Andrew Moss
Group Chief Executive

Adam Gray
Long-term Focus Consultation
Corporate Law and Governance
Department for Business, Innovation and Skills
1 Victoria Street
London
SW1H 0ET

clgconsultations@bis.gsi.gov.uk

Dear Adam,

As the largest insurer in the UK, and the owner of Aviva Investors a global asset management business, Aviva welcomes the opportunity to respond to this call for evidence.

Given Aviva's size - 53 million customers worldwide with approximately 19 million within the UK – and our combined role as the owner of, and, investor of the capital, I trust that our insight will prove helpful to you in furthering your policy development in this area.

Our submission highlights a number of observations by Aviva Investors of misaligned incentives throughout the supply chain which may require further analysis, as well as indicating areas of good practice or recent policies that should be kept under review. In general we believe that:

- One of the causes of short-termism is a lack of certainty about the stability of the regulatory and tax framework within which investors and companies work.
- The tax system should be used to encourage longer-term equity investment above short-term ownership. Given the international nature of such investments, due consideration would need to be given to the impact on UK competitiveness.
- There needs to be stricter adherence by both remuneration committees and investors to the key principle in the UK Corporate Governance Code of paying "no more than is necessary", and we would recommend that the Remuneration Committee's Code of Best Practice is kept under review.
- The capital markets should better integrate sustainable development to ensure that capital is more efficiently allocated and therefore not cost investors and society more in the long run.

I have attached for your reference Aviva's responses to recent related consultations:

- The European Commission's Green Paper "Audit Policy: Lessons from the crisis".
- The European Commission's Green Paper on Corporate Governance in financial institutions.

I or my team would be happy to discuss any of the issues raised within our consultation in more detail.

Best Regards

Andrew Moss
Group Chief Executive
Aviva

Aviva's Response

A Long-term Focus for Corporate Britain – call for evidence

1. Aviva is the UK's largest insurer, a leading pan-European insurance group with approaching 53 million customers worldwide (19.2 million in the UK), sixth largest in the world, and owner of a substantial global asset management business – Aviva Investors - with assets under management in excess of £370 billion. Aviva Investors own approximately 1.5% of the UK FTSE all-share index. As such we are able to speak as both the owner of, and, investor of capital in the market.

2. The issues being addressed in this paper are very wide ranging, inter-linked and very embedded in the way the capital markets work. Trust in business, banks, investment, regulators and Government has taken a severe knock and there is no better time to consider how we can restore trust in the capital markets.

3. Conflicts of interest abound within the investment chain and these need to be properly managed. It will be a challenge to Government to change a culture that has been and continues to be so profitable for so many participants for so long. However, we believe this is also an opportunity to think imaginatively, which may result in positive changes to the way the capital markets work.

4. On the other hand, and as stressed in the consultation paper, the UK has benefited greatly from open, free and well-functioning capital markets. There are many aspects of the way the markets are managed that are efficient and fair. We need to be careful not to remove the positive aspects of markets by allowing unrealistic ideals to override what is already good.

5. Although this is a UK consultation we also need to be aware that the UK is very linked to the EU and the rest of the world and we are a leading financial centre. UK governance arrangements are very different but considered one of the best in the world. Although there may be areas of constructive criticism in this document, we do not intend to give the impression that the UK model is totally tarnished. In fact, there are many areas of UK practice which we believe should be replicated elsewhere, and make just such a case to the EU Commission.

6. We need to find a pragmatic balance that allows the free functioning of markets but introduces incentives that direct behaviour towards a responsible longer term approach where appropriate. Where this balance finally rests is the job of Government who provide the incentives for behaviour through regulation and legislation. As Andrew Haldane says in his paper Patience and Finance "For countries which have already liberalised, the choice is how to promote patience while harnessing impatience. These are real public policy choices".

7. We see this call for evidence as the first step towards greater consideration, in depth, of the issues raised. In order to address the objectives of the consultation, we aim to keep our response simple and highlight areas we believe incentivise market participants to take the shorter term view to the detriment of a longer term outlook. Some short term practices and products can be positive for the market in that they provide liquidity and improve market efficiency. Where we can, we will give a view as to whether these incentives are good or unhelpful for the capital markets and whether they promote efficient allocation of capital and the long term sustainability of UK companies. Where we can, we will propose possible actions that may be taken.

8. Without taking a view on what is long term and what is short term, we believe that the capital markets are certainly much more short term than they were 10 years ago. It is our view that the pendulum has swung too far towards the short term and that the capital markets are not operating, in all cases, at optimal efficiency and effectiveness. Tellingly, a Chartered Financial Analyst (CFA) study of more than 400 executives carried out in 2005 confirmed that 80% would resist spending on R&D and reduce capital expenditure in order to meet quarterly earnings expectations. At the same time, from an investment perspective, our fund managers say that, given the opportunity,

they would invest for a longer period than they currently do. This indicates to us that there needs to be a rebalancing of priorities back towards incentives for investing for the longer term.

9. In summary, Aviva Investors has concerns over the structure of the capital markets which does not encourage fund managers to take a longer term view on their investments and which, in turn, may lead companies to shorten their strategic horizons. We believe there may be some misaligned incentives in some labour markets which could lead to behaviours which act against taking a long term view. Whilst some short term products usefully facilitate capital allocations and hedging of risks, there have been developments in the market place over the last decade which, we believe, lead to inefficient allocation of capital, such that deserving companies which produce physical goods and services to the general public are denied the financing they need because money is being diverted towards investment products that, in the main, benefit only intermediaries in the investment chain.

10. There are some "quick fixes" that may be available. However, in terms of possible Government action, we would like to stress that whatever changes are made should also be considered on a long term basis so there is stability of policy. One of the causes of short-termism is lack of certainty about the stability of the regulatory and tax framework within which investors and companies work. Such risk raises the cost of equity which is not in companies' or shareholders' interests. The Government should set out its principles on how it wishes the capital markets to behave, introduce best practice guidelines, regulations and, if necessary, legislation to incentivise desired behaviours. Government should work with the European Commission to ensure that a similar consistent long-term approach is embedded in policy development both domestically and internationally.

11. There are some areas for change which, whilst desirable, would be best introduced only if there is international agreement to act together so as not to jeopardise UK's position as a leading financial centre.

The Board of Directors

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

12. Aviva's view is that firms that have products which take a long time to develop and sell, such as pharmaceutical companies, have a long term strategy through necessity. For others, like technology companies there is a shorter lead time, more competition given low barriers to entry and products become obsolete sooner. Therefore, for some sectors, their time horizons are naturally shorter.

13. Aviva consists of a long-term life, pensions, savings, healthcare and general insurance business, alongside an asset management arm. As such, the very nature of our business is long-term focused. For example, our customers are directly affected by the impact of climate change in the form of extreme weather events which are growing in frequency, and the impact of medical advances, longevity and investments returns on life protection, retirement savings and annuity rates, and so require a business operation that is focused over a lifetime. We therefore understandably have a long-term focus throughout our operations and at all levels – most notably at the Board level.

14. All companies require sufficient capital to continue to develop their products so they can continue to regenerate and thrive, continue to be innovative and beat the competition. Companies can understandably therefore be very influenced by the short term pressures of the capital market despite the duty of directors as stated in section 172 of the Companies Act 2006 that they should

> "promote the success of the company for the benefit of its members as a whole, and in doing so have regard (amongst other matters) to (1) the likely consequences of any decision in the long term…."

15. Whilst we believe the duty is sufficient, the incentives within the board and in the market place mean that both directors and shareholders can be pressurised to take the short term view in practice. In particular, we would highlight the following pressures.

16. **Quarterly reporting.** Independent research from around the world shows that an increasing number of investors are becoming more focused on shorter term holdings and returns. This tends to lead to increased share price volatility across the insurance sector. This increasing short-termism needs to be carefully balanced with the need for companies' to have long term strategic plans to deliver value creation and growth.

17. Quarterly reporting is required by our investors and we are happy to provide them with this frequency of disclosure and insight into our business, again balancing the desire for the short term news flow against the longer term strategic direction and delivery. At the same time there is a strong demand for ad hoc updates to provide a more detailed insight into the business, to increase the transparency of our financials and to promote understanding of our business and business strategy.

18. Aviva Investors would support and encourage companies who decided to forego quarterly reporting, and Aviva plc would likewise give such a change consideration if desired by our investors. In the meantime. Aviva PLC hosts regular analysts days in which we seek to engage in an open, frank and honest fashion.

