not motivate fund managers to perform better despite what they claim.

Although Mr Bogle is an advocate of low cost index tracking funds as one solution to the problem, and the book is certainly well worth reading if you wish to get an understanding of these issues, index tracking funds do themselves create some problems as already pointed out.

Good examples of the pernicious influence of performance fees are present in the Venture Capital Trust (VCT) sector – these are small but fully listed investment trusts that specialise in investment in private equity deals and AIM companies. They might be seen as a microcosm of the investment fund world.

VCTs have high base management fees (typically 3% of assets) probably because high fee levels are normal in private equity funds. They also normally have performance fees on top of that. But if a VCT underperforms, the performance fee base index level is typically reset to a lower level. This is a heads I win, tails you lose situation so far as the fund manager is concerned. For example take the case of Quester/Spark/Kings Arms Yard VCT (it changed its name twice to reflect a change of fund manager and probably to try and distance the company from appalling past performance). At each change of fund manager the performance fee basis was re-indexed and while it was called Spark it also changed it to being based on dividends paid out. The company then paid out £1m in performance fee one year when the company had no profits overall (VCTs can do this because they can pay out dividends from realised profits on investments while ignoring offsetting losses). The net result over many years was rotten performance but the fund managers still collected performance fees.

Or take the case of Rensburg AIM VCT where we are currently running a campaign. This company has generated a total return (net asset value plus dividends) of a negative 1% per annum in the ten plus years it has been in existence. In other words shareholders have lost money on their original investment in the shares of the company even after taking into account dividends paid. But last year it paid out a management performance fee to the fund manager so that its overall fund management/admin fee was 6.3% of net assets at the year end – a truly astonishing figure. Why was a management performance fee achievable when historically the company had lost money? Because the performance calculation only looks back a limited period of time and does not take into account past losses, so when the company's investments in AIM stocks were raised in value by a general rise in the AIM market, a performance fee was collected. That might be seen as a one-way bet in favour of the fund manager.

One could argue that these particular performance fee arrangements could have been better designed, but in reality it is very difficult to design a performance fee structure that does not have disadvantages. In practice fund managers are often more expert at negotiating complex fee arrangements that benefit them than they are at managing their funds. When the results do not satisfy their needs, they are also usually expert at renegotiating a better deal.

Another recent example of resetting performance fees after past poor performance is Cognetas who run private equity funds. Its second fund suffered large losses after several investments had been written off so that at the end of June 2011 the gross value of the fund's investments was about a third of the original cost. They are proposing to reset the performance fee so that it is now indexed from that date (see the FT on 27th Oct for a fuller report).

We would like to see much clearer and more comprehensive reporting of fund costs, and the strict control of performance fees which we suggest should generally be discouraged if not banned altogether. In addition, investors need educating about the impact of fund management costs, and have the costs of a fund clearly explained in any promotional literature.

As regards question c) – "whether there are agency problems in the objectives and operations of asset managers that may be deleterious to the interests of the corporate sector or savers" – we already mentioned the "Principal-agent" problem in our response to Question 1 above. The lack of a proprietary interest, in effect having their own skin in the game as Warren Buffett put it, means that fund managers can be more motivated by fees which are directly related to the size of a fund, and that is often dependent on whether it is in a "hot" sector as perceived by investors, than by returns to investors. This often results in new funds being created for those hot sectors, and the creation of "me too" funds that copy successful ones. This results in grossly excessive numbers of funds with similar investment strategies and a high turnover of funds (they are often born and die within a few years). These aspects of the financial scene result in very high costs of course to investors.

It has been argued that one reason for performance fees is that it aligns the interests of investors with the fund managers, and that it provides incentives to perform well. We have already seen that the latter aspect is not true in reality in terms of the net returns seen by investors. One simple reason for this is that there are very few fund managers who demonstrate any consistent ability to outperform chance. Indeed some academics argue that there is no demonstrable superiority of the typical fund manager over that of a chimpanzee throwing darts at a list of stocks in the financial pages of a newspaper.

So even if the interests of fund managers were more aligned to that of the investors, this might not result in any substantial performance improvement. In any case, there are already strong incentives for fund managers to perform to the best of their abilities as fund management fees are usually based on assets under management. Successful funds grow by the growth in the value of their assets (and in open-ended funds by new investors joining). Unsuccessful funds decline.

There should probably be more emphasis on "stewardship" of the fund, their corporate governance and the choice of investment strategies when looking at the relative merits of funds but these are not the kind of things that are currently promoted to investors.

As regards question d) – how other intermediaries and market participants are remunerated and what impact this has on their incentives and those of their clients – it is obviously true that commissions paid to such intermediaries and the basis of those payments has had a very distorting impact on the financial markets and the costs borne by investors. For example, investment trusts often have very low fund management fees but are rarely recommended by IFAs because they typically do not pay commission to IFAs whereas unit trusts and OEICs do. Likewise pension investments are promoted because they pay high levels of trail commission while concealing these costs from the investor. The proposals in the Retail Distribution Review may help to tackle these problems.

We strongly support the disclosure of all fees up-front to investors including those paid to intermediaries such as "platforms". But even with full disclosure, we do not think that this will solve the underlying problem that most investors are ignorant of how the financial sector works, what they are paying for and why. Also in most cases more direct investment in UK equity markets would be financially sounder because it would be lower cost for many investors. But the current trend is in the opposite direction as retail investors are encouraged to abdicate responsibility for their own financial affairs and pass the buck to "professionals". More on the reasons for this and how to resolve it are given elsewhere.

7. Whether there is sufficient transparency in the activities of fund managers, clients and their advisors, and companies themselves, and in the relationships between them.

We have no comments on questions a), b) and c).

As regards question d), we have already made it clear that we believe the overall costs of intermediation are not understood by investors in general. We also suggest that they are not proportionate to the value of the services provided.

