CFA UK is a member society of

14 January 2011

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

Dear Adam,

The Chartered Financial Analyst Society of the UK (CFA UK) welcomes the opportunity to respond to the Long-Term Focus Consultation.

The society represents CFA Institute members in the UK, most of whom work as front office investment professionals (managing portfolios, researching securities and advising on asset management). This response has been prepared by the CFA UK's Market Practices and Professional Standard Committee, in consultation with the CFA Institute, on behalf of the CFA UK membership. The society has not surveyed members in relation to Department's paper, however, we make observations and cite evidence that we believe to be important and that we hope will be useful in informing the Department when it comes to achieving its policy objectives

About CFA UK and CFA Institute

The CFA Society of the UK (CFA UK) represents the interests of more than 9,000 leading members of the UK investment profession. The society, which was founded in 1955, is one of the largest member societies of CFA Institute and is committed to leading the development of the investment profession through the promotion of the highest ethical standards and through the provision of continuing education, advocacy, information and career support on behalf of its members. Most CFA UK members have earned the chartered financial analyst (CFA) designation, or are candidates registered in CFA Institute's CFA Program. Both members and candidates attest to adhere to CFA Institute's Code of Ethics and Standards of Professional Conduct.

CFA Institute is the global association for investment professionals. It administers the CFA and CIPM curriculum and exam programs worldwide; publishes research; conducts professional development programs; and sets voluntary, ethics-based professional and performance-reporting standards for the investment industry. CFA Institute has more than 100,000 members in 140 countries, of whom more than 90,000 hold the Chartered Financial Analyst® (CFA®) designation.

A Long-Term Focus for Corporate Britain: a call for evidence

Introduction

UK publicly listed companies, like any business entity, are allocatively efficient when they generate economic profits. Too often, companies and investors focus on accounting profits – the published net profit figure which is then used to derive earnings per share. Companies and investors should value companies by determining the net present value of future free cash flows to the firm[1] (FCFF) discounted by its weighted cost of capital[2] (WACC – the rate of return required by investors for investing capital in the company. This consultation would not be required if boards placed more focus on economic profits and investors focused more on value creation and less on accounting profits.

Meeting the cost of capital involves assessing information from both the balance sheet and the income statement and cannot be assessed merely by the change in a company's earnings or its share price. Evidence and financial market history demonstrate that earnings and share prices are imperfect measures of value generation and allocative efficiency. In spite of this evidence, companies and analysts often continue to use earnings and short term movements in share prices to assess value. As Ben Graham, an esteemed investor and the first proponent of the need for a professional qualification for financial analysts, said: 'In the short run, the market is a voting machine. In the long run, it's a weighing machine.' We support DBIS in its efforts to encourage the market to operate more as a 'weighing machine'.

Focusing on economic profit should allow boards to make informed judgements about the company's ability to generate economic profits while investors can assess the risks to their capital and price it appropriately. Where necessary, boards may want to engage with investors to ensure that the company's management is being effectively exposed to market discipline. For boards to do this effectively, they need to understand the nature of the current and potential shareholder base.

The UK market enjoys a diversity of equity market investors and they should not be discriminated against on the basis of their holding periods. The diversity of investment approaches available to the end investor base (whose members may themselves have different time horizons) is valuable as it promotes liquidity and market efficiency. Investors with different strategies and, therefore, different holding periods should be allowed to express their views in a manner that suits their investment approach. Each group has the same aim – to maximize risk-adjusted returns – but may use different approaches in expressing their views. They should not be discriminated against on the basis of their holding periods

Director remuneration should be more closely aligned with the generation of economic profit and the achievement of investors' required rates of return. Directors' remuneration is still dominated by earnings-related metrics and total shareholder return, even though these metrics have significant limitations.

In conclusion, allocative efficiency is achieved when the board of a publicly listed company focuses on economic profit as defined above; placing less emphasis on metrics related to earnings or the share price to assess the performance of their company and senior management. This focus would enhance the alignment with investors that are concerned with achieving the required rate of return on their capital. To ensure market

[1] Free cashflow to the firm (FCFF) = Net income to shareholders + noncash charges + Interest Expense (tax adj.) – investment in fixed and working capital.

[2] WACC – weighted average cost of a company's debt, preferred equity and equity. The cost of capital will include a risk premium required by investors for providing this capital to companies.

discipline is exerted effectively, boards need to understand the diverse nature of the investor base. Different groups of investors should not be discriminated against based on their investment horizons. Each has its own approach in generating the required rate of return on capital.

Consultation Questions

The Board of Directors

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

It may be appropriate to make a distinction between the boards of public and private companies with respect to their long-term focus. The boards of public companies may have a greater incentive to move their focus from long-term success to share price maximization and, whilst in an efficient market the highest possible share price is synonymous with long-term success of a business, markets are not efficient all of the time. However, there is also evidence of failing in the allocative efficiency of private equity firms as illustrated by Tim Jenkinson in his paper "Understanding the Private Equity Phenomenon."