19. **Pressure from shareholders for short term results**: For various reasons (see answers to question 7), the market is such that investors often seek short term improvements in share price. This can in turn be a pressure on companies. If a company has a high proportion of long term shareholders it is more able to take long term decisions. If, on the other hand, their investors are largely short term then it is more difficult. This is why there needs to be greater incentive in the market to take a longer term view so that there is a greater concentration of shareholders who will invest for the longer term.

20. **CEO tenure**: Booz & Company's 10th annual survey in 2010 founds that CEOs now need to deliver more and faster. In the past decade, boards have shaved nearly two years off the average CEO's tenure from 8.1 years to 6.3 years.

21. Companies that think beyond current CEO and other executive tenures reflect a longer term approach that is more attuned to long term leadership risk than those that do not have suitable arrangements. Companies should ensure good succession planning arrangements and shareholders should require evidence of good succession planning processes.

22. **Short term remuneration**: Within the boardroom, the opportunity to make a large amount of money in a short time also contributes to boards looking at shorter time horizons. Directors' incentive plans are generally made up of annual bonuses and long term incentives that are generally no longer than three years. It is understandable that directors' horizons may fall within this time span. The balance of short term and long term incentives may benefit from more focus on the longer term. Regulatory changes for financial institutions now require more deferral of incentives and clawback arrangements. We believe it would be helpful for both these developments to apply to all sectors (more under the section on remuneration). Given business cycles vary and may extend beyond 3 years, consideration needs to be given to ensuring incentives are structured to reflect this.

2. Does the legal framework sufficiently allow the boards of listed companies to access full and up-to-date information on the beneficial ownership of company shares?

23. We believe that the current framework for shareholding disclosure to companies (Companies Act. 2006 s.793) is broadly adequate in terms of direct share ownership - this provides a mechanism through which companies can seek disclosure of underlying investors. Any more onerous

requirement on investors during normal circumstances would create significant costs with very little benefit. However, we do consider that there could be improvements made in the disclosure regime relating to equity derivatives such as Contracts for Difference (CFD). It is important for companies to understand who has the underlying economic interest, rather than merely just the legal entitlement. This is especially so when the global derivatives market is in the region of US$ 658.2 trillion (source: BIS semi-annual derivative statistics December 2010. Data as at 30 June 2010) and the global equities market is in the region of US$32 trillion. Disclosure is currently being considered at the European level under the Transparency Directive framework, and we urge the Government to take an active part in this debate.

24. We believe that there would be significant value for both companies and investors for the equivalent of the s.793 framework to be introduced at a European level, and would urge the government to push for this.

Shareholders and their role in equity markets

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

25. There has been substantial change in the nature of share ownership in the last 20 years. As noted in the consultation document, this has included a relative decline in the percentage of the market held by UK institutional investors, and a corresponding rise in overseas and other investors. There has also been a further change, with the rise of alternative equity instruments, such as Contracts for Difference. Such instruments allow market participants to hold an economic interest in the underlying share without the need actually to own it.

26. As the UK framework is based on comply-or-explain under the FRC's Corporate Governance Code, relying on the influence of shareholders to hold management accountable, this decline in UK share ownership has a number of implications.

27. **UK shareholders are less influential**: Long term UK shareholders, insurance companies and pension funds now only hold 13.4% and 12.8% of UK companies respectively, the lowest level since 1975 (ONS data). However, if unit trust holdings are included the level of UK shareholders in UK companies climbs to approximately 40%. However, unit trust unit-holders are often denied the opportunity to vote which can be another problem in itself. It is therefore important that the managers of unit trusts apply good governance practices (as per the Stewardship Code) to their investments.

28. **Governance standards may fall:** The standards that are expected of companies may vary according to where the bulk of the company's shareholders are and the prevailing culture of shareholder activism. Britain is among those countries with very high standards of corporate governance and therefore the declining level of UK shareholders in UK companies could lead to a deterioration of standards both in terms of company practices and also in terms of shareholders requiring explanations and disclosures.

29. For the UK governance system to continue to be effective, we must consider ways to sustain and increase the UK traditional investor base and also encourage overseas and other shareholders to embrace consistent good governance standards. This can be done most effectively in two ways. Firstly, by drawing together the existing shareholders through a common set of values and secondly, by rebuilding the traditional UK shareholder base.

30. The UK's Financial Reporting Council (FRC) Stewardship Code is a potentially effective way to draw together existing market participants, including overseas investors, around a common set of principles. Since it became effective on the 30th September 2010, the Stewardship Code has already had over 100 institutions and other organisations, some from overseas, signing up to or offering their support to the principles it espouses. We consider this to be an encouraging start that shows the genuine commitment of investors both in the UK and overseas to a responsible

long-term focus. The Stewardship Code should now be allowed to bed in, and best practice should be allowed to develop against a stable background. BIS should have ongoing communications with the FRC to ensure that the Stewardship Code is achieving its purpose and to make amendments as necessary to encourage more shareholders to commit to the Code and to maximise its impact.

31. **It is harder for investors to collaborate**: Fragmentation of the shareholder base also makes it more difficult for shareholders to collaborate as encouraged by the Stewardship Code. This is for purely practical reasons such as the distances and time differences, Many overseas shareholders, particularly in the US and Germany, are also very cautious about falling foul of concert party rules. It would be helpful if there was better understanding of these rules as they apply to different jurisdictions and for regulators to state, more explicitly, what does or does not constitute a concert party.

32. **Power of proxy voting agencies**: It should also be noted that investors are under pressure globally to vote their shares. Many investors, particularly in the US, have responded to this pressure by appointing proxy voting services either to provide advice on resolutions tabled at the AGM or to vote on their behalf. This has led to proxy voting agencies having considerable power to either influence or control a substantial portion of the market at shareholder meetings. This obviously affects voting decisions at UK AGMs as UK companies' shareholder base becomes more international. The voting recommendations of voting agencies are based on best practice, but cannot take sufficient account of individual circumstances. In some instances, this creates a box-ticking approach to corporate governance. This situation could be improved if proxy voting agencies were to explain their processes and explain the rationale for their voting decisions.

33. **Rise of alternative equity instruments**: We would also highlight other changes in the UK (and global) equity markets through the rise of alternative equity instruments, such as Contracts for Difference. Such instruments allow market participants to hold an economic interest in the underlying share without the need actually to hold it. Whilst there is value in derivatives as a way to hedge risk, too often these are used as an instrument of short-termism, including creating or benefiting from volatility, or as a way to have exposure to benefits of equity ownership without the associated costs, including tax, and responsibilities, such as voting. If the desire is to increase equity participation in the markets then there needs to be a more level playing field in the cost of trading and holding equities compared to derivatives and other asset classes.

Reasons for the low level of holdings in UK equities

34. The relative decline of traditional UK institutional investors' holdings in the market is in part a function of globalisation as recognized in the consultation. However, it is also a result of a trend in tax, regulatory, accounting and solvency requirements that has discouraged the traditional institutional investors to hold equity.

35. **Tax:** Currently the tax regime is formulated in a way that discourages the ownership of equity by investors and the financing of business by equity. The existence of stamp duty on shares and the repeal of dividend credit are two examples of the tax system discouraging the ownership of shares (while at the same time debt interest repayments attract tax relief). This is an example of how companies have been encouraged to use debt rather than equity to finance their activities. This has in part caused many companies to leverage up their balance sheets, which, as we know, had severe consequences for some during the financial crisis, as they found access to debt financing cut off, or were unable to meet interest repayments. We consider that thought should be given to how there can be a more level playing field for equity.

36. **IAS 19:** It has not helped that pension funds are beholden to IAS19 which requires assets to be marked to market annually and any resulting scheme deficit to be reflected in the sponsoring company's balance sheet. As sponsors want to take volatility out of their accounts, pension scheme trustees have been encouraged to sell out of equities and move into liability-matching bonds. This has not served pension funds well, in that they crystallise their deficits and lose out

on the potential long term value and stable dividend income streams that are typically delivered by equity investments.

37. **Solvency Capital requirements**: There is an understandable desire by governments and regulators to ensure that pension funds and insurance companies have sufficient means to meet their liabilities. This has led to ever more stringent requirements regarding the forms of assets they are able to use to back their liabilities. This has resulted in a move away from equity as an asset class, as the regulatory, solvency and accounting requirements have considered equities to be too volatile and uncertain. These regulatory barriers have included prudential regulation that has driven insurers into short-dated government bonds in order to reduce risks. As a consequence traditional long-term investors have sold equities and their overall level of holdings across the market has reduced.

