Plurality, Stewardship and Engagement

The Report of

THE OWNERSHIP COMMISSION

March 2012

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About the Commission

The Independent Ownership Commission was instigated by Tessa Jowell MP as Cabinet Office minister in January 2010 supported by the Co-operative Group. It quickly broadened its initial brief beyond looking at employee and co-operative forms of ownership that might be applied in the public sector into a more comprehensive analysis of British ownership in the round. It has been a two year undertaking, with eighteen months of evidence gathering and Commission meetings followed by six months of consultations, drafting and writing. During this time we undertook two study trips, one to Boston and Harvard Business School in April 2011 and another to Singapore in July 2011. On each we were able to broaden our knowledge, bolster our arguments and examine the ownership debate in different contexts.

We would like to thank each of the Commissioners for giving up their valuable time, for their expertise, depth of knowledge and consistent commentary on the very many early drafts. And of course we thank the Co-operative Group without whose financial support we would have been unable to discharge our business. The Commission has been completely independent throughout its existence.

In particular we would like to thank our indefatigable Chair, Will Hutton, who has given his time freely and generously throughout the whole process and has been a constant source of energy, optimism and direction over the past two years.

About the Commissioners

Will Hutton (Chair)

Will Hutton is the Principal of Hertford College, Oxford and chair of the Big Innovation Centre. He is regularly called on to advise senior political and business figures and comment in the national and international media. He is one of the UK's pre-eminent economics commentators.

He began his career in the City as a stockbroker and investment analyst before moving to the BBC, where he worked both on radio, as a producer and reporter, and on TV as economics correspondent for BBC 2's Newsnight. Prior to joining The Work Foundation, Will spent four years as editor-in-chief of the Observer, for which he continues to write a weekly column. He also regularly contributes to the Guardian and the Financial Times. Before taking up his post at Hertford College, Will was Executive Vice Chair of the Work Foundation.

Will's book The State We're In was seen at the time as setting the scene for the Blair revolution. Since then he has published The State to Come, The Stakeholding Society and The Writing on the Wall: China and the West in the 21st Century.

His most recent book Them and Us charts the course of the financial crisis and examines fairness in Britain. It has been described in The Guardian as 'a tract for our times - passionate, erudite, with much common sense.'

Glyn Barker

Glyn Barker is the Chairman designate of Irwin Mitchell and a director of The Berkeley Group Holdings plc. He was formerly Vice-Chairman of PricewaterhouseCoopers (PwC) UK, where he had strategic responsibility for developing the PwC business across Europe, Middle East, Africa and India - a region of over 90 countries with a $15 billion revenue business.

He held a number of senior positions throughout his career at PwC, including Managing Partner from 2006 until 2008, head of the UK's leading Assurance practice from 2002 until 2006. Prior to this he was founder and global leader of PwC's Transaction Services practice. Throughout his career Glyn advised a number of the firm's largest public and private clients.
Glyn is also a director of the English National Opera.

Sir Roger Carr

Sir Roger Carr is chairman of Centrica plc, deputy chairman & senior independent director of the Court of the Bank of England and is president of the Confederation of British Industry. He is also a senior advisor to KKR - the world's largest private equity company. In addition, he is a visiting fellow of Said Business School, University of Oxford.

He has previously held a number of senior appointments including chairman of Cadbury plc, chairman of Chubb plc, chairman of Mitchells & Butlers plc, chairman of Thames Water plc and chief executive of Williams plc.

Throughout his career he has served on a number of external committees including the Manufacturing Council of the CBI, The Higgs Committee on Corporate Governance and Business for New Europe. He is a fellow of the Royal Society for the encouragement of the Arts, Manufacturers & Commerce and is a Companion of the Institute of Management.
He was knighted for services to Business in the Queen's New Year's Honours list 2011.

Lady Sylvia Jay CBE

Lady Sylvia Jay is Chairman of L'Oréal UK & Ireland. She is also non-Executive Director of Saint-Gobain, of Alcatel-Lucent and of Lazard Limited and formerly of Carrefour. She is Chairman of the Pilgrim Trust and a Trustee of the Prison Reform Trust and the Entente Cordiale Scholarships Scheme.
Her civil service career concerned government financial aid to developing countries. She also worked in the French Trésor and was part of an international team which set up the European Bank for Reconstruction and Development.

She was awarded a CBE in 2005 and made a Chevalier of the French Legion d'Honneur in 2008 and received an Honorary Doctorate of Laws from Nottingham University in 2009.