As regards question e) investors have access to sufficient information to understand the investment approaches of asset managers and to judge whether they are aligned with their investment objectives and timescales, but it is doubtful whether most retail investors have the education to understand that information, actually study it anyway even if they do have the knowledge to interpret it, and whether they make intelligent decisions on the basis of that information. Again the problem here is lack of financial education as regards stock market investment and collective fund investment in the UK.

To tackle this problem we suggest that the Government should take on responsibility for education of the general populace on stock market investment. This could be funded from a levy on financial intermediaries who do very little to really inform investors at present – what they do instead is tend to "sell" them on the wonders of their particular approach or organisation. Education could then be promoted via FRC recongised organisations.

8. The quality of engagement between institutional investors and fund managers and UK quoted companies, and the importance attached to such engagement, building on the success of the Stewardship Code.

We do not believe that the measures taken to stimulate engagement by investors in companies (such as the Stewardship Code) have been effective, or are likely to be so. We see no evidence that the situation has changed recently and have already pointed out the practical difficulties of meaningful engagement in our response to Question 5, because investors do not wish to become insiders. In addition, index tracking funds which represent a growing proportion of the market are never going to spend time or effort on engagement because their investment strategy is based simply on following the market.

Three of the key aspects of engagement are to have influence on the appointment (or removal) of directors, on the appointment of auditors and on executive remuneration. Without some say in those matters, shareholders are ultimately powerless to influence the board of directors on such matters as company strategy.

Although we accept that the appointed directors should manage the operations of a company, for many years now shareholders have lost control of companies and have abdicated all their stewardship responsibilities to the directors. But the directors' interests are frequently not aligned with those of shareholders because they have no significant financial stake themselves in the company. We covered some of these issues and some solutions in our response to the consultation of Executive Remuneration by the BIS.

Our proposed solution to the problem of engagement is the creation of Shareholder Committees that would have a more direct say in nominations and remuneration. It would ensure a more "consultative" approach between directors and shareholders for the benefit of all stakeholders. A full explanation of why Shareholder Committees are required and how they might operate is given in the attached document.

9. The impact of greater fragmentation and internationalisation of UK share ownership, and other developments in global equity markets, on the quality of engagement between shareholders and quoted companies.

The fragmentation of share ownership and its growing internationalisation (we gave some figures on the latter in response to Question 1) are certainly a problem. Indeed there are few UK company share registers now where the largest investors have more than 2% of the shares, and typically with an enormously long tail of other institutions including foreign ones.

This creates problems for companies in that they have difficulty often in identifying a reasonably small group of shareholders that is representative of the whole. In addition, the shares are often held in nominee accounts with stock lending and the use of CFDs also tending to confuse who the beneficial owners are. Companies often have problems identifying who their major shareholders are and what their opinions might be on a subject.

Our recommendation (see above) for Shareholder Committees might help to solve the fragmentation issue in that a formal process for creating a small group of informed advisers to represent shareholders could be established.

One particular problem that affects both institutional investors and private investors, but particularly the latter, is the use of nominee accounts. This undermines shareholder democracy and engagement in that the beneficial owners may not even be informed about the affairs of a company, let alone be given the opportunity to vote at General Meetings.

Private shareholders represent more than 10% of the shares held in publicly listed companies. They typically do not receive information, do not vote, and cannot attend general meetings of the companies they own because they are now mainly in nominee accounts. Unfortunately many stockbrokers do not, and will not, enfranchise their nominee clients.

The reforms in the 2006 Companies Act did not solve this problem. The alternative of an electronic replacement for share certificates was killed off by vested interests. We need a proper system to ensure that all beneficial owners who hold their shares in nominee accounts are treated in the same way as those on the share register. Indeed they should be on the share register with the ability to opt out of company or third party communications if they wish. Such an option should only be granted if they have read specific wording to advise them of the loss of their normal legal rights and an explanation of the disadvantages of doing so.

Private shareholders do not suffer from the "Principal-Agent" problem in that they have a direct interest in their investments and are often keen to engage with companies. Hence it would be a major advance in improving engagement and corporate governance if the use of nominee accounts were minimised.

We suggest therefore that the whole system of share ownership recording and the use of nominee accounts be reformed and that Nominee Account Shareholders should be on Share Registers by Default.

10. Likely trends in international investment and in the international regulatory framework, and their possible long term impact on UK equity markets and UK business.

Some of the proposals come out of the European Commission are positive, but others are negative, including of course some that potentially undermine London as a major world financial centre – no doubt you will get comments from others on that. One issue that was proposed for an update to MIFID was the banning of execution-only trading by retail investors, and other changes that would require them to take advice. We see this kind of change as wholly negative in that it increases costs while undermining an individual's responsibility for their own financial affairs. It would simply encourage the past trends to rely on more expensive intermediation.

Yours sincerely

Roger W. Lawson
Chairman

About the UK Individual Shareholders Society (ShareSoc)

ShareSoc represents and supports individual investors who invest in the UK stock markets. We are a mutual association controlled by the members with "not-for-profit" articles and incorporated as a company limited by guarantee. The organisation is financed by member subscriptions, donations from supporters and by its commercial activities. More information on ShareSoc can be obtained from our web site at www.sharesoc.org (our objects are fully defined on this page: www.sharesoc.org/objects.html).

Appendix – Questions posed to ShareSoc Members in a survey of members

We issued a survey to all of our 1,500 members in late October 2011, based on circulation of a draft of this document, and have had a response from 315 at the time of completing this note. A summary of the questions asked are as follows.

1. Do you agree that direct stock market investment (as opposed to the use of collective funds) should be encouraged by the Government?

2. Do you agree that there should be no requirement for institutions to be the managers or custodians of tax beneficial investments such as ISAs and pensions?

3. Do you agree that too much emphasis is placed on performance related pay elements in director remuneration (such as bonuses, LTIPs and share options) and that this encourages risky behaviour and short term thinking?

4. Do you agree that the legal framework for companies needs tightening up to make directors more responsible and more accountable?

5. Do you agree that regulation of the AIM market needs improving and that it would be better regulated by the FSA rather than "self-regulated" by Nomads and the LSE?