38. This problem may be further exacerbated by forthcoming regulatory initiatives such as Solvency II, which will make it even harder for insurance companies to hold equities to back their liabilities even when such liabilities are long term and potentially well related to long term equity investments. In addition, a particularly concerning potential unintended consequence of Solvency II is that long dated corporate debt is likely to be penalised more heavily from a capital charge perspective than shorter dated. Not only could this exacerbate the asset/liability mismatch on insurers balance sheets, but it could also quite feasibly increase the cost of capital to those corporates, such as utilities, that raise debt finance at the longer end of the credit curve to such punitive levels that they are forced to either raise shorter dated debt, thereby leaving themselves open to reinvestment risk when they refinance, or else simply cut back on longer term business investment spending. This, in turn, could weaken the nascent economic recovery, which in the UK at least has started to be built upon an upturn in business investment spending, but perhaps more disconcertedly, could result in shorter business cycles and more recessions. Furthermore, this has potential implications for government initiatives such as the Green Investment Bank, which Aviva and the insurance industry more widely are very supportive of.

39. **Pro-cyclicality of solvency requirements:** Not only do solvency requirements result in lowering the percentage of equities held but they also necessitate the selling of equities into falling markets, thus exacerbating the problem of lack of capital even further by not being able to time the sales to the fund's best advantage.

4. What are the most effective forms of engagement?

40. There are different forms of engagement starting with telephone calls, to emails and letters to face to face engagement and ultimately the vote at shareholder meetings (which we will deal with under question 6). In the main, telephone calls, emails and letters suffice. However, on occasions, where there are more serious concerns, a face to face meeting is usually the most productive approach. The important thing is for investors to inform the company of their concerns so that boards are able to consider and act upon shareholder concerns.

41. How face to face engagement is conducted depends on the aim, nature and subject of that engagement. It will also be affected by the investment style of the shareholder. For example, at times it is effective to engage directly with the management regarding a specific commercial issue. On other occasions, it is best to engage with the non-executive directors of the company, for example regarding remuneration or audit issues where the management may be conflicted. Similarly, it may sometimes be best to seek extensive dialogue, whilst at others it may be more appropriate or necessary to vote at the General Meeting or indeed sell the shares. The nature of engagement may also be a result of the investment style or mandate of the manager.

42. Each situation requires a different form of engagement with different people. The best meetings happen when both parties are well prepared and where both are working towards common goals. Collaborative meetings can be very helpful where no one shareholder has a sufficiently strong voice to influence the company but where, as a group, they represent a significant force.

43. In Aviva Investors experience, often the most effective engagement takes place in private. Companies are more likely to be frank and open with shareholders if they are confident that the discussions will not be made public. Quality dialogue and engagement by its very nature involves careful negotiations and does not benefit from publicity. Some engagements deal with very sensitive issues regarding strategy and sometimes involving people. In some cases, the information may be price sensitive so we are unable to disclose what was discussed until the discussions are completed and made public by the company. Therefore, it is important that the effectiveness of engagement is not measured by the publicity it generates or the outside attention it receives. Just because it is not apparent does not mean that it is not happening. ,.

44. All these styles and methods are equally valid dependent on the issues, circumstances and interests of the client. Therefore we do not believe there is any need to prescribe one form of engagement as being better or more valid than another. It is down to companies and their shareholders to decide how best to engage, according to circumstances.

5. Is there sufficient dialogue within investment firms between managers with different functions (i.e. corporate governance and investment teams)?

45. At Aviva Investors, those who engage with companies, the fund management, governance and SRI teams, all sit close to each other on the same floor. We are co-located and work closely together. Voting decisions, especially where we have concerns, are made with the fund manager or analyst with most exposure to the company. The SRI and Governance specialists often attend meetings with their mainstream fund management colleagues and vice versa.

46. However, we often hear from companies that other investor functions do not work together, and that they hear from fund managers that they are happy with the resolutions at shareholder meeting only for the investment firm to subsequently vote against them.

47. There are a number of reasons for this, not all of which indicate that there is a failure of communication within the investment firm (although this is possible), but rather a lack of understanding by companies on how some asset managers have to follow client's instructions and not those of their fund managers.

48. Also, where voting is outsourced, e.g. to proxy voting agencies, voting decisions are made without the fund manager's involvement. In fact, asset managers in the US can feel more comfortable not interfering with voting decisions because this may represent a conflict of interest for which they may be sued. This is why many US investors use proxy voting agencies such as ISS to do the voting for them which will result in a dislocation between investment decision making and voting at shareholder meetings.

49. Each individual fund management company will be organised according to their business model and investment style. Asset managers that commit to the Stewardship Code should disclose how decisions are made so companies are aware of how they work. Aviva Investors has publicly set out its Stewardship Policy against the Code's seven principles and intends to have its stewardship approach externally reviewed and verified under the relevant assurance standards that are currently being developed.

6. How important is voting as a form of engagement? What are the benefits and costs of institutional shareholders and fund managers disclosing publically how they have voted?

50. Voting is a crucial part of engagement. At the end of the day, it is voting power that is the backbone of shareholder influence. Whilst the majority of votes are routine and uncontroversial, it is the knowledge that shareholders can remove and appoint directors or vote against resolutions that will keep boards aware and alert to shareholders interests. Voting results in themselves are not necessarily a good indication of the quality or quantity of engagement.

51. It is in companies' interest to raise the level of shareholder voting and keep communication lines open long term with loyal shareholders in order to prevent holders whose interests are not aligned with the long term interests of the company from taking advantage of low voting turnouts to overturn a vote. With voting turnout in the region of 65% in the UK, shareholders with just over 30% of the shares have a good chance of succeeding in influencing the result of votes. This is a vulnerability that companies should be aware of.

52. However, we would not favour compulsory voting. There are significant dangers in doing this and potential unintended consequences. We would point to the experience in the US of the Employee Retirement Income Security Act, which resulted in pension funds being required to vote shares as part of their fiduciary duty. This did not improve the level of engagement, but merely caused the funds to outsource this activity as it was seen as a compliance cost rather than a way to add value to investment. This potentially increases "box-ticking" voting and the power of the proxy voting agencies rather than of long term shareholders. Another unintended consequence of mandatory voting is that may lead to thoughtless support for boards which would dilute more thoughtful voting.

53. The issue of the value of voting disclosure has long been discussed, and for a number of years a number of major UK institutional investors have voluntarily disclosed information on how they have voted. Indeed, the FRC Stewardship Code advocates that signatories disclose their voting. Aviva Investors publicly discloses its voting decisions, but to date we have had little interest in this from the public and whilst we are happy to disclose we do not believe it is currently a significant factor in accountability.

54. It is easier and cheaper for some investors to publicly disclose their votes. For example, those with fewer clients would find it cheaper (because there are fewer client votes and funds on which to disclose) and easier (because there are a manageable number of funds to monitor).

55. Furthermore, investment managers may find that they, on occasions, vote holdings differently according to the multiple funds with different investment aims and client instructions. If disclosure is required in aggregate, this can lead to strange disclosures (in that an investor will have voted several ways on a single resolution). A similar problem arises with the disclosures of clients e.g. pension funds, who may have a number of asset managers who may not vote in the same way.

56. Due to public lack of interest, we believe that compulsory disclosure of voting may not in all cases be money well spent. This is particularly so as clients of asset managers can, if they choose, have full information on voting and engagement activity. We believe the more important issue is the lack of interest by some clients rather than a lack of public interest and focus should be placed on how to develop client interest. We do not believe public disclosure of votes is currently of significant value on its own.

57. There is also the risk for single issue organisations to put pressure on investors to vote in a particular way or to criticise investors for their voting decisions. This has not yet happened to a significant extent but remains a possibility that needs to be treated seriously.

58. On the other hand, public disclosure of votes will help to identify the asset managers that make considered votes and are not afraid of voting against management when justified.

59. It is important that retail investors have access to the voting that is carried out on their behalf. If it is found that this is not the case, then there is justification for mandatory, public disclosure of votes.

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

60. Some of the issues relating to short-termism have been covered already. However, a distinction needs to be made between the short-term behaviour in boardrooms and behaviours in the equity markets. We therefore consider that there are a number of further issues that deserve consideration. These include the structure of the market, the role of the intermediaries and advisors, and the role of clients and their advisors.

61. Short termism may in part be driven by analysts' short term earnings forecasts. Share prices are driven by known information and the more often information is fed into the market the more adjustment to share price happens. However, earnings misses can happen for reasons that do not have a significant impact on the long term profitability of the company but the damage done to a company's reputation for missing its earnings target takes a long time to recover. In addition, there is evidence that analysts often get their earnings predictions wrong and it can take up to three consecutive quarters for them to change their earnings forecasts by which time the damage to the company is done. (see paragraph 14).