A public quote facilitates the ability to raise further capital (both equity and debt) and provides a currency for executive compensation. However, we are concerned that benchmarking executive compensation to the size of a business creates a motive to acquire businesses for the sake of increasing the status and earnings of board directors, not for increasing the value or long-term success of the business. We do not believe that the much-publicised acquisitions in the banking sector described by some commentators as value destroying[3], was a unique example of this phenomenon.

The relatively short term of executive tenure also concerns us. According to Director Magazine[4] the average duration for UK chief executives is four years. Four years is an inadequate period of time to plan investment, make that investment and reap its rewards. If executive compensation targets metrics such as earnings and stock price, in the short-term both can be managed to enhance compensation, but at a cost to a business long-term viability. For example, constraining investment, selling assets and writing-off previous investment increases earnings and improves return on equity and other capital ratios, but does not necessarily benefit the long-term viability of the business.

"Discounted cash flow is the standard for valuing financial assets in well-functioning capital markets" (Rapapport).The focus of UK boards should be on ensuring that the company earns the required rate of return on capital (ROIC) or "economic profit" rather than an accounting profit.

The value of a company should be the present value of its future cash flows discounted by the weighted average cost of capital (WACC); earnings are "irrelevant for valuation" (Rapapport). For a company to be a viable entity it needs to cover at least its cost of capital consistently over a time period that is appropriate for its industry or sector. In addition, UK boards should also understand how ROIC is related to earnings growth.

ROIC or metrics that reflect the economic return of a company are not widely used in assessing senior executive performance and compensation. Metrics such as earnings per

[3] http://business.timesonline.co.uk/tol/business/markets/article2763290.ece
[4] Lesson of Leahy's legacy
http://www.director.co.uk/magazine/2010/7_July_August/jane_simms_comment_63_11.html

share (EPS) and total shareholder return (TSR) predominate. Both EPS and TSR have flaws as measures and the material ones can be identified are as follows –

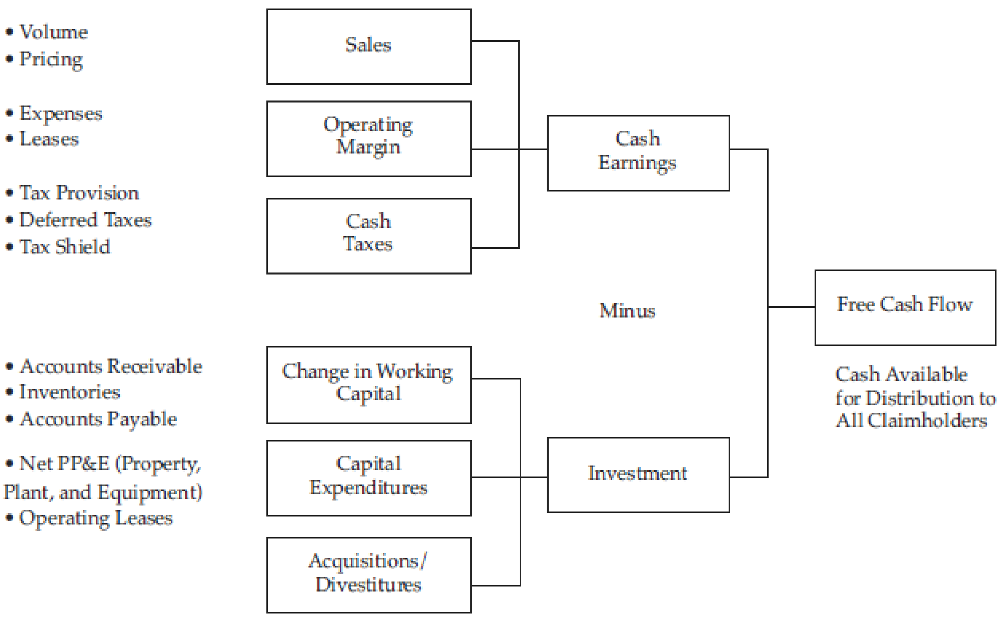
1) Earnings management – there is significant evidence that earnings management does take place which in some cases can distort the economic viability of a company.

2) Public equity markets have bull and bear cycles and sentiment can have a greater impact on the value of a company than fundamentals indicate. The best example of these swings can be demonstrated by the inflation and bursting of the dotcom bubble. This indicates that the share price is not a robust enough metric when assessing the value generated by a listed company.

Given the importance of discounted cash flow analysis it is crucial to use the appropriate definition of cash flow. Free cash flow available to the company/firm (FCFF) is more useful as it incorporates information from both the balance sheet and the income statement. Earnings uses information only from the income statement. As Michael Mauboussin, a senior investment practitioner, states, 'In reality, EPS (earnings per share) tells very little about value because EPS does not explicitly take into account capital intensity. In other words, two businesses can have the same EPS growth rates but different returns on capital; therefore, they will have, quite understandably, different valuations.' Sloan adds that 'the balance sheet can be used to help judge the quality of the asset side, where most of the earnings quality problems arise.'

Figure 1 (Mauboussin) demonstrates that FCFF is calculated by using items from the balance sheet and income statements.