Peter Marks

Peter Marks is Group Chief Executive of the Co-operative Group. He is the leading advocate for greater consolidation in the UK Co-operative Movement and for the ultimate creation of one national co-operative business. Peter has brought about a number of major co-operative mergers over the past decade, most notably that of United Co-operatives and the Co-operative Group in 2007.

Following the acquisition of the Somerfield business and the merger with the Britannia Building Society, the Co-operative Group now has an annual turnover of around £13bn, operates almost 5,000 food, financial services, pharmacy, funeral and motor outlets and is the UK's largest mutual business. The Group is owned by its six million customer-members and employs around 105,000 people

Peter is a non-executive director of Thomas Cook Group and a member of the Board of the Greater Manchester Local Enterprise Partnership. In 2011 he received an Honorary Doctorate in Business Administration from Manchester Metropolitan University.

Charlie Mayfield

Charlie Mayfield became the Partnership's fifth Chairman in 2007. He joined the Partnership in 2000 as Head of Business Development, responsible for business strategy and development for both John Lewis and Waitrose. Charlie joined the Board as Development Director in 2001 and was responsible for developing the Partnership's online strategy. He became Managing Director of the John Lewis division in 2005 prior to taking up his appointment as Chairman of the Partnership. Charlie began his career as an officer in the army. He joined SmithKline Beecham in 1992 before moving to McKinsey & Co in 1996 where he worked with consumer and retail organisations.

Charlie is the Government appointed Chair of the UK Commission for Employment and Skills.

Colin Melvin

Colin Melvin founded and leads Hermes EOS, an advisory service for large institutional investors, enabling them to be active engaged owners of the companies in which they invest. He is also non-executive director at Aedas, an architectural partnership, where he chairs the Remuneration Committee and provides guidance on strategy, restructuring and effective governance.

Colin has been at the forefront of developments in corporate governance, sustainability and responsible asset management for over fifteen years. He is a member of several industry steering groups and committees including the Supervisory Board of Eumedion and the International Corporate Governance Network's standing committees on executive remuneration, cross-border voting and shareholder responsibilities. He has co-founded various investor groups and initiatives such as the United Nations Principles for Responsible Investment, for which he was the first Chairman, and the Performance Pay Group and SRI Forum in the UK. He co-drafted guidelines for corporate disclosure on social, environmental and ethical matters, which have been widely adopted by the investment industry.

Professor Jonathan Michie

Jonathan is Professor of Innovation and Knowledge Exchange at the University of Oxford. He is also Director of the University's Department for Continuing Education, and President of Kellogg College.

From 2004-2008 Jonathan was Director of Birmingham Business School and Professor of Management. He previously held the Sainsbury Chair of Management at the University of London. Prior to that he was at the Judge Business School, University of Cambridge.

He worked for Analysys Ltd, and as an Expert to the European Commission before moving into academia. He is the founder Director of the Oxford Centre for Mutual and Employee-owned Business.

Paul Mullins

Paul Mullins joined DC Advisory Partners in January 2011 as European Chief Executive.

Prior to joining DC Advisory, Paul spent six years at Bank of America where he initially established and built the European M&A team. He then took over the pan-European Global Industries & Natural Resources sector team.

Paul's career in banking has spanned 30 years at Schroders, Citigroup and BofA both in Europe and the US. He has extensive experience in the Industrials, Automotive and Utilities sectors, advising both regulated and public companies. He has advised on both UK and cross-border M&A.

Oliver Nyumbu

Oliver Nyumbu is Chief Executive of Caret UK. Caret specialises in Leadership and organisational effectiveness. Oliver and his colleagues help senior managements and their teams to intentionally make evident 'best use' of all relevant strengths within an organisation.

As well as the UK, Caret has undertaken international assignments in USA, Canada, Singapore and Africa. Working across a range of sectors, they take a keen interest in interplay between types of organisations, strategies they adopt, levels of engagement and sustainable performance. Oliver has a particular focus on coaching and mentoring Chief Executives and supporting the development of their teams.

Ruth Sunderland

Ruth Sunderland is Associate City Editor at the Daily Mail. She has previously held a variety of posts on national newspapers and magazines including as the Business & Media Editor of The Observer, Deputy City Editor of the Daily Mail, Business Editor of the Mail on Sunday, Personal Finance Editor of the Daily Express and a financial report writer on Which? magazine.

She has published two books on finance and contributed to a number of others. Ruth has an MA in American Literature and is a Fellow of the Royal Society of Arts.

The Commission Secretariat

The Commission secretariat was provided by staff from Mutuo, who have supported Commissioners over the two years of meetings, research and visits.

Peter Hunt
Commission Secretary, Peter Hunt has been Chief Executive of Mutuo since 2001, which he founded as the first cross mutual sector body to promote a better understanding of mutuals.