62. **Quarterly reporting.** As we suggested earlier, long-termism would be improved if companies were able to better balance the desire for the short term news flow against longer term strategic direction and delivery. There is a strong demand for ad hoc updates to provide a more detailed insight into the business, to increase the transparency of financials and to promote understanding of businesses and business strategy. Therefore Aviva Investors would support and encourage companies to forego quarterly reporting as such a move would reduce the financial community's dependence on quarterly earnings expectations.

63. **Analysts' research**. Based on examination of sell side research notes, Aviva Investors' view is that it is clear that some analysts focus on short term numbers promoting short term trading as a means to adding value to portfolios, rather than focusing on the long term value of a company's prospects. The notes often do not focus on information that may promote ownership responsibilities (e.g. there is very little on effectiveness on boards and how they are incentivised for the long term). It would be helpful if analysts' training covered governance issues and other longer term risks, such as climate change. Investors should be encouraged to pay analysts for taking a longer term view through awarding broker votes to analysts who provide more holistic information on the prospect of companies.

64. **Short term client mandates**: Although most institutional client mandates tend to run for 3 to 5 years, despite the long term nature of the liabilities institutions face, asset managers know that if they under-perform for a short period within this time they could be replaced. Therefore, some asset managers may take risks to get the required returns over a shorter time frame. Efforts have been made in the past to devise longer term mandates but the need to plug pension scheme deficits has, in recent times, been the greater priority and so aggressive pursuit of short term performance continues. According to National Employment Savings Trust (NEST) chief investment officer, Mark Fawcett, improving companies through corporate governance will remain "a fantasy" until pension trustee's better align their managers' incentives. Speaking at the Organisation for Economic Co-operation and Development - WPC World Pensions and Investments Forum in December 2010, Fawcett suggested that pension scheme trustees are too focused on short term returns by hiring and firing fund managers on a three year cycle, whereas they should be looking at five years as a minimum, maybe ten. Fawcett maintains that "until pension funds start behaving the right way by aligning the incentives for fund managers... the idea that corporate governance is going to make a change is unrealistic." (Source: Professional Pensions, 15 December 2010)

65. Some trustees consider it just as much a risk to award long term mandates as to not remove under-performing fund managers before their mandates are completed. However, as it takes time to discern the extent to which a fund manager's performance is attributable to luck or skill, we consider it often inappropriate for managers to be judged solely on their short term performance. Indeed, over time as luck evens out, skill, where it exists, will shine through. Indeed, a study by Goyal and Wahal in 2008 analysing how 3,400 pension schemes, endowments and foundations hired and fired fund managers between 1994 and 2003, found a tendency to hire managers who

had recently performed well and fire managers who had recently performed badly. The fired managers, on average, subsequently outperformed those hired, albeit marginally, notwithstanding the sizeable transition costs incurred in changing managers.

66. **Investment consultants:** Many pension funds employ investment consultants to advise on investment objectives, asset allocation, investment performance benchmarks and selection of fund managers. All of these functions affect investment horizons and allocation of capital. Trustees have a fiduciary duty to seek advice. If trustees do not take advice they are personally liable so the result is trustees tend to follow the advice of their investment consultants. Therefore, the role of investment consultants, the advice they give to trustees and how they are paid should be part of any investigation into short termism. It is important to know their views (we know many investment consultants do not view corporate governance or environmental and social issues as important or material to investment and investment returns). We should also know what they are incentivised to do through their reward structures and to identify if they are perpetuating the short-termism in the capital markets..

67. **Hugging benchmarks:** The concern over fund managers sticking too closely to benchmarks has grown over the last decade. Fund managers who feel constrained to stick closely to their benchmarks may abandon their best ideas and it may mean investing in companies they do not believe in. This is an understandable response to the need to stay within risk parameters imposed on individual funds and by measuring beta and tracking errors and a fund manager's propensity to take risks. However, the effect of looking at investments relative to a benchmark as opposed to investing in the companies fund managers believe in, and avoiding those they believe will under-perform, means that capital is not directed to companies they believe are the best investments. This is especially the case where the benchmark being tracked is a market cap based index, where the biggest companies are disproportionately large, such as the top 5 within the FTSE 100. Here, most of the capital available for investment will go into the biggest companies in order to more closely track the index.

68. **Measurement of risk:** Perhaps an equally important issue is the way in which funds measure risk. Most calculate risk using risk measurement models based on normal distribution of returns, such as VaR and tracking error, etc which have not worked in many cases. For example, there is an inverse correlation between size and performance relative to the benchmark, that is, the larger the company the less risky it is perceived to be e.g. BP, Vodafone. If the company is deemed to have lower risk than it has then the share price is pushed upwards implying lower cost of capital and vice versa. If risk is mispriced then the cost of capital can also be mispriced benefiting poorer companies and penalising the good.

69. **Index funds:** Index funds are the ultimate in benchmark hugging. Their remit is to track their benchmark as closely as possible. Therefore, the fund managers have no discretion as to which companies they personally believe are good or bad investments, they put money into companies in the index even if they suspect a company is going to fail. This is not efficient allocation of capital.

70. On the other hand, it is the ultimate in long term investing because the funds cannot sell the shares in a company if it is still in the index. There are downsides to this approach too. Should a company leave the index being tracked, investors will sell the company irrespective of the merits of doing so which may not be in the company's interest. Moving in and out of the index is a cause of volatility as the movements cause significant share price movements due solely to forced buying and selling.

71. Because investment decision making in index trackers is purely mechanistic, the fees charged by index tracking funds tend to be much lower than actively managed funds. The fear is that these funds may not be able to fund good ownership activities as per the UK's Stewardship Code. However, in the UK the two largest index tracking companies have strong governance credentials. They vote their stock and engage when appropriate. The problem in the UK therefore is more in

the misallocation of capital than in any inability of index trackers to engage in long term ownership issues.

72. **Increased liquidity and growth of financial innovations.** As noted in the consultation, the last decade has been characterised by increased financial liquidity, falling costs of trading and increased flows of corporate information. All of these are generally seen as having positive effects. However, whilst we agree that these changes have had some positive effects, we believe that consideration needs to be given to their other consequences.

73. Liquidity is necessary and beneficial on the whole. However the massive increase in liquidity has been more to the benefit of the facilitators of liquidity, e.g. the banking intermediaries, rather than the market participants. We come back to the question of what is the right balance. For example MiFID says there should be no monopoly on trading of shares and as a result other recognised exchanges have developed such as dark pools and Electronic Communication Networks. This has created different pools of liquidity. Therefore innovation has fragmented capital pools and liquidity, meaning prices and volumes of trading are less transparent.

74. Over recent decades, trading in the markets has become progressively more short-term oriented, with traders attempting to exploit intraday price trends, market cycles and leverage off product innovation in the capital markets. This speculative trading creates excessive price movements and exacerbates market cycles. These activities impact on a wide range of areas. The Credit Default Swap market was a notable example with an estimated 80% of the $62 trillion outstanding in 2007 being 'naked' (i.e. the related underlying reference security was not held and it was being used for speculative purposes). The ETF market in the US has been both the target of speculative trading (ETF arbitrage is one of the more common types of high frequency trading strategies in the US) and a contributor to it (synthetic and increasingly exotic ETFs are now often derivatives). The effects of this were seen in the problems that banks faced in seeking to raise new capital during the crisis, as well as in the commodity markets, as the concerns over the effect of speculative trading in driving up price and volatility of essential food commodities indicate. A further look into the extent of speculative trading and innovation may be warranted in view of the impact this has on the real economy.

75. The combination of public sector capital spending cuts and capital-strapped banks means less funding was coming into social housing and social infrastructure projects. These organisations have been forced to look elsewhere including approaching pension funds for alternative sources of funding. With over £1 trillion of assets at their disposal allied to long dated liabilities, pension funds are arguably natural providers of capital for long term capital intensive projects such as building hospitals, schools, social housing etc. Attracted by the long term index linked cash flows that are typically backed by a quasi-government covenant and/or are secured against physical assets, potential returns from these long run highly illiquid investments, which currently stand at 200 or so basis points above those available from index linked gilts, enable pension funds to both better match their liabilities and address their deficits. Moreover, by pension funds investing in these projects, the potential long run economic growth rate is potentially enhanced. Therefore, rather than encouraging further growth of synthetic products, the government should focus on how pension funds and other long term investors might be incentivised to commit capital to these projects – likewise the Green Investment Bank offers a similar opportunity.

76. **Volatility:** Increased liquidity, new products and the constant flow of information has led to greater volatility of markets. This has led to a slew of products that are focused on short term trading in an effort to benefit from market timing and bears very little relation to underlying fundamentals This activity again diverts money from the real economy but the effect of such volatility on a company's share price can complicate a company's ability to operate.