Figure 1. Cash Flow Derivation



The distinction between earnings and FCFF is crucial one to understand. It indicates that a company can grow earnings as much and as fast as it likes, but if it does not cover the cost of capital it is destroying value just as fast as it grows earnings. This is further demonstrated by Mauboussin in Table 1, which demonstrates how to understand the direction of the relationship between ROIC and earnings.

Table 1 (Mauboussin) demonstrates the importance of the link between the return on invested capital and the price earnings multiple. The information is based on an all equity financed company to make the analysis more accessible.

Table 1. ROIC and P/E Multiples: Theory

Earnings Growth	ROIC 4%	8%	16%	24%
4%	6.1×	12.5×	15.7×	16.7×
6	1.3	12.5	18.1	20.0
8	NM	12.5	21.3	24.2
10	NM	12.5	25.5	29.9

NM = not meaningful.

Note: Assumes all equity financed; 8 percent WACC; 20-year forecast period.

Table 1 presents three essential observations about valuation as a multiple of a company's earnings -

I. The P/E multiple will be maintained as long as the company covers its cost of capital regardless of the growth rate of earnings.

II. The P/E multiple will decline if a company does not cover its cost of capital.

III. The P/E multiple will increase if the company earns a return greater than its cost of capital.

However, this does not imply that high P/E multiples necessarily indicate that companies are generating returns in excess of the cost of capital. As equity markets have demonstrated on a regular basis, sentiment can diverge dramatically from fundamentals. Rising P/E multiples should be supported by returns in excess of the cost of capital.

In conclusion, short-termism, where it exists, appears to be driven by attention to inappropriate performance metrics rather than myopia per se and the investment horizon of each company board, whether private or public, should be focused on the generation of economic profit. The appropriate time horizon will be determined by the specific investment opportunities available to them and where there is a dearth of opportunities to generate an adequate return for investors, excess capital should be returned for investors for reallocation.

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?

The current legal framework is cumbersome; the custodian record keeping system often obscures the identity of the ultimate investor behind several layers of holding accounts. Therefore, a Section 793[5] inquiry essentially amounts to a 'speculative request'. Given the public desire for companies to build a dialogue with their shareholders (Section E of the Code) we think the framework could be improved. However, it would be administratively very costly to manage a near real time list of all shareholders, due to trading activity, particularly in the larger and very active securities. Hence, we believe

[5] Section 793 of the Companies Act 2006

that balance compromise would be achieved by reducing the 3% threshold of public disclosure.

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?

As the consultation notes (paragraph 4.2), there has been a decline in the proportion of total equity capital owned by U.K. institutions that corresponds with a rise in non-U.K. ownership, such as overseas pension funds and sovereign wealth funds.

The shift to foreign ownership of UK securities probably reflects global changes such as the relaxation of capital controls, technological improvements and the increasingly global nature of investment analysis and investment (in search of diverse, attractive returns), which has made all markets more accessible to overseas owners and increased the attraction of international investment. The ability to tap global capital markets potentially reduces the cost of funds by having access to a bigger pool of capital.

The location of the beneficial owner (the investor) is not particularly relevant or worrisome. All investors, wherever they are based, ought to have the same interests and objectives and to operate in broadly the same manner. They should seek to channel funds to the most promising investment prospects as identified through discounted cash flow (DCF) analysis[6]. Alfred Rappaport's paper "The Economics of Short-Term Performance Obsession[7]" is highly critical of non-DCF approaches to investment analysis.

Where investors are undertaking rigorous analysis - and preferably applying sensible ESG (environmental, social and governance) filters, capital should be allocated efficiently. Therefore, it is not changes in the nature of UK share ownership that should concern DBIS, but flaws in the approach to value creation and investment.

4. What are the most effective forms of engagement?

Companies need to convey their vision and strategy to the markets, and they should frequently report their progress against strategic goals, without delay. Within the constrictions of the market abuse regulations, the boards of public companies need to be frank and open with their investors. The most effective forms of engagement are those that are pragmatic and open and that alert management and boards to investor concerns.

From the investor perspective, there is no one size fits all solution. Each type of participant will engage in a manner that is consistent with their approach to investment and generating returns for their portfolios. Some may express their views purely by buying or selling the shares, even shorting the shares; others may be more actively involved and might provide valuable feedback to management and Boards on ways to enhance economic profits.

There should be no impediments to investors expressing their views about the relative allocative efficiency of publicly listed companies.

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[6] http://www.cfapubs.org/doi/pdf/10.2469/faj.v61.n3.2729
[7] Ibid

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

Investors are concerned with generating returns and the governance of a company will be one of the factors to take into account alongside other quantitative, macroeconomic and microeconomic factors.

Many investment firms employ ESG teams and dialogue will exist between the ESG team and investment teams. While analysts and portfolio managers may focus on financial analysis, ESG factors may necessarily be more subjective and less suited to quantified approaches, but with informed dialogue an investment teams should be able to adjust the required rate of return to reflect risks introduced by adverse ESG behaviours in an investee company. However some firms may not necessarily integrate these function, instead simply using their ESG teams to inform voting and engagement decisions rather than to inform buy and sell decisions, or screen the universe based on ESG and then apply financial criteria to the reduced universe that do not necessarily take account of the ESG team's output.