6. Do you agree that the General Meetings of companies need substantial reform to make them for effective and purposeful?

7. Do you agree there should be more open disclosure and a stop to private briefings by companies, i.e. the equivalent of a US Regulation FD implemented?

8. Do you agree that fund management charges are often excessive?

9. Do you agree that fund management disclosure should be improved, performance fees banned altogether or severely limited in scope and more education of investors undertaken to try and reduce fund management charges?

10. Do you agree that the Government should take on the responsibility for education of the general populace on stock market investment?

11. Do you agree that the "Shareholder Committee" proposals, as developed by ShareSoc, are a good solution to tackling the problem of insufficient engagement by investors with companies?

12. Do you agree that the whole system of share ownership recording and the use of nominee accounts should be reformed (with nominee account shareholders on share registers by default)?

The results of the survey are given below. There was overwhelming support for all of our proposals except in respect of Question 10. Perhaps there was concern about the cost of that, how it would be financed and doubts about making the Government responsible for education on financial matters (our proposals were not spelled out in any detail).

Constant Contact Survey Results

Survey Name: Member Survey 2

Response Status: Partial & Completed

Filter: None

11/4/2011 7:15 AM EDT

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There are two very important public consultations which have been issued by the Government (from Vince Cable's BIS Department) on which we would like your views. For example the second one is on escalating director pay which was highlighted in the news yesterday. We have drafted responses to these consultations based on our adopted Manifesto, but we would like to get your views on what we are proposing before submitting our responses so that they carry more weight. The full draft response documents are present on the ShareSoc Members Network under the Forum titles of "Kay Review of Equity Markets" and "Controlling Pay" if you care to read them. But in summary these are our proposals:1. That the Government needs to encourage more responsible share ownership among investors. It can do this in many ways so as to reverse the recent historic trends to growing "intermediation" which takes information and control out of the hands of the beneficial owners of shares.2. We propose specific changes to tackle the growth of director remuneration including binding, forward looking votes and that shareholders should determine pay, not the directors themselves.For both the above topics we suggest that Shareholder Committees be formed so as to control board nominations and pay, and introduce a more consultative approach on board strategy.We will try to take into account the views of our members in the final responses we submit to these consultations.This survey consists of only 12 simple questions so should take only a few minutes of your time to complete. You can add comments or questions in the notes boxes. Thanks for your assistance.

Do you agree that direct stock market investment (as opposed to the use of collective funds) should be encouraged by the Government?

Answer	0% 100%	Number of Response(s)	Response Ratio
Strongly Agree		136	43.1 %
Agree		117	37.1 %
Neither Agree Nor Disagree		41	13.0 %
Disagree		5	1.5 %
Strongly Disagree		0	0.0 %
No Response(s)		16	5.0 %
	Totals	315	100%

Do you agree that there should be no requirement for institutions to be the managers or custodians of tax beneficial investments such as ISAs and pensions? (we see this as taking control out of the hands of the investors while introducing unnecessary charges)

Answer	**0%**	**100%**	**Number of Response(s)**	**Response Ratio**
Strongly Agree			152	48.2 %
Agree			95	30.1 %
Neither Agree Nor Disagree			31	9.8 %
Disagree			13	4.1 %
Strongly Disagree			7	2.2 %
No Response(s)			17	5.3 %
		Totals	**315**	**100%**

Do you agree that too much emphasis is placed on performance related pay elements in director remuneration (such as bonuses, LTIPs and share options) and that this encourages risky behaviour and short term thinking? It is also been one of the reasons why overall pay has grown so rapidly.

Answer	0% 100%	Number of Response(s)	Response Ratio
Strongly Agree		189	60.0 %
Agree		74	23.4 %
Neither Agree Nor Disagree		27	8.5 %
Disagree		7	2.2 %
Strongly disagree		3	<1 %
No Response(s)		15	4.7 %
	Totals	**315**	**100%**

Do you agree that the legal framework for companies needs tightening up to make directors more responsible and more accountable?

Answer	0% 100%	Number of Response(s)	Response Ratio
Strongly Agree		203	64.4 %
Agree		65	20.6 %
Neither Agree Nor Disagree		24	7.6 %
Disagree		5	1.5 %
Strongly Disagree		0	0.0 %
No Response(s)		18	5.7 %
	Totals	**315**	**100%**

Do you agree that regulation of the AIM market needs improving and that it would be better regulated by the FSA rather than “self-regulated” by Nomads and the LSE?

Answer	0% 100%	Number of Response(s)	Response Ratio
Strongly Agree		113	35.8 %
Agree		106	33.6 %
Neither Agree Nor Disagree		58	18.4 %
Disagree		12	3.8 %
Strongly Disagree		6	1.9 %
No Response(s)		20	6.3 %
	Totals	**315**	**100%**

Do you agree that the General Meetings of companies need substantial reform to make them for effective and purposeful?

Answer	0% 100%	Number of Response(s)	Response Ratio
Strongly Agree		138	43.8 %
Agree		112	35.5 %
Neither Agree Nor Disagree		44	13.9 %
Disagree		3	<1 %
Strongly Disagree		1	<1 %
No Response(s)		17	5.3 %
	Totals	**315**	**100%**

Do you agree there should be more open disclosure and a stop to private briefings by companies, i.e. the equivalent of a US Regulation FD implemented?

Answer	0% 100%	Number of Response(s)	Response Ratio
Strongly Agree		161	51.1 %
Agree		100	31.7 %
Neither Agree Nor Disagree		29	9.2 %
Disagree		4	1.2 %
Strongly Disagree		2	<1 %
No Response(s)		19	6.0 %
	Totals	**315**	**100%**

Do you agree that fund management charges are often excessive?

Answer	0% 100%	Number of Response(s)	Response Ratio
Strongly Agree		191	60.6 %
Agree		92	29.2 %
Neither Agree Nor Disagree		16	5.0 %
Disagree		0	0.0 %
Strongly Disagree		0	0.0 %
No Response(s)		16	5.0 %
	Totals	**315**	**100%**

Do you agree that fund management disclosure should be improved, performance fees banned altogether or severely limited in scope and more education of investors undertaken to try and reduce fund management charges? Note: you may care to read the full draft submission for our justifications of these points.