In 2008 he established Westminster Bridge Partnership, which provides strategic advice to leading businesses.

Mark Willetts
Assistant Commission Secretary, Mark Willetts worked in Westminster for four years as a Parliamentary Researcher. During this time he gained extensive Parliamentary and government affairs experience. He is a partner at Westminster Bridge Partnership.

For more information about Mutuo, please visit www.mutuo.co.uk
Mutuo is operated by Westminster Bridge Partnership. www.westminsterbpa.com
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Additional Research and writing
Additional expert research and writing was provided by **William Davies**, Academic Director at the Centre for Mutual and Employee Owned Business, Kellogg College, University of Oxford. We are grateful in particular for his work on the employee ownership section.

Philippe Schneider, independent advisor, provided invaluable research and drafting advice. His contribution ensured that the report held together in a consistent and coherent manner.

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Executive Summary

The ownership framework in which economic activity takes place is one of the central institutions of the modern market economy. The particular form it takes influences the character and performance of enterprises so that necessarily there is an important public and social interest in ownership being discharged well. Owners can take their responsibilities as stewards of their assets more or less seriously with profound implications for their performance over time. And because decisions by private owners have public and social consequences these actions cannot be free from any societal or public constraint. After all property rights are granted and enforced by public institutions; it is perfectly reasonable for the public to have a reciprocal view of what is expected in return.

The Ownership Commission was established in 2010 to review the state of ownership in the UK, to examine the extent to which it supports or inhibits successful, long-term value creation by business in all its ownership guises. This involves assessing the governance and ownership of Public Limited Companies (PLCs) plus also considering the contribution of non-PLC forms, including family ownership, mutuals, co-operatives and employee ownership.

The Ownership Commission is especially focused on the following questions:

- Is the balance between committed long-term owners (or 'stewards') and short-term transactional owners currently working in the best interests of British business and society?
- How are ownership trends, including consolidation via takeovers, the rise of foreign ownership and the growing dominance of the PLC, affecting the long-term interests of British businesses and the British economy?
- Can further steps be taken to encourage engaged ownership in all forms of enterprise – from the co-operative to the PLC?
- Is there sufficient recognition and support for non-PLC forms of ownership, such as mutuals, family-ownership and employee-ownership? In particular can more be done to stimulate the growth of a British "mittelstand" of vibrant medium sized family enterprises?
- What can government do to increase the plurality of ownership forms in the British economy and promote a culture of popular engaged ownership?

Analysis

The Commission places a particular emphasis on corporate plurality, for two reasons:

1. **PLC monoculture and short-termism**

   The British private sector is dominated by a single company organisational form, namely the PLC. While the PLC has many advantages that should be celebrated, it has become the default corporate organisational form for risk-taking investors, financiers, regulators and government, to an extent that reduces opportunities for other ownership forms to grow and prosper. Plurality of ownership forms should be viewed as an economic good in its own right, increasing both choice and the variety of corporate forms available for varying business models and their investors while spreading risk more effectively (discussed in Chapter Two).

   The Commission is also concerned that PLC share ownership is increasingly influenced by short-term transactional imperatives, generated partly by an increased number of intermediaries in the chain between assets and their ultimate owners. We are anxious that there is evidence that short termism is increasing, making it harder for Britain to have strong companies where long termism is central to the business model, like those dependent on an expensive infrastructure or long term product development. The ease with which British PLCs are open to hostile and foreign takeover is a further concern. (These concerns are explored in Chapter Three).

2. **Unrecognised plurality**

   The regulatory and financial focus upon the PLC hides the degree of ownership plurality that Britain already has. By failing to recognise alternative ownership forms as they do exist, policy-makers fail to offer them the supporting infrastructure that they need to grow. The Commission notes the contributions of the following ownership forms (outlined in Chapter Four):

   - Private equity
   - Partnerships
   - Family ownership
   - State owned businesses
   - Sovereign wealth funds
   - Employee-ownership
   - Mutuals

   Each of these ownership forms brings its own advantages and disadvantages, managing risk in distinctive ways, and benefiting from different regulatory and legislative conditions. Having given insufficient consideration to consider the meaning of ownership or 'good ownership', policy-makers have not examined how their actions inadvertently impact upon this diverse ecology of ownership forms, to the detriment of many good owners.

Recommendations

There is no single magic bullet that will deliver better ownership. What we propose is an interconnected matrix of nudges, new protocols, better processes, the scaling up and deepening of some existing institutions together with the creation of some new ones, new capabilities and strengthened and clarified legal obligations that cumulatively will deliver more plural, engaged and stewardship-oriented ownership. The organising common theme in our proposals is that we want better to link the preferences and interests of the ultimate owner – whether investor, worker or consumer – with the organisation they own.