77. **Investment banks:** One of the reason why markets appear skewed in favour of innovative new forms of trading may be because governments have, in the past, been too willing to listen to the views and respond to the interests of the intermediaries such as investment bankers, and have not paid sufficient attention to the need and the views of the users of the market, i.e., companies

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and investors. We would therefore urge the government to make sure that in the future, and in particular under the new regulatory architecture, the views and interests of the market users are properly heard and taken account of. The Institutional Shareholder Committee comprising the four investment bodies such as the ABI, NAPF, IMA and AIC, is a good place to start engagement between Government and investors.

78. Intermediaries, such as investment banks, also provide advice to the market users, in particular companies. High quality professional advice can be highly valuable when dealing with complex issues such as mergers and acquisitions or corporate financing. However, consideration should be given to the extent to which the incentives of these advisors are properly aligned to the interests of their clients. Corporate activity, such as M&A, generates large fees for advisors and this in turn may in many cases cause them to be more eager to promote such activity even when it is not in the long-term interest of the company. Similarly, when a merger has been proposed, the advisors' fees may be contingent on the completion of the deal or their fees may be larger if the deal is agreed at a higher price. Such factors may cause the advisor a conflict of interest and affect the independence and impartiality of the advice

79. **IFRS**: Another factor that has played a role in facilitating short-termism in the capital markets is International Financial Reporting Standards (IFRS). IFRS standards are pro-cyclical in nature and played a notable role in facilitating and exacerbating both the dynamic and behaviours that drove the credit bubble and the subsequent crisis. Despite a common assertion of some standard setters, IFRS are not just presentational, they have real world effects, not just for pensions, capital management, behavioural and risk taking, prudent loan loss provisioning and, not least, financial product innovation. The effects and problems have arisen both as a result of how the standards have been implemented and their effects on accounts. Not least, critical concepts like prudence and accounting conservatism have been superseded by a compliance orientated model. Concepts like the 'true and fair view' have also been diluted (this has been addressed now in the UK Companies Act 2006, but this may need to be considered further in light of EU directives and related regulations). IFRS compliance allows significant discretionary scope within fair values. Anecdotal evidence from auditors has highlighted the effects of de-prioritising prudence. It can be argued that Warren Buffet's concerns about mark-to-myth were borne out in the crisis. The standards have also resulted in the Companies Act accounting requirements being obfuscated, e.g. in relation to distributable reserves and dividends. From an investor perspective, a significant proportion of bank capital raising over the crisis actually went to redress precisely the results of that.

80. To avoid a repetition of the credit bubble crisis as well as to ensure that the accounting framework is effective in supporting prudent long-term investment, the UK needs to re-emphasise the principle of prudence as well as ensuring that the unencumbered true and fair view is clearly understood to apply across the EU. In light of the crisis and issues that became apparent during that, there would be merit in a wide ranging review of the standards and standard setting.

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

81. We consider that the best way to encourage a more long-term focus in UK equity investment decisions is to consider the current regulatory and tax issues that may be discouraging this.

82. In a number of other jurisdictions there are systems in place that provide incentives or benefits for holding equities for longer periods. These can include additional voting rights, additional dividends for voting, or extra dividends for those holding shares for a set period. The theory is that longer term holders of equity are more likely to have a long-term focus and that such loyalty should be rewarded.

83. Such systems may be seen as being desirable in terms of promoting a long-term approach. However, their operation, consequences and benefits need to be considered carefully. These

systems tend to operate in markets characterised by block holdings (either family or institutional). They often enable these block-holders either to exercise corporate control in excess of their economic interest, or to reward them at the expense of other holders. This goes against the concept of one-share one-vote and the equal treatment of all holders. It can entrench bad management, lead to excessive rent extractions by one group or groups at the expense of others, and undermine the efficient allocation of capital. We consider that equality in the treatment of shareholders is key to a free and functioning equity market that provides capital at the lowest cost and has an efficient system of corporate control.

84. If there is an appetite for differential treatment between long term and short term investors we would recommend against any action that would compromise the principle of one share one vote but would be open to considering ways of rewarding long term shareholders in other ways. We would welcome changes that used the tax system to encourage longer-term equity investment above short-term ownership – for example through the capital gains tax regime. Given the international nature of such investments, due consideration would need to be given to the impact on UK competitiveness.

85. Setting aside these issues, it is also worth noting that such systems of differential shareholder voting rights are extremely difficult to operate in practice. Our experience in jurisdictions with such systems has shown that, because of complications in the voting and ownership chains, it is extremely difficult for shareholders or companies to determine who is entitled to extra dividends or votes. Given, the dispersed ownership model in the UK, this approach would be even more complicated to operate and provide few benefits to the ordinary shareholder.

86. Other solutions could be to equalize the tax treatment of the various asset classes and derivative instruments so there is a more level playing field – dealing with one asset class should not be more advantageous than another.

87. We could follow the Dodd Frank Bill in the US where proprietary trading by Investment Banks will be curtailed. Proprietary trading by big banks can often drive the market at the expense of long term investors simply by the size of their trading. This causes volatility and raises the implied cost of capital. There are also potential conflicts of interest when an investment bank trades for clients as well as themselves.

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

88. Yes, the investment chain is riddled with conflicts and these need to be suitably resolved see Aviva Investors' response to Stewardship Code consultation - www.frc.org.uk/corporate/stewardship.cfm. These conflicts can make it difficult to establish a longer term outlook and/or better allocation of capital, as each participant in the chain needs to sign up to the benefits. However, that is not to say that nothing can be done. The core function of good corporate governance is to address the agency problem, either by controlling the agent's actions or holding them to account, and by seeking to ensure that the agents' interests are aligned with those of the principal. This is equally true in regard to the relationship between the client/principal (asset owner) and the agent (fund manager) in the investment chain.

89. Under the current regime, the client is free to choose the agent that it feels will best serve its interests and is also free to determine the method of reward that creates the best level of alignment. However, we recognize that there could be improvements made, particularly in relation to transparency.

90. The issue of investor transparency is addressed in the UK FRC's Stewardship Code. This requires that fund managers explain, firstly, if they apply the Code Principles and, if they do so, how this is achieved. Each fund manager that applies the Code is asked to make a statement regarding its approach to stewardship on a comply-or-explain basis. Those adhering to the Code are listed on the FRC website. This transparency allows the asset owners to better understand

the fund managers' approach, to make informed decisions when allocating mandates and to hold fund managers to account for their actions and decisions as appropriate. However, the Stewardship Code will only work if other participants along the chain value good governance and the longer perspective. For example, if pension funds do not promote longer term mandates or sign up to the Stewardship Code, there will be no incentive for asset managers to commit to it either as their primary objective is to satisfy clients. We believe that all institutional investors should be required to disclose on the FRC website whether they commit to the Stewardship Code and if not, why not.

91. Pension funds are required to state in their Statements of Investment Principles (SIP) what their approach is to governance, environmental and social issues, but in reality these responsibilities are delegated to their fund managers and the fund managers are rarely held to account. So, in practice, the clause has made little practical difference. This is because there is nothing in legislation or regulation that compels pension funds to do anything other than make a statement in their SIP. This situation is not helped by investment consultants who do not advise pension funds on how they might include governance and other extra-financial considerations in the way they manage their investments. There needs to be some follow through to encourage pension funds to act as responsible owners such as suggested above, that pension funds disclose on the FRC website their approach to governance, environmental and social issues.

92. Pension funds have, post -crisis, started to review the fees they pay their asset managers in order to find ways to reduce the cost of managing their investments. There is plenty of evidence that over-trading has had a significant negative impact on pension fund returns. Indeed, in a seminal study, Barber and Odean (Journal of Finance 2000) quantify the negative correlation that exists between the excessive trading of stocks and subsequent portfolio returns. Pension funds should therefore look more closely at the level of trading within their funds as well as fees charged by asset managers.

93. Transparency of investment consultants' approaches to advising clients and the way they are paid will help to identify whether there is evidence of short term advice and whether their own remuneration incentivises them to churn fund managers. And lastly, consultants should be asked if they profit more from choosing new managers than pure advice. Pension funds should perhaps consider using consultants that are conflict free – i.e. they only give advice and do not benefit from other activities like being paid to appoint new managers. Consultants should also make their approach available on the FRC website.