Answer	0% 100%	Number of Response(s)	Response Ratio
Strongly Agree		129	40.9 %
Agree		119	37.7 %
Neither Agree Nor Disagree		39	12.3 %
Disagree		5	1.5 %
Strongly Disagree		1	<1 %
No Response(s)		22	6.9 %
	Totals	**315**	**100%**

Do you agree that the Government should take on the responsibility for education of the general populace on stock market investment? (this is on the basis that it needs a strong promoter and nobody else is likely to do it).

Answer	0%	100%	Number of Response(s)	Response Ratio
Strongly Agree			74	23.4 %
Agree			111	35.2 %
Neither Agree Nor Disagree			58	18.4 %
Disagree			41	13.0 %
Strongly Disagree			11	3.4 %
No Response(s)			20	6.3 %
		Totals	**315**	**100%**

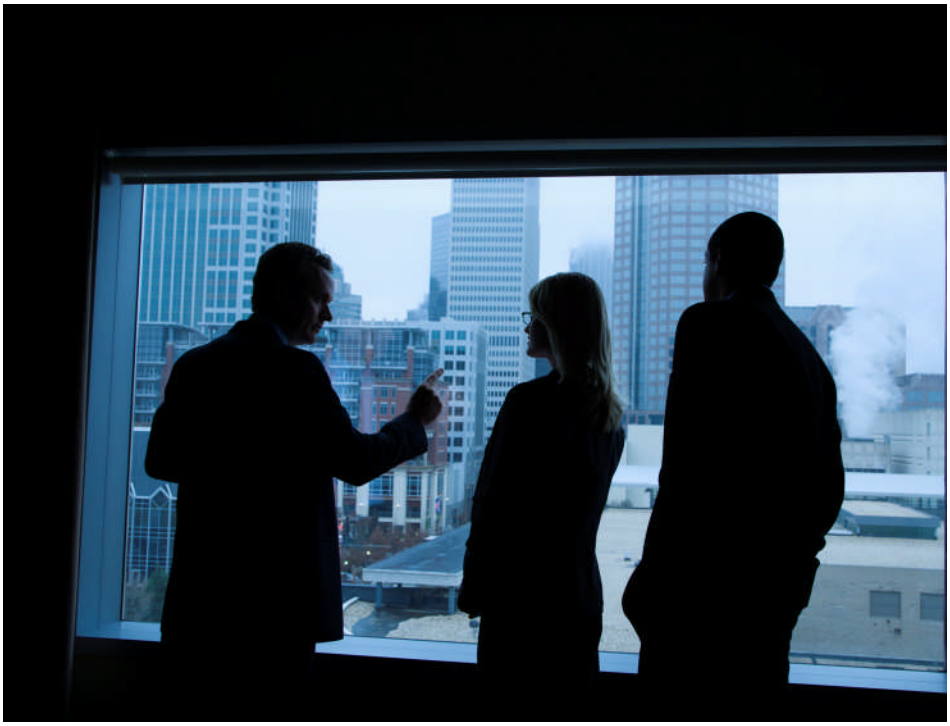
Do you agree that the “Shareholder Committee” proposals, as developed by ShareSoc, are a good solution to tackling the problem of insufficient engagement by investors with companies? (see this page of our web site for more information on Shareholder Committees: www.sharesoc.org/policies.html)

Answer	0%	100%	Number of Response(s)	Response Ratio
Strongly Agree			148	46.9 %
Agree			125	39.6 %
Neither Agree Nor Disagree			29	9.2 %
Disagree			4	1.2 %
Strongly Disagree			1	<1 %
No Response(s)			8	2.5 %
		Totals	**315**	**100%**

Do you agree that the whole system of share ownership recording and the use of nominee accounts should be reformed (with nominee account shareholders on share registers by default)? (so as to ensure that nominee accounts shareholders are properly enfranchised)

Answer	0% 100%	Number of Response(s)	Response Ratio
Strongly Agree		196	62.2 %
Agree		91	28.8 %
Neither Agree Nor Disagree		16	5.0 %
Disagree		3	<1 %
Strongly Disagree		2	<1 %
No Response(s)		7	2.2 %
	Totals	**315**	**100%**

SHAREHOLDER COMMITTEES



A way to improve shareholder engagement

This document explains how shareholder committees might be used in the UK to improve corporate governance and the oversight of companies by their shareholders.

Published by the UK Individual Shareholders Society (ShareSoc)

Contents

Shareholder Committees

A WAY TO IMPROVE SHAREHOLDER ENGAGEMENT

FOREWORD

It is widely acknowledged that there are a number of problems with the governance of public companies at the present time. Despite the introduction of the Combined Code, the presence of nominally independent directors, the annual re-election of directors and of other changes in recent years, there are still frequent failings by boards. For example, the excessive and rapidly rising pay packages of directors in some companies has been highlighted by many commentators as an example of the difficulty that shareholders have in influencing the board of directors of companies. Indeed, although improved "engagement" with companies by institutional investors has been promoted in the Stewardship Code, in practice it still seems to be ineffective. That is not just because investors do not try to have some influence, but because ultimately they can be ignored.

"It is not just because investors do not try to have some influence, but because ultimately they can be ignored."

The reason for this is because directors in essence appoint themselves and are not directly accountable to shareholders other than at an Annual General Meeting which has become rather a formal ritual where no real scrutiny of the affairs of the company takes place (most shareholders, particularly the major institutions, do not attend). As regards board remuneration for example, although there is a vote on the Remuneration Report, which is only "advisory" of course, this is a retrospective review of past decisions by the board and has little real influence on future pay trends except in extremis.

More explanation of the nature of some of the problems that result is given in our Policy Manifesto (in the Section entitled "Why these policies are needed") – see www.sharesoc.org/policies.html for our full policy manifesto. One of our proposals in the Manifesto which we see as key to solving these problems is the introduction of "Shareholder Committees". Such Committees could enable shareholders to regain ultimate control over the business which they own, without affecting the operational management of the company in any way.