We believe there are three dimensions to good ownership - plurality, stewardship and engagement. If these can be sufficiently strengthened a different self-reinforcing dynamic will be created that will drive better ownership and corporate behaviours. It is because good ownership matters that Britain needs its current and future governments to start thinking in terms of ownership policy. What follows brings together our proposals made over the report. It is by no means the last word, but we hope it stirs a long overdue debate.

Plurality

Plurality of forms of ownership provides more opportunity to align the form of ownership with the appropriate business model, promotes more resilience to shocks within particular sectors and wider economy, allows investors and savers more avenues in which to save and invest and gives consumers more choice. It can be promoted in the following ways:

- Britain's medium sized family firms are a fraction of their comparable scale in Germany, denying the country a crucial source of innovation, investment and constraining the numbers of future big companies. Their share of output needs to increase substantially over the next twenty five years. We propose that Britain develops new mechanisms and tax concessions to support the build up of equity capital in the medium sized family business sector, from corporate venturing to new tax reliefs on rates of corporate return as proposed by the Mirrlees Report. In addition we believe that Britain should build up a supportive network of institutions to support SMEs with more generous flows of credit and equity, innovative new technology and skilled workers.
- A twenty first century new mutualism should trigger the foundation of a new wave of co-operatives whose combined output is only around 2 per cent of national output. We recommend that mutuals become permanent through emulating in Britain the European principle of disinterested distribution so that when mutuals are wound up their assets have to be placed with another mutual. We also propose radical measures to allow co-operative mutuals to raise external capital, the major constraint on their growth.
- Employee owned companies, which constitute less than 2% of GDP, should receive greater support, including via the tax system. Employee Benefit Trusts, which hold shares on behalf of all employees in a company, lost their tax advantages in 2003, due to their being abused. However, this has significantly disadavantaged founders and owners of companies, who view employee ownership as a long-term ownership model (for instance, as a route for business succession), as they now pay tax twice – once when profits are put into the Trust, and again when profits are distributed. In the absence

of tax relief, every £100 of employee trust shares cost £139 in company cash, which is a punitive premium. As a result, fewer employee buyouts can be financed and, of those that do get started, a higher proportion will unravel prematurely. A number of further steps can be taken to overcome the disadvantages faced by employee owned firms at critical times in their business lifecycle, including creating taxation and regulatory equivalence with other types of companies, especially at the time of ownership succession.

- The government should play an active role in providing simple templates for employee ownership. For founders seeking to establish new companies or exit existing ones, there is currently inadequate professional advice on employee ownership options. A single 'off-the-peg' model of employee ownership should be available.
- The government should extend the provisions of the Enterprise Act to better define the strategic public interest powers of the Secretary of State. Currently, the Enterprise Act identifies defence, financial stability and aspects of media and news provision as specific areas where a public interest intervention may be considered. The Commission believes that the government should be pro-active in considering additional sectors to be of strategic public interest, allowing the government the latitude to make interventions that reflect the public interest.
- Public sector mutuals should be protected from demutualisation by a clear 'asset lock'.

Stewardship

Shareholders, trustees, investment management companies and directors should have the definition of their fiduciary obligations widened to include better stewardship, and for this to be better enforced by closer links between the ultimate owners and managers. In particular the Commission proposes:

- All businesses should be required to make a statement of their business purpose in their annual report.
- Corporate directors should be required to declare what they consider is in the best long-term interest of a business to achieve such a declared business purpose. This should attract new "safe harbour protections" insulating their judgements from legal challenge. This would be part of the listing rules on the London Stock Exchange. At least 50 per cent of equity should be freely traded.
- The government should consult with interested parties about the extent to which fiduciary duties are too narrowly defined and offer a redefinition to include a "duty of stewardship". As a starting point all institutional investors should be required to sign, comply with and implement the Stewardship Code. In particular investment institutions should provide a guide to what returns they are seeking and how they exercise their stewardship responsibilities.
- Pension funds and other long-term end assets owners should be encouraged to take more long term control over the terms for the management of their beneficiaries' money. Excessive competition for investment mandates, promising immediate improvements in investment performance, exacerbate the already strong tendencies for short termism.
- There should be maximum transparency for all aspects of ownership and change of ownership including advisers' fees and stock lending policy.