94. We believe that in some areas, such as remuneration, it is very unlikely that much will change without regulatory input. For example, it took the actions of regulators in requiring deferral and clawback. We think the current EU focus on disclosure, deferral and clawback is helpful. However, Aviva Investors observation is that for remuneration reform to be effective it also needs to consider how to factor in the level of pay as well as its links with performance. For example, we have seen banks doubling base pay to make up for bonuses because the regulatory approach has focused on bonuses - please see section on remuneration for more information.

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

95. We are unclear about what is meant by the transparency in the role of fund managers, their mandates and their pay. However, we will answer this question as follows:

96. So far as transparency at Aviva Investors is concerned, our general approach to ownership is described in our Stewardship Policy. So far as individual funds are concerned, our role and our fees are clearly discussed and agreed with clients before we are appointed as their fund managers. Different funds will have different arrangements and pay scales. However, we can provide guidance for this paper in the (1) structure of pay for our fund managers and (2) some specific examples of longer term mandates we have with some of our clients.

97. Our fund managers are paid a base salary and a bonus. The bonus is based on performance relative to a benchmark over 1 and 3 years (50% for 1 year's performance and the other 50% is measured over 3 years). We believe this is fairly standard. However, Aviva Investors see merit, in some cases, in extending the spread to 1, 3 and 5 years so, for example, 25% is paid for one year's performance, another 25% for 3 years and 50% for performance measured over 5 years. However, we are aware there may be practical and competitive implications that may need to be addressed and will not be appropriate for all fund managers e.g. where they manage short term funds. We believe this will change fund managers' behaviours towards the longer term. As investors we expect a longer term approach from company management so we should be measured over similarly long terms otherwise the incentives would be misaligned and the market will have investors pressing for quick returns.

98. Whilst no one fund manager organisation is likely to move to this structure voluntarily, if it became the norm in the market then no one house would be disadvantaged.

99. However, even if fund management houses were prepared to go down this route, it is unlikely to happen if the clients of fund managers want short term returns. So for change to happen there must be wider consensus along the investment chain that longer term performance measures are a good thing.

100. Also, there is a case for more transparency in how the fees are distributed. There should be a breakdown on how the fees that clients pay are divided so they know how much is going to the fund manager, how much to sales and how much to general administrative costs. Similarly if the consultant awarding the mandate gets a percentage then this should also be disclosed.

101. The US mutual fund system has upfront fees that are rebated the longer the investors hold the units. This system should be investigated to see if it could be applied in the UK.

102. For some of our clients we have a fee structure that involves lower management fees but higher long term performance fees for mandates of 3 years or longer

Directors' Remuneration

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

103. There has been much debate regarding the causes of the increases in executives' remuneration over the last 10 years or more. There is no simple answer, but rather there appear to be various contributing factors.

104. **Globalisation**: Globalisation has been used as the rationale for pay increases. Highly talented individuals can now move much more freely around companies and the world and this has led to a highly competitive environment for talent, which in turn has led to an increase in remuneration. For example, in the FTSE-20, over half of the companies have a chief executive who is not British by birth. In addition, the UK listed market itself has internationalized, with an ever growing number of companies on the UK market being multi or trans-national in nature.

105. **Size of business**. The consultation paper also notes that the major determinate of pay is the size of the business rather than performance. We agree this has played a role in increasing directors' remuneration and in some cases provides an incentive to grow the company, e.g. perhaps by taking short term M&A action.

106. **Disclosure**: Since the Directors' Remuneration Report Regulation came into force, a view has developed that transparency has contributed to the "arms race in remuneration". A propensity to benchmark against peers leading to an ever spiralling upwards in quantum seems to be the main result of this greater transparency. We believe there is an element of reality to this proposition and that there needs to be stricter adherence by both remuneration committees and

investors to the key principle in the UK Corporate Governance Code of paying “no more than is necessary”. However, we do not believe that transparency on its own is responsible for increases in pay. Other jurisdictions that do not have transparency or have introduced transparency later, such as Switzerland and Spain, also have seen higher levels of remuneration over an extended period.

107. **Shareholders have not acted against quantum.** Although there is transparency, shareholders have not generally acted to constrain pay. Many shareholders believe they are not best placed to determine the level of pay. Whilst quantum was within reasonable bounds, this may have been an acceptable stance to take. However, over the last few years executive pay has increased far faster than pay of other employees and, over time, there have been studies that suggest that there is only a tenuous link to performance. There came a point some years back at Aviva Investors when we decided that we needed to take a formal view on quantum, and we now undertake a balanced comparison of pay taking into account the size of the company, its turnover, the number of employees and its sector. We find the relevant median for the company (ie against the average of the benchmark we use) and apply it to our assessment of the company we are dealing with. If overall pay is above the median, our starting point is to vote against the remuneration report. If we become aware of special circumstances that may lead us to change our view, we may amend our voting decision. In 2010, we voted against remuneration arrangements because of excessive pay at 127 UK companies and abstained at 40.

108. **Role of remuneration consultants:** Aviva Investors believes that there may be incentives, in some cases, for remuneration consultants to compete by erring on the generous side when considering pay arrangements for their clients as executives may be more likely to appoint the consultants that are more generous to them. Aviva Investors is also aware that consultants can come under intense pressure from executives. Where consultants are appointed by remuneration committees, the member non executives may not always provide an attitude of constraint, as they are often executives themselves at other companies. We would recommend that the Remuneration Committee’s Code of Best Practice is kept under review.

109. **Structure of pay arrangements:** When considering remuneration, the structure of the package overall should be looked at, not merely the quantum. There has been a move over the years to a package that is based more on performance, with an ever greater proportion “at risk”. This has been coupled with a significant relative decline in the value of the most long-term element of the package, the pension. The means now for creating a comfortable retirement and building up personal wealth are bonuses and LTIPs, with employee performance being measured over 1 to 3 years, rather than 30. As an example of the extreme end of long-termism, Handelsbanken in Sweden puts the profits of the bank into pensions for staff. The staff do not get big bonuses or incentives but are guaranteed a generous pension. Whilst this may be difficult to implement in the UK, it may be worth considering a shift of the balance towards more valuable pensions vis a vis incentives which may help with retention over a longer term. This does not mean going back to Defined Benefit Schemes which are no longer affordable for many companies but adjusting the balance between pay that is received over the short term and pensions over the longer term.

110. We agree with the key principle within the UK Corporate Governance Code, that of “paying no more than is necessary”. To do otherwise would not be in the company or more importantly the shareholders’ best interests.

111. We further note that executive remuneration is not just an issue in the UK and that UK practices, in comparison with some other countries, are better than other countries in some respects. Remuneration is the subject of discussion, regulation and other initiatives in many other jurisdictions. We should also be mindful that in some areas we already have adopted best practice and that over the last ten years or more there have been some successes. For example:

- In the 1990s, it was common for executives in the UK to have three year rolling contracts and receive compensation for loss of office ("golden parachutes"). This was considered to be unacceptable by shareholders, the authorities and the public at large. The ABI and the NAPF issued its first Joint Statement on Contracts and Severance, stating that one year contracts were the lowest acceptable apart from in exceptional circumstances. As a result one-year contracts are now the norm and directors' severance payments generally do not include compensation for loss of office.

- Similarly, when share options were first introduced they routinely included retesting provisions of performance conditions for up to 7 years after the performance period ended. This did not adequately align pay and performance and, as a result of shareholder pressure, retesting is no longer a feature of UK executive share plans.

112. On the other hand, we note that termination payments, in terms of absolute amounts, have not decreased. Whilst retesting at companies has, by and large, been eradicated, at the same time pay at companies has continued to rise. However, we do believe that in general shareholder vigilance in the UK has prevented some of the more unacceptable or significant arrangements from taking shape.

113. In answer to the second half of the question 11 "What are the main reasons for the increase in directors' remuneration? Are these appropriate?" our view is that we are still struggling to find a clear link between pay and performance. Pay has increased far more than performance has improved. Moreover, as executive pay continues to rise without a close link to performance, this may become even more inappropriate over time. Aviva Investors' view is that the only way for the outcome to be fair vis a vis performance, quantum, relationship with employees, state of the economy, the company's sector etc is for remuneration committees to have significant discretion, around a set of agreed criteria, to take all these matters into account when making awards/making decisions on how much should vest, based on information available at the time of payment.

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

114. The UK Corporate Governance Code requires that the board and its committees should have the appropriate balance of skills, experience, independence and knowledge of the company to enable them to discharge their respective duties and responsibilities effectively. We consider that there is significant benefit in a board and its committees being constituted of individuals from a wide variety of backgrounds, with a diverse range of skills and experience. Further, we believe that, in accordance with the UK Corporate Governance Code requirements, the Remuneration Committee should be made up of independent directors and that they should have due regard to pay and conditions elsewhere in the company. As with many areas of corporate governance, the effectiveness of the Remuneration Committee will be determined by the individuals involved in the decision making, and therefore will vary from company to company. The best way to ensure the effectiveness of boards is through an active and engaged shareholder base and boards engaging in high quality board evaluations.