Continued….

This document has been written to explain how Shareholder Committees could solve the perceived problems, and how in practice they might work, without laying down all the detail which would have to be subject to further work and debate. But the key aspect is that they might bring about a change of corporate culture where the boards of companies recognize they are the stewards of the company on behalf of the shareholders, and should work with them, rather than them perceiving their role as the only competent body to oversee the affairs of the company. In other words a more "consultative" approach.

> "The key aspect is that they might bring about a change of corporate culture where the boards of companies recognize they are the stewards of the company on behalf of the shareholders, and should work with them….."

Obviously this document has been written by an organization that promotes the interests of private shareholders, who have been particularly abused by developments in recent years. Although directly or indirectly they represent a substantial proportion of the shareholders in most public companies, their views are generally disparaged and their voting rights have been lost. But the proposals contained herein are not intended to give them or anyone else a privileged position, but to generally improve the lot of all investors in public companies. In addition the proposals should improve the health and vitality of the UK commercial scene so that the UK can effectively compete in world markets.

Roger W. Lawson

Chairman

Shareholder Committees – What Are They?

Shareholder Committees can take many forms. But as discussed in this document we suggest **they should primarily take on the role currently taken by board sub-committees that recommend on the appointment on new directors and that recommend on board remuneration.** They would also have a role in reviewing the appointment of auditors.

Their recommendations would be made to the board who would then put them to the Annual General Meeting in the form of appropriate Resolutions. It is important to emphasize that they would have no binding authority or statutory position in Company Law – at least not as initially envisaged. This means that no changes are required to legislation to implement such a concept. They might be adopted in the Articles of companies if the shareholders desired it, although that is not a pre-requisite, or as recommendations for good practice in the Combined Code.

They could be applied to all kinds of public companies from the largest to the smallest – indeed in any companies where the shareholder base is so diverse that they lack effective means of communication with the board and the ability to influence its decisions on the three matters mentioned above.

Such a Committee would not be dictating to the directors how they managed the affairs of the company, and neither would they be determining company strategy. They would simply be advising the board on the three specific areas and would normally expect the board to follow their recommendations in those areas – as the board does at present from existing board sub-committees in general.

Clearly there might be some debate if the board did not agree with the recommendations so as to achieve a consensus. However, just as companies consult their major shareholders at present before making important decisions, the board could consult such a Committee on anything they chose simply on the basis that this would be a convenient forum from which to take advice.

We envisage one Shareholder Committee for each company covering all the three issues mentioned, not separate ones for each function, simply on the grounds of keeping the arrangements as simple as possible.

Who Would Sit on a Shareholder Committee?

In essence, shareholders should dominate these Committees (or in the case of corporate shareholders, their representatives, of course). But it would be important for the board of the company to be able to present information and put proposals to the Committee so we would anticipate that at least one board director would sit on the Committee – probably the company Chairman.

Should there be other stakeholder representatives on the Committee? We suggest there might be, subject to the discretion of the board and the Committee. For example, it may be a good way to introduce an employee representative, or a representative of the local community where a company has a major impact on local affairs. The more varied voices and the wider spread of views the better in achieving a consensus on many issues. Employees might have a lot to say about levels of board pay for example, but we see such non-shareholder representatives as being in a minority even if they were introduced.

Is This a New Idea?

Shareholder Committees are not a new idea, and ShareSoc cannot take credit for inventing the concept. Indeed a shareholder "Nomination Committee" for the appointment of directors and determining their pay has been in use in Sweden for some years, and how this system operates in practice was well described in a report from Tomorrow's Company entitled "Tomorrow's Corporate Governance" – see www.tomorrowscompany.com/publications.aspx

That report suggested that such a system could evolve in the UK, just as it did in Sweden, given some commitment from companies to improve shareholder representation. Otherwise the use of such a system in Sweden seems to have had a positive effect on shareholder engagement. Note that the structure of shareholdings in listed companies in the Swedish stock market is somewhat different, though not now enormously different, to that of the UK market. Likewise main board operation and company law is of course different in minor ways. But in essence there are more similarities than differences and these are not sound arguments for dismissing such examples as irrelevant.

"The use of such a system in Sweden seems to have had a positive effect on shareholder engagement"

There have been past attempts to introduce shareholder committees in the UK (for example there was a private bill introduced by an M.P. in Parliament). These were aimed to improve shareholder engagement and improve the influence of minority shareholders so they had broader objectives than those contained herein. The proposals also contained some obvious practical difficulties, and as a result did not gain widespread support at the time.

How Would Committee Members be Selected?

It is important that the Committee Members are representative of a broad section of the shareholder base. Likewise the largest shareholders should have more representation (if they so wish of course) so that their views are adequately represented. It is also wise that Committee Members should have some knowledge of the affairs of the company concerned and the market in which it operates (i.e. they should be "informed" investors), and that they have some general background in financial and business affairs.

Within those general parameters there are many ways that Members could be selected. For example, the four or five largest shareholders could be invited to nominate members, with other members being co-opted from smaller shareholders as necessary so as to provide a broader representation.

The shareholder base of a UK listed companies is often now very diverse with no one shareholder holding more than a few percent and a "long tail" of smaller institutional holdings. In addition there are often many holdings from foreign entities (who should certainly be encouraged to participate but might have practical difficulties in doing so). In addition there are often significant numbers of private shareholders although their apparent representation might be less than in reality because they are concealed behind a few nominee accounts (see below for discussion of private shareholder representation).

In reality, it may not matter exactly how Members are selected because most shareholders are likely to have a common interest in promoting the long term success of their investment (and hence the company). Those who are short term holders or traders in the shares may not have an interest in participating in any case.