Engagement

Engagement of employees, shareholders and other business stakeholders with management is proven to increase the performance and accountability of business. This can be promoted in the following ways:

- All companies should set out their approach to employee and investor engagement in their annual reports. In particular employee ownership should be actively encouraged from employee share ownership schemes to fully fledged employee owned companies – see our proposals on Employee Benefit Trusts (Chapter 4).
- Strategies and new technologies should be explored to allow disparate, individual and institutional shareholders to act collectively in engaging with the management of PLCs.
- In particular the Commission recommends that serious consideration is given to the creation of share-voting pools or so-called "aggregation platforms" to whom individual or institutional shareholders can cede their voting rights. We are attracted to the idea that they could be not- for profit- mutuals, established to aggregate the voting rights of institutional investors to give more muscle to the shareholder voice – and developing a business model in which they charge for the service. This will address the emergence of "ownerless corporations".
- Stewardship requires an integrated and skilled approach. We believe that individuals with the right skills and credibility employed by the new aggregation platforms should carry out intervention on behalf of corporate owners at senior management and board director level. Making realistic and realisable demands of companies, informed by significant hands-on experience of business management and strategy setting is critical to the good ownership of our public companies.
- It is becoming technologically possible to canvass the opinions of the pension fund beneficiaries and the other ultimate owners directly. We recommend that pilot schemes are developed and, subject to their success, that such consultation becomes the norm.
- The Annual General Meeting of PLCs needs revitalising to promote the greater involvement of shareholders.
- The participation of the whole range of stakeholders is essential in public service providers that are spun out of the public sector. Government should encourage Foundation Trust style models of multi-stakeholder ownership to be extended across the public sector where independent organisations are being considered

Chapter 1

The Philosophy of Good Ownership

1.1 The Ownership Commission was established in January 2010 to investigate the issue of better ownership of business and economic assets, recognising that given the scale of Britain's economic challenges it was time to reassess whether the balance of ownership obligations and rights had been struck correctly.

1.2 The Commission also had an objective to examine whether more could be done to promote, where appropriate, more diverse, plural forms of ownership in both the public and private sector.

1.3 The performance of the British economy, now experiencing what threatens to be the most protracted period of economic difficulty since the nineteenth century, demands a rethink about whether the British solution to the ownership dilemma has produced the best results.

1.4 So who owns Britain? We all do. Millions of us are part-owners of the companies listed on the FTSE 100 index through pension and collective savings schemes. Others may be members of co-operatives and mutuals and others again may work for companies that are wholly or partly owned by their workers. Yet many concerned British citizens are not aware of their ownership, do not recognise it and do not act as owners.

1.5 Yet we all have a stake in how well or badly our businesses are run, and in the long-term creation of value by companies for the UK economy. Companies are run by their executives. The open question is whether they act consistently in the best interests of their shareholders and owners, and whether even if they did that would mean they are acting in the best interests of the wider economy and society.

1.6 To own is to have autonomy over assets and contracts, and to decide how any surplus is distributed. This can be autonomy that I exercise myself or in concert with others. But however organised these are important prerogatives which have a massive impact on the societies in which they are exercised, and to which society cannot be indifferent. Indeed there are some economic functions that are so crucial that no single owner or group of owners can be allowed prerogatives that might damage others.

1.7 Thus in many countries, communication services or energy utilities such as gas and electricity are collectively owned for precisely such reason. Even when that is not the case, as in the UK, their private owners are closely regulated to ensure that ownership rights are not abused.

'Good ownership matters.
We should be concerned to secure more of it.'

1.8 In Britain there is growing awareness that one ownership type – the PLC – dominates all others. The country has disproportionately fewer co-operatives, consumer mutuals, worker owned firms and family enterprises than most of our peers. Until the welcome emergence of foundation trusts, public ownership was similarly monolithic. Moreover the PLC, although in principle a good ownership structure with many benefits, can demonstrate weaknesses if too many of its owners are disengaged and do not take their stewardship obligations seriously. The recent debate over the explosive growth of executive pay compared to performance is another example where it is felt that PLC shareholders have not exercised their ownership responsibilities as they should have done. Equally the evidence is that PLC owners tend to over prioritise short term profit considerations; as we describe later two markets have emerged – a market in which real firms undertake real business, and a market in which share prices are benchmarked against expectations of profit performance, and where expectation management dominates corporate decision making – often over-emphasising immediate rather than long term strategic objectives.

1.9 Yet owners are part of society and ownership rights necessarily come with responsibilities. How owners deploy their assets and contracts, rationally assess time scales and divide their profits, impact on others. Good ownership matters. We should be concerned to secure more of it.