The number of managers and institutional investors who have signed up the FRC's Stewardship Code (in excess of 100 as of December 2010) is encouraging.

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?

Technically the shareholder vote is a very important form of engagement, but may not be as effective as perceived. Voting is the second of three levels of engagement, the first being dialogue, and the last being the decision to buy or sell.If the investor decides to vote against a corporate resolution, and if the vote does not go according to the investor's wishes then a review of the holding in the portfolio must surely follow. However, with the rise in popularity of index funds and closet index funds, the fund manager may be compelled to hold the stock, even though in principle he disagrees with the company's policy. Such a situation undermines the authority of the vote as an autocratic board may choose to ignore the will of the shareholders, knowing that they cannot sell.

We strongly believe that as agents of the ultimate investors, the investment management firm should offer a report to its customers on how and why it voted on their behalf. This report (ideally an engagement report covering: dialogue, voting and trading activity) should be integrated as part of the performance reports presented to customers. Through an engagement report, the ultimate investors can assess and comment upon the fund manager's stewardship of their assets. However, some institutional clients, providing they have the support of their beneficiaries, may choose not to concern themselves with governance matters. Therefore, it should be their choice as to whether they demand from their fund manager the production of an engagement report.

We do not believe that the voting decisions of institutional investors should be made public. Secret ballots protect against coercion. Where voting concerns corporate resolutions, investment managers face potential coercion from the issuers, either directly through withdrawal of business, or by exclusion. The conflicts of interest are particularly strong at an integrated investment firm, where the business of the issuer is the product of several relationships. The investment banking division could be pitching for the issuer's corporate finance and advisory business, the brokerage operation could be researching the issuer's securities, and the investment management division could be managing the issuer's pension fund assets. Hence, the freedom to act in the best interest of the ‘client’ investor will be constrained by the public disclosure of voting behaviour. However, many institutional fund managers do choose to disclose their votes, typically 3 months in arrears.

In the post Lehman world investors will become more vocal and use a variety of means to engage with company management. As Sule states, the listed companies’ “management teams will have to get used to dealing with an increasingly more demanding and less tolerant group of investors.”

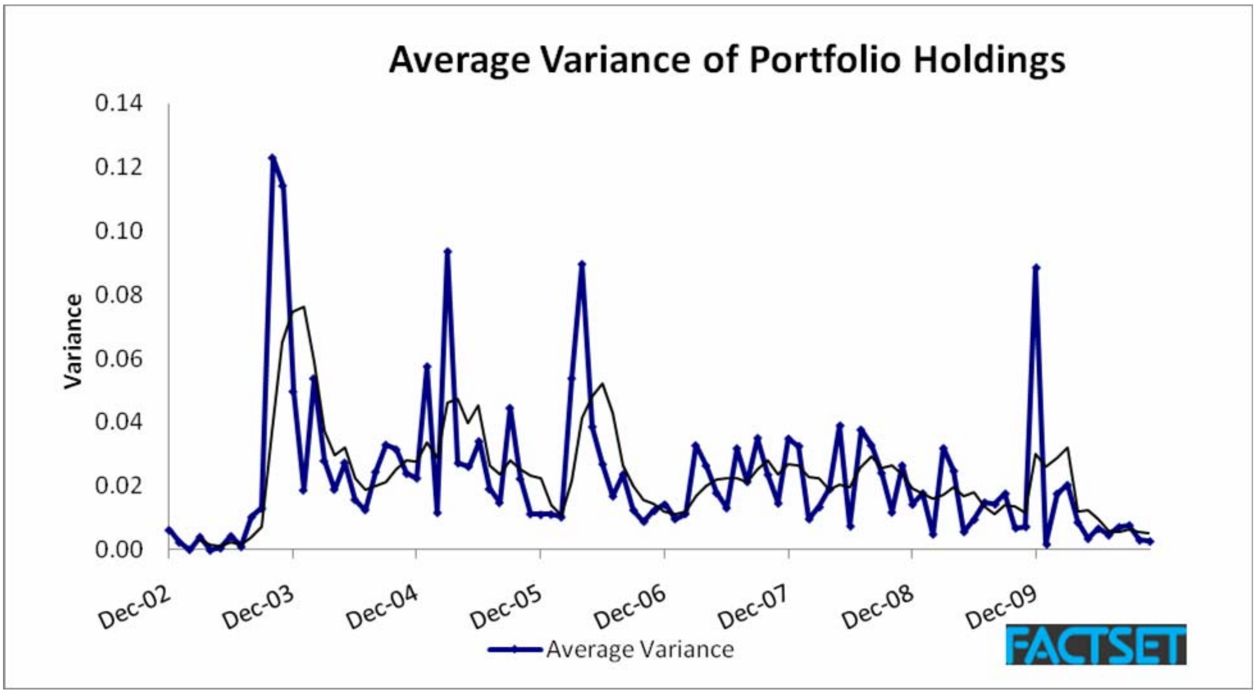
7. Is short-termism in equity markets a problem and, if so, how should it be addressed?