The key differentiation between the proposed arrangements and the existing one is that the Committee will have the interest of the shareholders as their main concern, unlike at present where the directors might have their own self-interest at heart on matters such as pay. A Shareholder Committee would be truly independent of the company board of directors and its executive management. Hence any advice they give is likely to be unbiased. But they would need to justify any such advice to the company board and to a general meeting of shareholders.

"The key differentiation between the proposed arrangements and the existing one is that the Committee will have the interest of shareholders as their main concern, unlike at present where the directors might have their own self-interest at heart….."

Shareholder Committees should themselves establish how members should be identified and selected. There may be different approaches for different companies – clearly larger companies with more diverse shareholdings may take a different approach to those where there are more concentrated shareholdings. Institutional shareholders would clearly need to identify people who could represent them on a Shareholder Committee – although they would not necessarily have to be employees of the institution.

The success of such a system does depend on the engagement of shareholders and their need to act as "owners" which has been one of the things lacking in recent corporate history. The problem of "absentee landlords" who do not pay close attention to the interests of shareholders has corrupted shareholder democracy. For example institutions who manage funds on behalf of other investors but have no direct interest in a company may act very differently to direct shareholders.

One issue that might arise, and hence is worth mentioning, is the problem of becoming an "insider". Committee members might become aware of "price sensitive" information. For example, although board pay is not likely to be a particularly price sensitive matter, the appointment of a new chief executive might be. Institutions may be reluctant to participate if they were barred from trading in the shares of the company as a result of becoming an "insider". The solution to this is to establish a protocol or "Chinese wall" between Committee members and the trading arms of the body they represent.

This issue is already present in that companies do consult their major shareholders about important decisions, without such discussions necessarily becoming public knowledge. This whole subject probably requires further consideration because it is unclear at present how shareholder democracy can be supported if the board of a company, or any proposed Shareholder Committee, cannot discuss strategic options.

One person on the Committee should be a board director who can act as the communication channel between the board and the Committee, but they should not act as the Chairman of the Committee who should be appointed by the Committee Members from their number.

Note that the shareholders in General Meeting should approve any selection method that is to be used to appoint members of a Shareholder Committee.

It is important to emphasize at this point before moving on that the quality of people on any such Committee would be very important. No board, and neither will shareholders, respect the views of a body whose members cannot speak from knowledge and experience and promote their views in a logical manner. It should not be difficult to identify the kind of personal background that would qualify people to be Committee members, and document those parameters in corporate governance guidelines. We would like to see such Committees dominated by people with a broad knowledge of business affair rather than by those with academic or professional qualifications. We also suggest that anybody proposing someone for members of such committees should ensure that they had suitable training and mentoring (as ShareSoc would do for private investors).

"It is important to emphasize that the quality of people on any such committee would be very important".

The Role of Private Shareholders?

Individual shareholders are often long term investors who have a strong personal interest in the success of a company. They often have lengthy business backgrounds and are frequently very experienced investors in a wide range of companies. On the other hand, some will have limited experience of financial and stock market regulations and practice, plus they do not always have the right personal attributes to take part in Committee meetings. Also of course they might similarly be reluctant to accept becoming an insider of a company in which they hold shares. So any involvement of private shareholders in a Shareholder Committee would have to be carefully considered. The best solution would be if they could be represented by a person nominated by a recognized body such as ShareSoc who have taken on the task of generally promoting the interests of such shareholders. They could bring the views of individual shareholders to the table.

ShareSoc would have to ensure that anybody that they put forward as a representative was suitably qualified, trained and experienced to take on the role.

How They Might Work and Why They are Needed – Board Appointments

“A board can be immune to shareholder influence (directors can be resistant to change)”.

One of the reasons why it is very important to give shareholders more say in the appointment of board directors is because, without that, shareholder “engagement” can ultimately be defeated. There are many examples of major shareholders disagreeing with the strategy of a company, or taking a dim view of the existing Chairman or Chief Executive of a company. One only has to look at the campaigns mounted by “activist” institutional investors or by private shareholder “action groups” in recent years to see that “engagement” is often pursued initially to no effect. A board can be immune to shareholder influence (directors who have been there a long time can be resistant to change), and most shareholders have insufficient votes by themselves to be seen as having enough influence. But they cannot easily communicate with other shareholders. Only the company can easily do so and they can “manage” the process by speaking to their shareholders individually and emphasizing the widespread support for their own views, whether there is or not.

The end result is that one of the few options for activist investors if their views are ignored is to escalate the matter to a full blown public dispute, and try to put an appropriate resolution to a General Meeting. That can be very damaging to the interests of the company, and consume a large amount of management time, much to their annoyance.

A good example recently of this "negative" approach to shareholder engagement was the attempt by Laxey Partners to encourage a more active discount management approach at Alliance Trust. Ultimately it was successful, but not without a public airing of the competing views with allegations from both sides that became quite forceful.

That of course is an extreme example of where the board might not have been representing the views of some shareholders as they wish. But even more problematic is engineering a change of Chief Executive or Chairman. A person already in those roles may have a very dominating influence on a board, from a long standing involvement in the company and his personal relationships with the other directors. In theory one could approach the Senior Independent Director, or the Nomination Sub-Committee and express one's concerns but a single shareholder speaking out is likely to have little impact.

One of the problems is that the directors appoint themselves via the nomination board sub-committee. This creates problems with the "independence" of directors and the diversity of boards – two problems that are well known. Non-executive directors do not frequently challenge the executive directors, as was very evident when looking at the recent history of banks and their involvement in risky business and investment strategies. Non-executive directors are keen to retain their positions and they realize that their continuance on the board depends on the views of the nomination sub-committee – in other words of other directors. So a culture of "conformance" results. Likewise nomination sub-committees tend to select new board members who they know will "fit-in" with the existing board and not dispute their past decisions. So boards tend to become in-bred with similar backgrounds. If shareholders perceive that substantial change is required, this can often be defeated as a result.

"One of the problems is that directors appoint themselves via the nomination board sub-committee".

Obviously it would be wrong to ignore the views of existing board members, or the current consultants they might employ to review board appointments, but the existing system is a recipe for conflict with shareholders rather than consultation. The use of Shareholder Committee to ensure that the broader views of shareholders were taken into account in the appointment of new directors, or any general restructuring of the board, would solve many of the perceived problems.