1.10 There are three broad preconditions for better ownership. A healthy market economy needs diverse ways in which ownership can express itself and be applied to varying business models: the PLC, while important, should be one part of a diverse population of ownership types. The consequent diversity will give the system more resilience and more opportunity to experiment with ownership forms as they are appropriate for different business models. It will also give savers and investors a diverse choice of forms through which they can save and invest, and so offer a better hedge against risk. Secondly an ownership culture is needed that at the very least does not downgrade the long term and takes its responsibility for good stewardship seriously. This will lift investment and innovation, but also promote a denser ecology of more long lived firms at every stage of their growth. Such firms are not only our economic lifeblood – they anchor society. They offer training and careers to our young people, and underpin the vitality of our towns and cities. And thirdly owners are needed to participate and engage in the strategies and behaviours of the companies they own: "absentee shareholders" are bad for everyone.

1.11 The Commission wants to find ways of better expressing these needs for a plurality of ownership types, stewardship and engagement in as least prescriptive and as liberal means as possible so that the benefits of good ownership interact with dynamic markets. It does not believe that these three preconditions have been successfully achieved today. More can be done.

1.12 The entitlements of private ownership are at the heart of our system, which depends on diverse corporations and organisations experimenting with the new, competing with each other and responding to the incentives of the market place. Multiple firms, each having their own capacity to act because they have sovereignty over the assets under their control, constitute the core building block of our economy.

1.13 However that does not mean that the entitlements and responsibilities of ownership are easy to define or free from debate. The degree to which any private owner has complete or instead more bounded sovereignty over the assets to which he or she has title has been contested in most societies. Necessarily, the sovereignty of ownership is limited by wider social obligations – and attempts to trump the debate by either opting for system-wide socialisation of ownership or system-wide libertarian private ownership, in which such obligations are ignored, have both failed.

1.14 System-wide social, public and collective ownership fails because the system moves in lockstep following one course of action rather than experimenting with diverse answers in a world of uncertainty. There are no checks, balances and challenges: ossification and waste become endemic.

1.15 Equally, system-wide unconstrained private ownership fails because societies need private owners to accept that there are obligations to ownership, notably to other stakeholders in the organisation, for example the employees, and to the wider society beyond.

1.16 Ownership thus needs rules just as society needs rules, and indeed there are some rules: in the same way we need the Highway Code to govern how we drive or even rules to manage how we behave when we eat, so we need rules to govern the exercise of ownership. Owners cannot treat their property, workers, customers and neighbours only according to their own preoccupations, values and interests. Their actions and decisions impact on others. There are codes and rules (Companies Act, Takeover Panel, Listing Rules, Governance Codes etc.) and these are constantly reviewed and updated.

'System-wide social, public and collective ownership fails because the system moves in lockstep following one course of action rather than experimenting with diverse answers in a world of uncertainty.'

1.17 The company has long been regarded as one of the best ways of organising the delivery of goods and services for most business models. In the next chapter we set out its advantages in raising capital, sharing risk, organising professional management, limiting liability and promoting transparent use of resources. However even in the late seventeenth century governments were careful to set out what were the obligations that accompanied incorporation. Today company law, voluntary codes of governance and stock exchange listing authorities set out the responsibilities of directors for how they discharge their responsibilities both to the company and beyond – what must be disclosed, how accounts are to be presented and what the liabilities are to the company's various stakeholders etc.

1.18 This is in part because no company should be allowed to impose unlimited costs on others extraneously; in the same way polluters should pay for their mess and waste, so as far as possible, should companies accept the costs that they impose on the rest of society. But creating firm rules for the company is also an attempt to establish the company as a legal personality in its own right that has the capacity to act autonomously while balancing all the interests of those who contribute to its success – investors, workers and customers – and between the short and long term. The open question is whether the rules as currently structured succeed sufficiently in helping directors strike that balance in driving forward the company as a whole.

1.19 It is because good ownership matters and extreme solutions are no answer to the dilemma that societies are forced into complex and difficult arguments about how this balance and trade-offs are struck. A healthy, pluralistic capitalism will have – indeed needs – a mix of ownership forms that strike the balance in different ways. But it will start to malfunction if one ownership characteristic or interest starts to dominate. How the various balances are struck is a matter for continual debate and appraisal.

1.20 The property rights associated with the shareholders in private business are necessarily part of this debate. For more than thirty years there has been a growing presumption that the more ownership structures in business lean towards little regulation and intervention, where owners and managers have as much unconstrained sovereignty as possible, the more society will enjoy the benefits of a resulting increase in business dynamism, entrepreneurship and innovation.

1.21 In this conception, emphasis on the attendant obligations of ownership has been reduced. However, after the global financial crisis there is less willingness in many quarters, including much of finance and business, to accept these propositions as uncritically as before.