The fixation with the length of holding periods for equities is not the key issue. There is no optimal holding period for an investment and there is little evidence that supports the view that short holding periods are detrimental to allocative efficiency, indeed research carried out by Jonathan Brogaard published in his paper “High Frequency Trading and its Impact on Market Quality” finds that high frequency trading has contributed to market quality.

There is evidence that senior executives preoccupied with meeting short-term based metrics like earnings will be more inclined to undertake activity that undermines the ability of the company to cover its cost of capital (Schilit; Sloan; Jansen et al). Directors should focus less on the changes in the share price and meeting earnings expectations of their companies and more attention should be devoted to delivering the required return on invested capital.

To some extent, shorter holder periods ought to be welcomed as a means to improve market liquidity and, thereby, to promote improved price discovery and the efficient allocation of capital. However, for prices to return to fundamentals, arbitrage has to be effective. Practitioners that try to address these inefficiencies may not be able to do so because of impediments or the continuation of irrational pricing. Several academics (Shleifer, Thaler, De Jong) have demonstrated the impact of the limits to arbitrage and how prices can deviate significantly from fundamentals even in the most straightforward of cases such as dual listed shares and when companies float their subsidiaries. For example, restrictions on selling short will ensure that prices that should otherwise be lower will continue to deviate from fundamentals.

The consultation notes (paragraphs 4.19 and 4.22) that there is evidence in recent years of increased trading activity, heightened share-price volatility and shorter holding periods. CFA Institute has conducted research reviewing the variance of holdings by the top 100 institutional investors in the 19 largest companies of the FTSE100 index, monthly over the last eight years. We are grateful to CFA Institute and to FactSet Research Systems Inc. for providing the data and analysis.



The chart above illustrates that (bar a few spikes) the level of trading activity has remained steady and is on a slight declining trend over the last eight years.

This research was unable to capture data prior to 2002. However, anecdotal evidence from market veterans indicates that significant changes occurred in the management of portfolios from the mid 1980s. The most significant catalysts for these changes were the introduction of affordable desktop computing and the development of platforms for delivering real-time securities data and news. The increased availability of information and the means to act on that information (combined with reductions over time in the costs of trading) have supported increased trading levels and a decline in holding periods.

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?

No action should be taken on prescribing holding periods; instead, boards, senior executives and investors should be focused on ensuring that publicly listed companies at least cover their cost of capital over the period appropriate for that company.

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

Investment is about postponing consumption today to have higher purchasing power in the future. An investor's aim should be to generate real returns, net of costs, in line with their risk requirements and these should be made clear in any delegated investment mandate. Investors should hold diversified portfolios that include equity and non-equity assets. When investing in most asset classes, the investor has the choice of passive management (tracking an index or benchmark), active management (where a manager takes active decisions to generate returns that are ahead of the benchmark after fees), or a combination of the two approaches.

Active asset managers will turnover their portfolios although they should be sensitive to costs of this activity which will cause a drag on performance; the prospect of short-term underperformance may place active fund managers under pressure to demonstrate the value of their active strategies. Evidence shows that very few active managers deliver benchmark beating returns net of fees on a consistent basis. This is not lost on investors and is demonstrated by the move towards passive strategies as these vehicles have become available to investors. As passive mandates become more popular turnover is likely to lessen over time.

Investors always have the right to terminate their mandate. However investors that have delegated the management of their assets to third party managers do have a tendency to terminate their managers when they have underperformed. Montier points out that the top performing managers do underperform over short periods and that this is a by-product of a sensible asset allocation. Despite this, it is short-term underperformance that often results in a manager losing their mandate. In another study cited by Montier it appears that pension funds have an uncanny knack of firing their managers at the wrong time, given their propensity to focus on short term performance. In the study, managers who had underperformed and fired went onto generate better performance than those that did well in the recent past and were hired. Investors often fail to resist chasing the top performers of the recent past.

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

Equity fund managers usually supply sufficient information regarding their process, portfolio positioning and performance such that their investors can ensure that their mandate meets their requirements. However, the investor should be aware of any conflicts of interest and how they are managed. How the fund manager is remunerated may be a factor if, for example, the manager is incentivised by the amount of assets under management rather than performance generated for investors. If the manager is remunerated by assets under management this could misalign interests and consequently sow the seeds of the manager's underperformance.