It is worth quoting from the Tomorrow's Company report mentioned above where they discuss the view that company Chairmen and Non-executive Directors may feel they sense the needs of the company and know the dynamics of the board better than a Shareholder Committee ever could. What the report says is: "*It is true that chairs and NEDs are closer to the board members, knowing them better and seeing them in action at close quarters. But it is precisely this closeness that becomes the issue, exposing boards to the risk of group-think, a lack of objectivity, an excessive sense of loyalty to established colleagues, and a tendency to recruit 'people like them'.*"

In essence a Shareholder Committee would take over the role of the existing board nomination sub-committee and operate in the same way. It would take advice from the company executives, board members, and recruitment consultants as needed.

Chairmen of companies might complain that their role might be undermined if they did not have the current level of control on board composition, but that might be a good thing in some companies as it would prevent the excessive dominance of boards by their Chairmen. In any case the Chairman could make his views known to the Shareholder Committee on any board changes.

The key here is to evolve into a more consultative approach and restore more power to the shareholders who after all are the owners of the company. But it is not so abrupt a change as some might perceive.

"The key is to restore more power to the shareholders who are the owners of the company".

How They Might Work and Why They are Needed – Board Remuneration

It would be wrong to suggest that the pay of all directors in all public companies is excessive. But it has clearly been growing much faster than the pay of other employees in some companies. Indeed it has reached levels where some people think it has become socially divisive. A good report on this has been produced by the High Pay Commission (see http://highpaycommission.co.uk/).

So far as shareholders are concerned, their main concern is that the pay of directors can actually reach the point where it reduces the returns to shareholders – for example by reducing the available cash distributable via dividends, or diluting their share interest by excessive grant of "free" or low cost shares via LTIPs or via share options. In addition, if pay at the top of a company rises, then it does tend to have some impact on the pay of senior management generally (even if not at the bottom of the company) which can divert profits to employees as opposed to shareholders. Or shareholders might believe that a very wide disparity in pay within an organization can undermine social coherence – it encourages employees to think that the senior management are solely motivated by their own personal financial interests rather than the good of the company as a whole. Indeed some directors can obtain so much wealth via remuneration in so few years, that they might be assumed to be motivated to take a very short term view of a business whereas other employees and shareholders have longer term interests.

Why has director pay been increasing so rapidly in the last few years? One reason is the problem already covered where shareholders have lost influence over the board. Pay is now set by a Remuneration board sub-committee, after they have typically taken advice from remuneration consultants. They have little motivation to reduce recommendations and boards tend to take the view that they should all be in the top quartile of comparator companies – so as to enable them to attract the best people. As a result there has been repeated "leap-frogging" of pay levels, or as one writer recently called it – a "trickle-up effect".

Annual General Meeting resolutions to approve Remuneration Reports were introduced a few years ago in the UK to try and establish some control over pay, but to little effect. Such resolutions are only advisory and are voted on in retrospect (which is rather equivalent to shutting the stable door after the horse has bolted). Despite the sharp growth in total pay, very few such Resolutions are voted down. Perhaps that's not surprising because in the case of major institutions, the board will know who voted against such a Resolution and that might lead to a significant freezing in the relationship between the board and that investor (for example access to the board by the institution might become more restricted).

"There are good reasons why Remuneration Sub-Committees do not work to control pay".

Of course there are good reasons why Remuneration Sub-Committees do not work to control pay (Ruth Bender of Cranfield Business School has written widely on this subject if you want more background including a very revealing paper entitled "The Platonic Remuneration Committee" available on the internet). One problem is that such sub-committees now have members who are directors and whose pay tends to reflect the pay of other directors. So it is hardly in their own personal interests to exert downward pressure on pay levels. In addition, as their retention as a director tends to depend on the views of their fellow directors, they will hardly want to stand out against the views of other directors on what the latter's pay should be.

A Shareholder Committee would simply act in the same way as the existing board Remuneration Sub-Committee. In other words, it would take advice from the board and from Remuneration Consultants before putting recommendations to the board (and subsequently to the AGM perhaps). In might be possible therefore to enable a Remuneration Resolution that defined future pay to the AGM, but clearly there would need to be the ability to change remuneration, or to set it for new appointments, during the year. Moving pay determination into a independent forum such as a Shareholder Committee is not the only change that might be required to bring pay under control, but it would certainly be a major step in the right direction.

One difficulty at present is the complexity of pay arrangements such that the total remuneration package, and how it relates to levels in other companies, can be very difficult to both determine and to comprehend. This might have to be solved in other ways.

How They Might Work and Why They are Needed – Auditor Appointments

A Shareholder Committee could also recommend the appointment of auditors and their remuneration. The role of auditors has come under scrutiny of late because of their failings to identify significant accounting abuses, particularly in the USA which led to onerous legislation being introduced. However their role in the UK banking crisis has also been criticized for allowing banks to operate with apparent imprudent levels of reserves, to produce accounts which most people had difficulty in understanding and failings in their valuation processes on complex financial instruments. In smaller companies (and an example was AIM listed Aero Inventory), there seem to be more basic and quite common failings in the scrutiny of accounts and the reliance on the opinions or statements of directors - which of course is why shareholders and not directors might be best to scrutinize such matters.

The role of auditors in sometimes acting as consultants to companies on non-audit matters has also been questioned (there is a suggestion that such revenue might bias their audit role), and the lack of apparent competition between audit firms and the low level of switching which builds an incestuous relationship between audit firms and their clients has been criticized.

Even more than with Remuneration Resolutions, the impact of the need for shareholders to vote on a Resolution to approve the appointment of auditors has been minimal. It is a very exceptional case where there is any significant vote against the board's recommendation on auditors, and we cannot recall a single instance where such a resolution has been voted down. For example PIRC recommended recently to vote against the appointment of PwC at TUI Travel, for possibly good reason, but the result was only 7% against with 6% abstaining. Introducing an independent body into the audit relationship will surely avoid some of these problems.