1.22 There is plainly good and bad ownership of businesses and freedom from wider obligations does not necessarily deliver good business ownership. Indeed, 'bare ownership' can result not only in the imposition of insupportable costs on the rest of the economy, but also the erosion of shareholder value.

1.23 For example Andrew Haldane, Executive Director for Financial Stability at the Bank of England, has recently argued that one of the reasons that banks grew their balance sheets unreasonably large, with too much risk supported by too little capital, was that the immediate result was to increase perceived shareholder value – although subsequent events have created widespread losses for shareholders and protracted loss of output.

1.24 Britain's system of company law and codes of corporate governance set out a framework for good ownership. Certainly in the case of the largest PLCs a great deal of effort is directed towards meeting these obligations. Bigger firms will experience strong engagement from major shareholders, but it is not clear that smaller PLCs will have the same experience. We can say that short-termism is a risk that has to be managed in PLCs and there is always a need for managers to seek to balance City expectations. In a takeover situation, this is even more pronounced with shareholders demanding short-term gains.

1.25 The existing system is under closer examination now than at any time since the 1930s – also a period of economic recession and high joblessness – and questions about how capitalism can best deliver sustainable prosperity are properly and reasonably being asked again.

1.26 The role of good ownership and the right balance being struck between long and short-term value is fundamental to a system capable of delivering creativity, innovation and economic dynamism. The evidence is that everyone does better. The World Economic Forum's report on the Future of Long Term Investing[1] highlights the evidence that long term investors by avoiding excessive transaction costs, accepting high up front development costs and running the risk of less liquidity often receive higher returns than short term investors and owners. In turn directors with long term owners can trigger more investment and innovation knowing that their owners are engaged and behind them: workers commit more and work more efficiently and effectively in such environments.

1 www.weforum.org/issues/future-long-term-investing

'There is plainly good and bad ownership of businesses and freedom from wider obligations does not necessarily deliver good business ownership.'

1.27 The financial crisis has forced governments in Britain and elsewhere to revisit ownership and corporate governance, especially in financial services, as part of the process of stabilisation and attempt to mitigate future risks. For example the Financial Services Authority now involves itself in the appointment of suitably qualified non-executive directors of banks and has become more prescriptive over capital adequacy and the liquidity of both bank assets and liabilities.

1.28 The UK Government is to implement the Vickers Report ring-fencing investment and retail banking. It has made the Co-operative Group the preferred bidder of Lloyds 600 or so branches, building up a force in retail banking organised as a co-operative rather than a PLC, and thus give the system more resilience. The Commission notes and supports these initiatives which underlie our conviction that the story of ownership is integral to the wider debate about the how our economy is run, how we return Britain to stable growth and with that, create wealth and improve standards of living. The open question is how these principles could be extended more widely.

1.29 The question of how well private ownership is discharged is fundamental to the success of the private sector, so central to wealth generation. Indeed the more Britain can exploit the opportunities of the emergent knowledge economy in the decades ahead the more it will grow: managing risk, innovation and the crucial engagement of the workforce that are central to success in high value added knowledge industries can best be done in well owned companies. The resilience of the economy can best be secured by diverse ownership structures. Equally the issue of whether ownership in the public sector can be better structured to create engagement, innovation and stewardship is no less important. We offer this report as our contribution to a vital national debate.

The Pillars of Good Ownership

Corporate pluralism

1 A plurality of ownership forms provides more opportunity to align the form of ownership with the appropriate business model, promotes more resilience to shocks within particular sectors and wider economy, allows investors and savers more avenues in which to save and invest so giving them more chances to balance their portfolio and hedge risk and gives consumers more choice. Law, regulation and tax should be neutral between ownership forms – and designed to allow the system to function as far as possible without recourse to intervention and inappropriate regulation

Owners have responsibilities as stewards

2 Shareholders, trustees, investment management companies and directors have a stewardship obligation alongside their fiduciary obligations. Incorporation is a privilege which must be associated with a business purpose that owners choose to pursue. Boards of directors must have the power, authority and legal rights to deliver that purpose. Boards have thus both rights and responsibilities.

Ownership rights are contingent on accepting shared responsibilities

3 Boards must have a clear and transparent chain of accountability to their owners, but owners can only expect to exercise their rights to such accountabilities if they are committed to the enterprise and its purpose.

Owners have multiple aims, preoccupations and interests. The legal, tax and regulatory system must be neutral between them

4 Corporate owners will be both committed, long term owners and transactional short term owners. The system must be careful not to privilege the short term transactional owner even while it respects their rights.