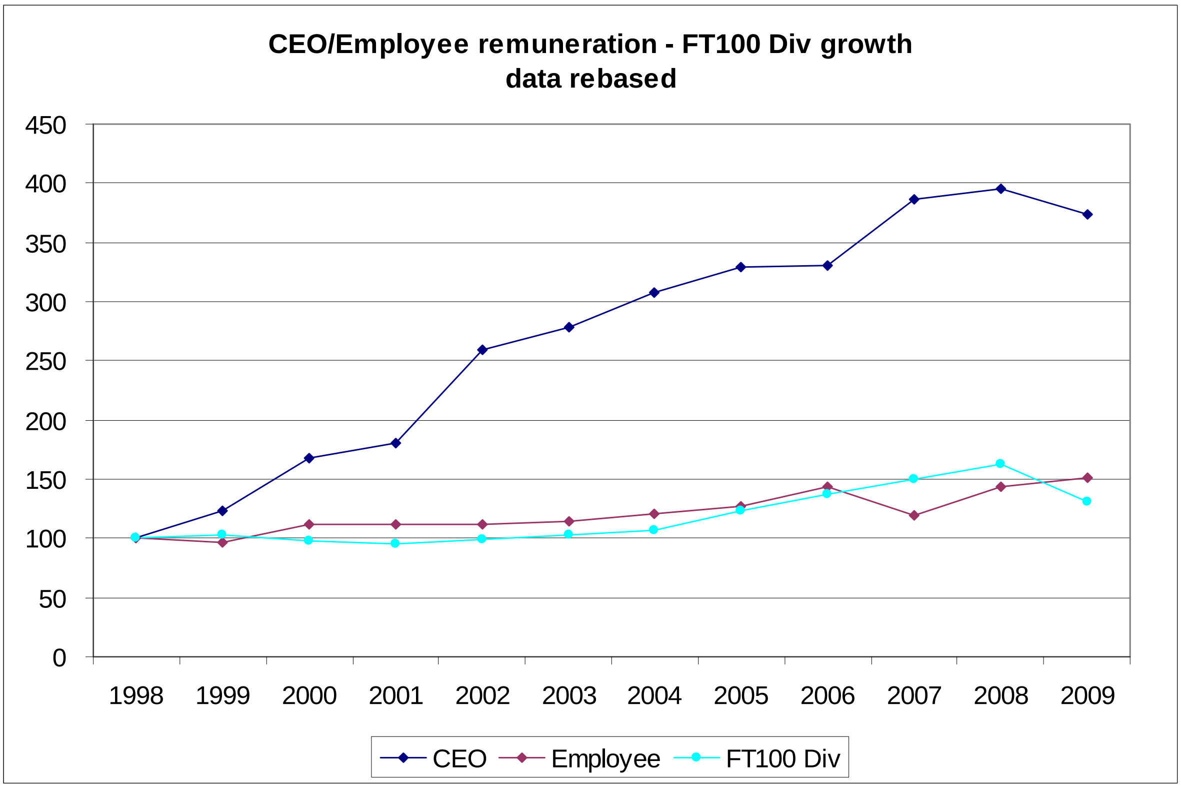
Directors' Remuneration

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

Sir Paul Judge's article "How we lost grip of top pay" in the Sunday Times (14th Nov 2010) succinctly outlines the reasons behind the acceleration of executive compensation. Sir Paul believes that the unintended consequences of the Greenbury report were to change the basis of calculation of executive remuneration from the circumstances of the individual firm to where the firm lay in the league table of all executive remuneration. Sir Paul's observation is that remuneration committees have a bias to rating their executives as above average and remunerate accordingly. This means that average remuneration steadily accelerates, as the league table is only populated by the compensation of above average executives. Another ratchet is applied based on the opinion that we operate in a global market, and hence Britain can only attract the best talent if it is prepared to match the global league tables of pay.

In reference to the second part of the question, are these increases appropriate? The increases would have to be measured by the economic profits generated by these executives and whether or not these executives delivered the required rate of return on capital. Relative share price performance is not a suitable metric.

Analysis of CEO and employee remuneration relative to dividends (admittedly a somewhat blunt comparator) suggests that the increase in CEO remuneration has advanced at a rate greater than justified by the value delivered to shareholders.



As can be clearly seen the increase in employee compensation has been of the same order as the increase in dividend payments, there is no similar relationship with the increase in CEO remuneration.

The widening gap between the average worker and the CEO also has to be measured in terms of labour productivity metrics such as output per worker. Senior executives may be the driving force in managing these resources better and if they genuinely deliver value then they and the shareholders should benefit more from the any rise in economic profit.

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

We do not believe that widening the membership of the remuneration committee will have much impact on remuneration. We support Sir Paul Judge's approach, which calls for a return to the established process pre-Greenbury, where executive remuneration is considered in the context of the firm, its prospects and how it relates to management and those working on the shop floor.

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?

The influence of investors is a consideration. Shareholders in all EU states have at least a non-binding vote on remuneration (Italy is an exception where the vote is binding). In the main, from an investor perspective, executive compensation has not reached a level where it impinges on economic profit. Therefore, of the fund managers who read remuneration reports, many may not be concerned by substantial increases in remuneration because they have a negligible impact on earnings per share. However, the structure of compensation and the incentives that structure creates should be of concern to investors and there is evidence that this is the case. When it comes to ‘Golden Parachutes’ and other guarantees, shareholders tend to be vocal in opposing these benefits. Such benefits go against the established practice of aligning the interests of executives with those of the shareholders.