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

115. Shareholders have various rights and mechanisms to hold companies to account and we consider that these are generally adequate. Shareholders elect and re-elect directors to act as their agents and in their interests. Under the revised UK Corporate Governance Code issued in 2010, best practice is that directors' of FTSE-350 companies must seek annual re-election, thereby strengthening this accountability mechanism. In addition, since 2002, every listed company has been required to submit a remuneration report to their annual general meeting on

an advisory basis. Also, any share based incentive scheme that affects or dilutes their holdings must be approved at a General Meeting.

116. However, despite these rights and mechanisms, we do not believe that shareholders have been wholly effective in holding companies to account over pay. Whilst shareholders may have made some small strides in influencing certain aspects of pay, overall they have been fairly ineffective. Shareholder influence may have had some effect by putting brakes on what may otherwise have been even greater acceleration of pay and the adoption of other pay practices that are apparent elsewhere e.g. in the US.

117. There are a number of reasons for this lack of effectiveness. Globalisation has has been used as the rationale for pay increases and this affects the arrangements put in place in the UK. In addition, shareholder influence is diluted because they respond to pay in different ways – for example, some shareholders will vote against the remuneration report while others may vote against individual directors. Some shareholders believe in engagement but not in voting against management at shareholder meetings, and many do neither. Some shareholders have a view on quantum whilst others do not. Remuneration consultants have added complexity to the arrangements and their advice does not appear to have resulted in significantly better alignment of pay with performance or alignment with shareholders.

118. Shareholders that engage seriously on remuneration spend an inordinate amount of time going through every single detail of pay plans, the results of which are not always clear. We do not believe this is good use of time.

119. What we would like to see is less focus on the technical details and more emphasis placed on outcomes. Disclosure of pay should focus on (1) backward looking information on what performance was achieved and how much was paid for this performance and (2) forward looking information on how proposed performance conditions link to strategy and how much executives will get for meeting their range of targets over specified time periods. It is difficult to avoid tackling some of the detail, but if these two aspects became the focus of votes, investors would have to consider the appropriateness of the amount being paid (because they would have to take a view on amount paid for performance) and also if vested pay turns out to be well above what was expected, then shareholders would have a basis for discussion on quantum and quantum linked to pay. The forward looking statements would hold management accountable in ensuring that performance conditions are indeed challenging.

120. Pay arrangements should also be a lot simpler and easier to understand. We believe we should not consider a binding vote on remuneration until we are sure that voting leads to better remuneration arrangements. Otherwise, if votes were binding, all this would do is to make binding inappropriate outcomes which, for example, may not link pay to performance and may crystallise arrangements that turn out to be too generous.

121. **Golden parachutes**: The ABI's Remuneration Guidelines and Joint Statement on Contracts and Severance statement makes it clear that any payments in excess of the basic contractual entitlement should be kept to a minimum and that the duty of mitigation should be enforced. We believe it is of the highest importance to minimise payment for failure. We know, however, that additional payments often are made, for example, in respect of bonus entitlement. However, this is an area where corporate governance and company law begin to interact with employment law.

122. The relationship between these factors is further complicated by the existence of precedent. In Mallone v BPB Industries plc [2002] the courts recognized that if an employee had a reasonable expectation of even a discretionary bonus and this was not paid then, by not paying it, the employer was in breach of contract. Although the Court of Appeal said that the appropriate test should relate to what could be expected of a 'reasonable employer', this created uncertainty regarding how this would be applied on a case by case basis. In Horkulak v Cantor Fitzgerald [2004], the Court of Appeal stated that the employer must not exercise its

discretion in relationship to the amount payable 'capriciously or irrationally'. This further adds to the difficulty relating to the amount that should be paid. Finally. although in Keen v Commerzbank AG [2006] it was decided that in cases where there was a high degree of discretion in relation to bonus levels, such as Investment Banking, the employer should retain the discretion to award lower amounts. It is difficult to see how this would be applied at executive level in listed companies where bonuses are generally paid against clearly defined objective targets (rather than a high degree of discretion). Further investigation needs to be undertaken on how contracts can be written to allow flexibility where golden parachutes may be inappropriate.

123. Ironically (in view of the questions on takeovers later in this paper), proponents of golden parachutes argue that they make it easier to hire and retain executives, help executives to remain objective during a takeover process, and may act as a poison pill by increasing the cost of takeovers. However, we believe that, in general in the UK, severance payments are not sufficiently large to act as poison pills.

124. However, shareholders have had some success in relation to pay-offs in the event of change in control whereby best practice now is to pro-rate the amount that is awarded according to how much of the performance period has elapsed e.g. if the executive leaves one year into a three year performance period they get a pro-rated payout and secondly, that payment should only reflect performance to date.

125. The growing incidence of large recruitment packages is an issue which requires further consideration. The practice of buying out the previous arrangements of new appointees has become common practice. However, these payments have the effect of crystallising bonuses, options and incentives that have been awarded at an executive's previous employment. In addition to ratcheting up pay, recruitment payments serve to perpetuate shorter term outlooks and executives may be incentivised to move on. They may also promote a culture of "buying in" executives rather than incentivise long term succession planning. As stated earlier in this response, the UK has gone against the global trend of appointing insiders and has instead significantly increased the incidence of external appointments, which is not always optimal.,. We believe that significant recruitment payments should always ensure that any form of rewards (bonus, options or long term plans) which are still at risk should be subject to acceptable performance targets at the recruiting company, unless the rewards have already passed any required performance threshold or the value of such awards have been reduced to take expected performance into account.

14. What would be the impact of greater transparency of directors' pay in respect of:

- **linkage between pay and meeting corporate objectives**
- **performance criteria for annual bonus schemes**
- **relationship between directors' pay and employees' pay?**

126. **Linkage between pay and corporate objectives**: A more "outcomes" based approach to remuneration disclosure is desirable. Currently, investors receive a great deal of information regarding the policy and design of remuneration packages. However, there is very little clear disclosure on how these policies and schemes work out in practice. It is the outcomes of the remuneration structures that ultimately tell the shareholder how successful the link between pay and performance has been. Better disclosure could take the form of clearly setting out what level of performance was achieved during the period for all schemes, and what was paid out as a result. It is important that forward looking information on alignment with strategy and performance, and how this is linked to pay, is also made available. We believe that this is achievable for both short-term and long-term incentive schemes, and that any potential issues around commercial sensitivity can be successfully managed.

127. **Performance criteria and annual bonus schemes**: There are concerns about non-disclosure of performance criteria for bonuses, as bonuses become an increasingly greater part of overall pay. Aviva Investors would like to see any bonus that is more than 100% of salary (or some other appropriate level such as more than 20% of all incentive pay) have appropriate performance criteria and, ideally, relevant targets disclosed.

128. **Regarding the potential disclosure of the relationship between directors' pay and employees' pay**, the nature and business of companies vary immensely. Some have thousands of staff paid different levels of remuneration from very low to very high, whilst others have relatively few staff all of whom receive high levels of remuneration. Therefore, it will be difficult to assess what is a good relationship except over time when shareholders are able to see how the disparity has widened or narrowed. This will take some years, if ever, before this information becomes a useful tool for shareholder engagement. In the meantime, we anticipate that it will be the public rather than shareholders that are more likely to react to this disclosure, which is why it needs to be considered carefully so as not to provoke unjustified reactions.

Takeovers

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

129. Takeovers perhaps represent the greatest challenge to boards in considering both the long-and the short-term implications of whether their decisions are most likely to promote the success of the company (i.e. the section 170 Companies Act 2006 duty). Judgments are required as to long-term implications (which are subject to a degree of uncertainty) against the prospect of short-term value being crystallised through a takeover. This point is relevant to the boards of both the bidding and the target company.

130. The problem with many takeovers is that companies wait until the weather is fair rather than when valuations are depressed. Companies sometimes make ill advised acquisitions at the top of an economic cycle as can be seen in 2007/8 with acquisitions by RBS for ABN Amro, Cookson and SIG. They all had to resort to rights issues because they over extended themselves at the peak. Often M&A deals are proposed for reasons related to personal ambition. There is also an element, in some deals, of companies wanting to become "the global leader".

131. Investment banks encourage companies to do deals at all times including at peaks of cycles. We believe there is often insufficient independent advice available to boards that may have prevented some of these deals which is a flaw in the system. Given the evidence, it is clear that boards do not always understand the long-term implications of takeovers.