However, the discussions about audit matters can take a very technical slant and a Shareholder Committee might not have many financially qualified members on it. We therefore propose that a Shareholder Committee only gets involved in reviewing the work of the Audit function if there are concerns about the financial accounts of a company, or an obvious need to consider a change of Auditor. In other words, there is no proposal to change the role of the board Audit Sub-Committee in essence, but the Shareholder Committee should have the ability to review the work of the board Audit Sub-Committee and the role of the auditors, and recommend a change of Auditor if necessary.

This might enhance the accountability of auditors to shareholders, which has been seriously undermined by the Caparo judgment and other trends in UK audit law. Again though it is important to emphasize that the role of the Shareholder Committee would be advisory on the board and to the shareholders convened in General Meeting.

What Might be the Objections?

Some of the possible objections to Shareholder Committees have already been mentioned above. Such as the impact on the role of company Chairman – it might weaken their position – the difficulties some institutions might have in getting involved and the problem of recruiting competent individuals to become members of such committees. It has been pointed out that those institutions that typically have the largest stakes in UK companies might need to be represented on hundreds of Shareholder Committees, but this would not be essential, unless they had a particular interest in being so represented. What matters is that there are simply sufficient nominees from a broad spread of investors to be representative of them and of their interests.

The issue of recruiting sufficient competent individuals, and resolving conflicts of interest, do not seem impossible of solution to us, and the overall benefits of Shareholder Committees seem to strongly outweigh the possible disadvantages in a reduction in the power of boards and their Chairmen.

Indeed the whole point of these proposals is to slightly adjust the power of shareholders versus the power of boards, where the latter seem to have lost sight of the foundations of shareholder democracy.

The increased fragmentation of shareholdings, the use of nominee accounts (that disenfranchises most private shareholders and generally leads to low voting turn-outs), and the fossilization of Annual General Meetings has put much more power into the hands of board directors then the original limited company legal structure anticipated. Directors now have control over the communication channels to shareholders whereas the latter cannot communicate with one another easily. This needs rectifying by the introduction of new concepts and systems and a Shareholder Committee system would be one aspect that would assist.

Complementary to the Stewardship Code

It could be argued that the engagement of shareholders with companies will be enhanced by the introduction of the UK Stewardship Code (refer to this web page for details: www.frc.org.uk/corporate/investorgovernance.cfm) and that it might be premature to introduce further changes until the impact of that Code has become obvious. However there are two points to make on this:

We see the Stewardship Code as complementary to the use of Shareholder Committees. The Stewardship Code is designed to encourage institutional investors to monitor companies in which they invest, to use their votes, to act collectively with other investors when necessary and more generally "engage" with company management. But without the presence of a Shareholder Committee, the extent of influence any investor might have is quite limited.

Certainly on matters of board appointments and pay, even if investors are adhering to the Stewardship Code, it does not mean that companies will be paying attention. In addition of course the Stewardship Code does not provide for any real engagement by private shareholders or smaller institutional investors as there is no obvious "platform" to enable their engagement with company management.

In reality, a Shareholder Committee would support the role of the Stewardship Code in improving the engagement of shareholders with the companies in which they invest.

What Should be Done to Implement Shareholder Committees?

Any company could adopt a Shareholder Committee tomorrow if they so wished. A board of directors can take advice from anyone they choose including a committee of shareholders. But a large public company might not wish to do so without wider support for this approach – for example the presence of board sub-committees for nominations and remuneration is part of the Combined Code so removing them instantly would be problematic.

So it requires a lead from the Government or from standards bodies such as the FRC (and the FSA who have responsibility for the Listing Rules which reference the Combined Code). Alternatively it could potentially be imposed by a Resolution from shareholders - Company Law enables any shareholder to requisition such resolutions if they can garner sufficient votes.

Note that the board of directors would continue, as at present in UK Company Law, to prepare the required Resolutions to put to General Meetings of a company, based on the recommendations of the Shareholder Committee. Therefore they would of course need to support those recommendations – but this could be made an obligation under the Combined Code. We would certainly recommend that it be introduced gradually as a requirement so that experience could be obtained before it was widely introduced, and so that good practice for the role and membership of such Shareholder Committees could be established.

Note that we have not attempted to cover all the details of how Shareholder Committees would operate in this document. For example, how members would be selected, whether they were paid, whether they would report formally to shareholders or the board, and many other aspects. It would be best to establish such matters by debate among shareholders and companies so as to ensure a good practical system was established and to counter problems or objections that any parties can foresee.

A working group to establish some recommendations under the auspices of one of the bodies mentioned above would be one approach to take matters forward. But we also suggest that a wider political consultation on this matter be undertaken. The role of public companies, and the way they are governed is of wide interest not just to the financial community but also to the general public. Most people are employed by limited companies of which most are listed public ones, and pensioners are largely dependent on the wealth that such companies generate.

In Conclusion

We hope that you have read this document with an open mind and can see the advantage that a Shareholder Committee might bring in improving the oversight of a public company. We see it enabling companies and their shareholders to move from a confrontational approach to a more consultative one, with less need for public disputes and quicker resolution of issues as a result.

Some companies have suffered from damaging boardroom battles when trying to change underperforming CEOs or Chairman (Marks & Spencer was an example). A Shareholder Committee could assist the directors of a company and their Chairman as such a Committee would provide a good and independent "sounding board" on a lot of matters. In addition it would enable a sharing of responsibility and a wider consensus to be easily achieved on the basic matters of board appointments, board remuneration and auditor appointment.

"It would enable a wider consensus to be easily achieved on the basic matters of board appointments, board remuneration and auditor appointment."

But if you think we have overlooked anything in these proposals then please let us know. Likewise if you have any questions then please contact us.

Send an email to **sharesoc@btconnect.com** if you wish to contact us on this matter or contact us via post or telephone (see the last page for contact details).

About the UK Individual Shareholders Society (ShareSoc)

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