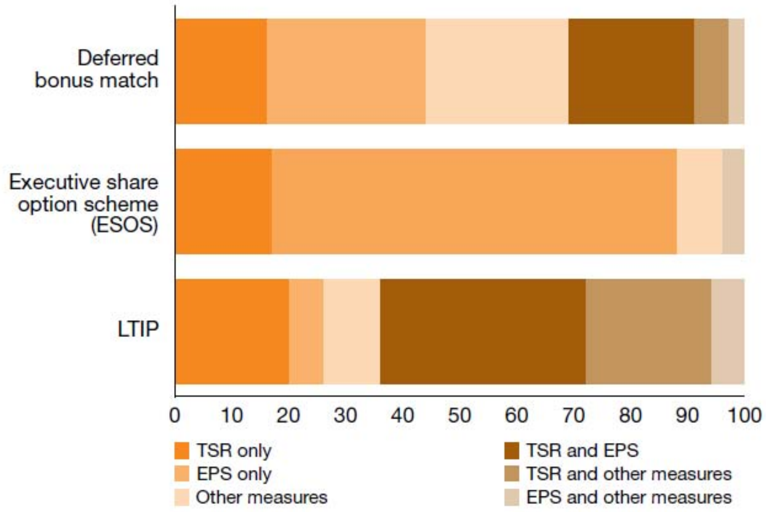
14. What would be the impact of greater transparency of directors‟ pay in respect of:

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

In general, greater transparency over director’s pay would enable shareholders to make more informed decisions when exercising their advisory vote over remuneration packages. Moreover, greater clarity in remuneration disclosures and over corporate governance practices in general may encourage investors to take a more active role with respect to exercising their rights. The current opacity in disclosures – largely a function of complexity and use of boilerplate – deters investors from seeking to exercise their rights.

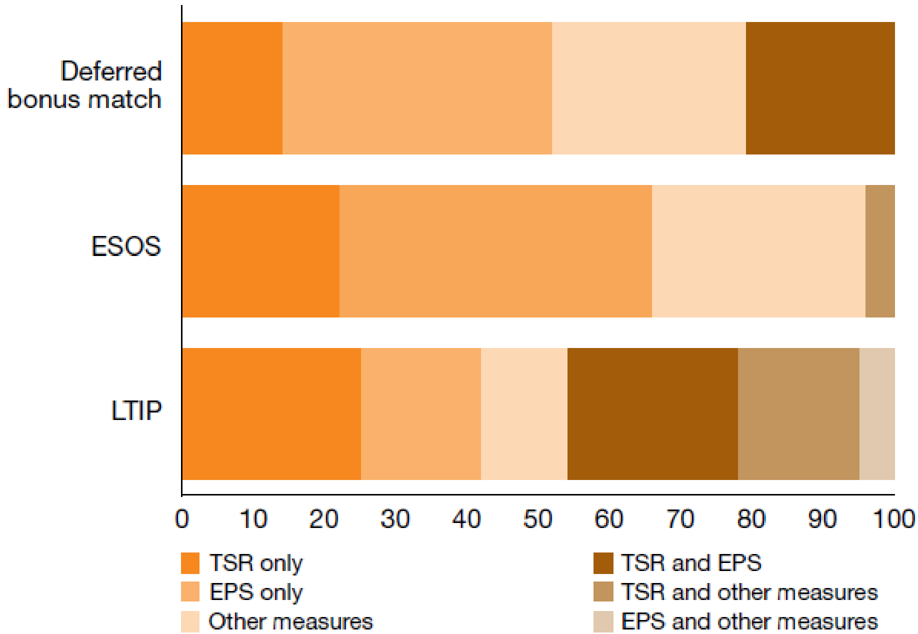
Setting the right targets for performance measurement is the fundamental challenge behind incentive schemes. As stated in our response to the first question above, targeting earnings promotes short-term behaviour and earnings can be manipulated. The share price is not an effective measure of performance as there is no link to personal performance in a rising market.

There is too little focus on economic profit or meeting the cost of capital when assessing senior executive remuneration. The table below highlights the dominance of total shareholder return (TSR) and earnings per share (EPS) as metrics for assessing performance of Chief Executive Officers of FTSE 100 companies for their deferred bonuses, share option schemes and long term incentive plans (LTIPs).



Source: Annual reports, PwC-Monks database, IVIS

For FTSE 250 CEOs the metrics are little different. Other measures remain a minority among the metrics used.



Source: Annual reports, PwC-Monks database, IVIS

To some extent the PwC report identifies growing frustration with the use of TSR and ESP and there have been more use of other measures. However, it appears that there may be challenges with calibrating these other measures with performance and so companies use relative TSR.

Takeovers

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

The key issue in response to this question is how management's assessment of a takeover opportunity or a bid is made. AOL/Time Warner, Vodafone/Mannesmann, Daimler/Chrysler and Royal Bank of Scotland/ ABN Amro are prominent and headline grabbing examples of where the market for corporate control may have been driven more by hubris and overconfidence than by business development strategies to enhance the return on capital. These examples, in hindsight, indicate that capital was being allocated inappropriately yet these transactions still took place.

The evidence on the effectiveness of the market for corporate control suggests that large buyouts are value destroying. Bayazitova et al's (2010) analysis of mergers involving publicly listed companies in the US between 1980-2007 found that 43% of all activity by value was associated with megamergers (acquirers with market capitalization of more than $4.7B) but accounted for only 2% of the number of transactions. On average the mega-merger was value destroying compared to non-mega mergers which were value creating. In another study by Netter et al (2010) the analysis covered a shorter period (1992-2009) and included private transactions. The results were similar to Bayazitova et al. However, in most of these studies the analysis uses share price movements as the metric for whether or not value is destroyed. There is little stated about whether or not the acquirers' actions enhance their ability to cover or even earn returns in excess the cost of capital. In addition, on the basis that investors hold diversified portfolios, gains by holding the target may be offset by losses by holding shares in the acquirer; this may mean that the gains and losses may be overstated. Despite these key issues regarding metrics many of the large takeovers in recent years has seen the acquirers subject to writedowns of shareholder equity due to the premiums paid for their acquisitions.