132. With regard to the communication of the long term implications of bids, these are usually fully presented in the documentation.

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

133. We start from the position that the current arrangements in the UK in this regard are well-specified and achieve the right balance between giving corporate boards the powers to run companies while ensuring proper accountability to shareholders. The Listing Rules of the UK Listing Authority, currently part of the Financial Services Authority, impose an obligation to obtain prior shareholder approval for transactions that exceed a 25% materiality threshold as measured by any of a number of 'Class Tests'. This is an important element of investor protection for shareholders of (premium) UK-listed companies.

134. We regard the 25% level as being right for categorising transactions as ‘Class 1’ and therefore subject to the shareholder authorisation requirement. This 25% threshold is well-embedded under the Listing Rules and, although detailed operation of the Class Tests has changed a little over time, the principle and the threshold have applied for many years. The benefits of significantly extending Class Test requirements would, we believe, be outweighed by the costs.

135. Offerors that come from overseas jurisdictions and, indeed, unlisted companies in the UK, are not subject to the UKLA’s Class Tests. As investors in overseas companies, UK institutional investors would wish to enjoy shareholder rights equivalent to those in the UK but this is not something that UK Government or regulatory authorities have proper jurisdiction over. We do not believe it would be right for the UK to seek to impose extra-territorial jurisdiction. Nor do we think it would be easy to devise an obligation that could not be circumvented.

136. Our conclusion therefore is that whilst in theory it would be good for shareholders of an acquiring company in all cases to be invited to vote on takeover bids, the current arrangements in the UK are considered fairly good and it is likely to be difficult to implement effectively in view of the extent of cross border M&A activity and other ways of by-passing the vote e.g. by tendering shares prior to the vote.

Other

17. Do you have any further comments on issues related to this consultation?

137. Yes, we would like to say that when we talk about efficient allocation of capital and time horizons we should also consider whether current allocation of capital to corporate activity promotes very long term sustainable development. We define sustainable development as development that meets the needs of the present without compromising the ability of future generations to meet their own needs (Brundtland, 1988). This is an important concept in the context of this paper as development that provides short term benefits but creates significant costs over the long term can reduce the absolute value of long term investment portfolios.

138. It is our view that the capital markets do not integrate sustainable development sufficiently to ensure that capital is efficiently allocated in order not to cost investors and society more in the long run.

139. A further reason for market short termism is the inadequate information on which many capital allocation decisions are being made. Markets are driven by information – if the information they receive is short term and thin – then these characteristics will define our markets. If companies do not provide an assessment of the wider sustainable development risks and opportunities associated with those numbers, then how can the market assess the sustainability of that growth?

140. Conventions like the United Nations Global Compact are now routinely taken up by leading companies around the world (as Aviva has done). These companies understand that long term shareholder value is enhanced by operating in a sustainable way and with integrity. Such companies now attempt to integrate these concepts into their own business policies, governance structure, strategy, and incentive structures. As the Global Compact requires a Communication on Progress to be published, attempts to be more sustainable (or lack thereof) can be seen through their disclosure to the market.

141. However, there are major regional variations and significant differences in the quality and comparability of corporate disclosure in this area. Even for large companies where data does exist, much of the information reported is not material, not assured, not comparable and provides favourable, rather than balanced reporting. There is also particularly poor reporting on performance measures and objectives. It is also frequently hard to track one company’s performance through time as three to five year performance analysis is routinely absent.

142. One of the most effective ways of promoting enhanced corporate responsibility disclosure is for investors to use their vote on the annual report and accounts at company annual general meetings to promote better disclosure. Some investors has been doing this since 2001 and, as a rough measure of effectiveness, companies respond to disclosure requests at the next annual general meeting roughly half the time. While this is a reasonable record of success, it is likely to be far more effective if this practice were conducted market wide. For this to happen, the support of listing authorities is required. Listing authorities need to both make corporate responsibility reporting a "comply or explain" requirement, as well as then require this report or explanation to be put to the vote at the annual general meeting (AGM). For example, stock market listing authorities could make it a listing requirement that companies must put a sustainability report to the vote at their AGM. This would help to create the right kind of discussions within companies at the board level and then between them and their investors. It would also provide investors with the data that would need in order to be able to conduct these long-term evaluations.

143. However, simply providing this information does not guarantee that investors will be interested, nor ensure that they will know how to use it. This is a key reason for market short-termism that arises from a lack of education among market participants on the long term costs and benefits of corporate sustainability. One practical way of changing this over time would be for the most highly regarded fund manager and analyst training centres around the world such as the Chartered Financial Analyst Institute ensure that their training syllabus and – crucially – the charterholder examination to improve the ability of analysts to think through how the sustainable development work of companies will enhance corporate valuation. Aviva Investors has produced its own free, impartial and comprehensive Investment Tutor service dedicated exclusively for Trustee investment education.

144. Furthermore, buy side asset managers and sell side brokers may benefit from mandates from companies, for example, to run their pension funds. This may lead to reluctance to vote against boards and reluctance to be critical.

145. In addition, investment consultants who advise institutional investors which asset manager to select are often paid on the basis of a retainer for ongoing advice, with an additional higher fee in return for running a tender (or issuing a request for proposal – RFP). Arguably, this incentivises consultants to move their clients to alternative fund managers more often than is desirable, leading to a lower return to their clients net of fees.

146. Such conflicts of interest require the implementation of strong cultural norms supported by independent whistleblowing mechanisms, overseen by professional bodies who offer the whistleblower appropriate protection. Governments could also intervene to help create such norms. For example, sell side brokers could be required to offer a view on the ESG characteristics of a company and the quality of their management. If such a transparency measure were allied to a requirement on fund managers to ring fence a percentage of their broker research budgets to reward high quality ESG research then this would begin to correct this failure. Similarly, governments could set the norm that investment consultants' fee structures should not reward them for moving clients between fund managers.

147. Turning to the public good argument, engagement that supports responsible long term business behaviours is under-delivered by the market. This is because there are elements of it that can be considered a public good. For example, it is in all investor interests that the company is well governed by a strong board with sanctions and incentives in place for poor performance. However, engagement can cost time and money and all investors will benefit, so many asset managers routinely overlook engagement and free-ride on the back of others. In common with other public goods, this has contributed to a lack of delivery of engagement – or responsible ownership by investors. In other words, institutional investors are significantly under-resourced and not sufficiently incentivised to carry out proper engagement on all their stocks in their firm's portfolios.

148. The role here for government is to establish mechanisms that promote, encourage and require investors to maintain an appropriate oversight role of companies, as proposed by the UK Stewardship Code, via a range of transparency mechanisms – for example, public disclosure of their voting record, and requiring pension trustees to report to beneficiaries on how their ownership rights have been exercised.

149. However, the critical issue is about behaviour in the City and within companies. This depends as much on culture than on legislation or regulatory procedures. This could be addressed in part through the UK Corporate Governance Code by articulating more forcefully the role of the Chairman and the Board in promoting the right culture and the need to act with integrity and respect for all shareholders and stakeholders. Other ideas for the development of the Code include:

- The remuneration of executive board members and throughout the organisation should in part be determined by how well they live the culture and standards of the company. Individuals should suffer the consequences of not meeting the company's expectations by having their remuneration scaled back. In some situations, it may be appropriate for employees to be dismissed.
- Boards should ensure they are reassured that Audit and risk committees are not focused just on the most expedient considerations for the short term e.g. doubtful accounting approaches but focused on the long term interests of the company.
- The approach to culture and ethics in succession planning, board evaluation and the processes around facilitating this culture throughout the business should be disclosed and transparent.
- Proper, externally managed whistle-blowing processes should be available to staff.

150. A company should put a summary of its Corporate Responsibility Report to a vote at the AGM. The main purpose of such a provision would be to create the right kind of discussions within boardrooms, throughout the business, and between the company and its shareholders. It will also help to ensure that shareholders understand the company's values and standards, and provide them with the opportunity to feed back to the company their views on its broader behaviour. Aviva was the first company in the UK and the first financial services group in the world to take the step of presenting its CR report to a separate investor vote at its 2010 AGM - achieving a 99.7% positive response.

151. In conclusion, (and despite the numerous shortfalls we have highlighted), we should bear in mind that the system of corporate governance and the regulatory approach to the capital markets in the UK are amongst the best in the world and we have to be careful to protect what is good about our system. However, as in most things, there is room for improvement. The suggestions we have made in this response identify areas for improvement and for further review. We look forward to knowing the outcome of this consultation and BIS's next steps in taking some of the issues forward.