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?

All shareholders on the register should vote on takeover or merger as long as it is of a material nature. Where a proposed transaction could be considered material, the boards of both the target and the acquirer companies should distribute information to shareholders that sets out whether or not the proposed takeover or merger will result in an improvement in the allocative efficiency of the companies' resources.

Other

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

Events from corporate and financial market history have demonstrated that the way that public equity markets work in practice differs significantly from the theory of how they are supposed to work. Corporate managers are supposed to work in the interests of the owners and are kept honest by market discipline either through the price mechanism of the equity market, or from the market for corporate control.

The market value of the equity of a firm should reflect all relevant information. Any changes to this valuation should be based on a consistent and dispassionate reappraisal of information related to the quality of a company's earnings, earning power and prospects. Despite its intuitive appeal, financial market history has regularly demonstrated that the share price is not a useful metric for determining allocative efficiency; something that has not gone unnoticed by prominent commentators and practitioners[8] and in Greenspan's case even shocked him.

"I made a mistake in presuming that the self-interests of organizations, specifically banks and others, were such as that they were best capable of protecting their own shareholders and their equity in the firms…………. you know, that's precisely the reason I was shocked, because I have been going for 40 years or more with very considerable evidence that it (free market theory) was working exceptionally well." Alan Greenspan.

If the world was populated by perfectly-informed, rational economic agents that participated in frictionless, efficient markets then the share price would be a more valuable metric.

According to one study by Graham et al (2006) "real earnings management" such as deferring value enhancing projects and investment to meet earnings expectations to minimise the cost of equity capital has destroyed more value than that destroyed by those companies involved in high profile fraud cases. These events highlight the undesirable consequences of "running a company with the sole aim of raising the share price" in the short-term.

Scope

The UK is a major global financial centre that prices and allocates equity and non-equity capital. The focus of the consultation document on public equity markets is too narrow. There are over 4 million businesses in the UK of which 2.6 million are companies; only a small proportion (9,950)[9] of these companies are publicly listed. Productivity depends on all of these businesses using their capital efficiently and having capital allocated to them appropriately.

An effective regulatory environment can contribute to the appropriate pricing of capital and resource allocation.

La Porta et al suggest "laws and the quality of their enforcement by regulators and courts, are essential elements of corporate governance and finance… in contrast, when the legal system does not protect outside investors, corporate governance and external finance do not work well." On occasion, it may be more beneficial to enforce existing laws and regulations than devise new policies or as La Porta et al state "the strategy for reform is not to create an ideal set of rules and then see how well they can be enforced, but rather to enact the rules that can be enforced within the existing structure."

The interaction of frameworks and regulatory requirements can also help reduce the cost of equity capital. Hail & Leuz (2005) and Leuz (2006) attempt to understand and analyse the complexity of the influences of legal institutions, securities regulation and the level of integration of a nation's capital markets. Emphasising the inherent caveats, they find some empirical support for the claim that firms from countries with more extensive disclosure requirements, stronger securities regulation and stricter enforcement mechanisms (as enabled by a high quality legal infrastructure) have significantly lower cost of equity capital than those that do not rate as highly on these parameters . The table[10] below lists the ten nations with the lowest cost of equity capital derived from the sample cited by Hail & Leuz and how they score with respect to the quality of legal infrastructure (LAW), disclosure (DISREQ) and securities regulation (SECREG).

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[8] Some such as Greenspan, Michael Jensen, and Gilson et al have revised their views.

[9] Companies House November 2010
http://www.companieshouse.gov.uk/about/busRegArchive/businessRegisterStatisticsNov2010.pdf

[10] Department for Business, Innovation and Skills (BIS) Economics Paper No1- BERR's (BIS) role in raising productivity: new evidence ch. 2 http://www.bis.gov.uk/files/file44504.pdf

Country*	Average cost of equity capital (1992 – 2004)	DISREQ**	SECREG**	LAW**
Japan	6.16%	0.75	0.47	0.9
Taiwan	9.87%	0.75	0.64	0.85
Singapore	10.01%	1	0.84	0.86
Germany	10.05%	0.42	0.21	0.92
United States	10.24%	1	0.97	1
France	10.37%	0.75	0.58	0.9
Canada	10.53%	0.92	0.91	1
Italy	10.61%	0.67	0.46	0.83
United Kingdom	10.64%	0.83	0.73	0.86
Malaysia	10.65%	0.92	0.78	0.68

(Source: Hail & Leuz (2005); Note*: sample size differs with country; **based on indices)

We hope that the CFA UK's response is helpful to the Department and would be open to further discussions with the Department about any of the points we have raised.

Yours,

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