The more engaged employees and shareholders are with the enterprise the more it is likely to prosper

5 Employee engagement and participation as with shareholder engagement enhances the performance of businesses.

Chapter 2

Why Corporate Plurality Matters

2.1 A plurality of ownership types and business models creates a corresponding diversity in forms of corporate governance; risk appetite and management; incentive structures; policies and practices; and behaviours and outcomes. It also offers wider choice for consumers through enhanced competition that derives in part from the juxtaposition of different business models.

2.2 Variety is the evolutionary fuel in economic development as well as in biology. Diversity is desirable across the economy, and diversity within the financial sector itself – both a variety of corporate forms and geographical dispersion, with stronger local presence – tends to support a broader variety of corporate forms in the rest of the economy which in turn enhances competition and consumer choice.[2]

2.3 Around half of Britain's GDP is delivered by the PLC, the largest proportion provided by any one form of corporate organisation. There is an emerging consensus that if the PLC is to loom so large then greater attention should be paid to how well it does its job. Moreover a dynamic market economy also needs a constant supply of vibrant new firms to replenish the stock.

2.4 These will frequently emerge from the small and medium sized business sector, in particular family owned business, which are also the principal driver of innovation. Demergers of large companies can create good sized firms too. Yet in the same way Britain has disproportionately more PLCs than other countries, so it has a disproportionately smaller Small and Medium sized Enterprise (SME) sector. For example there is nothing to compare with the famous German Mittelstand. At the same time, the customer owned mutual sector is small and employee ownership is less significant than elsewhere.

2.5 The experience of the financial services sector has shown that greater corporate plurality is good for systemic resilience. The Commission believes that the same can be said of the broader corporate sector. The UK requires different ownership structures for different business models, and each needs a critical mass to be deployed effectively.

Corporate plurality in financial services

2.6 The Commission was initially inspired by increasing unease about the nature and progress of corporate ownership in the UK. This was spectacularly brought into focus by the failure of the large bank PLCs that led to the financial crisis from 2008 onwards.

2.7 The key question is whether the lessons that must be learned from the systemically important financial services sector are valid for the broader corporate world.

2 Gagliardi, F. (2009), Financial Development and the Growth of Co-operative Firms, Small Business Economics: An Entrepreneurship Journal, Volume 32, Number 4, pp.439-6

'Variety is the evolutionary fuel in economic development as well as in biology. Diversity is desirable across the economy, and diversity within the financial sector itself...'

2.8 The credit crunch, which was largely caused by the activities of private sector banks, resulted in the UK Government giving them total support of £1.3 trillion at the peak, of which some £80 billion was direct injections of new capital. In addition, the Government borrowed in order to provide the fiscal boost that was co-ordinated internationally to prevent a slide into global depression. The cumulative loss of output caused by the financial collapse over the years ahead is calculated to run into trillions of pounds.

2.9 There were and are particular reasons why the financial services sector grew so over-stretched, but one reason is that board members were insufficiently skilled to challenge what was being done. In many cases shareholders were actively encouraging strategies that ultimately led to the financial crisis. In this sense the financial crisis is a more acute expression of the general weakness of the PLC model. Given the financial, economic and social costs of that credit crunch and concomitant recession, a key priority for policy needs to be to put in place measures to prevent a reoccurrence in the future. Otherwise such problems may well recur, whether that be in 10, 20 or 30 years time.[3]

2.10 However, the UK financial services sector is dominated disproportionately by a single business model, namely the large, shareholder-owned plc. This domination of the shareholder ownership model – whose purpose is to maximise financial returns to the shareholders – proved a lethal combination with the financial deregulation, the creation of new financial instruments and the concomitant rising levels of debt over the past twenty years.

2.11 Andy Haldane, Executive Director of Financial Stability at the Bank of England, has described well the way in which one of the factors that lay behind the 2007-2008 global financial crisis was that individual institutions had been diversifying and that while this might be thought to reduce risk, it does not if all are diversifying in the same way, so instead the system becomes less diverse.[4]

2.12 The Centre for European Policy Studies (CEPS) has produced two major and comprehensive research studies of diversity in European banking (CEPS, 2009 and 2010). Both reports emphasise the advantages of having diversity in banking structures and models, and illustrate this with case studies of several countries. The purpose of these reports is not to argue that one model is superior to others, but precisely that advantages accrue through diversity. Their first report, Investigating Diversity in the Banking Sector in Europe found that 'The most important conclusion is that the current crisis has made it even more evident than before how valuable it is to promote a pluralistic market concept in Europe and, to this end, to protect and support all types of ownership structures'[5]

2.13 The Government's Coalition Agreement is committed to diversity in financial services: "We want the banking system to serve business, not the other way round. We will bring forward detailed proposals to foster diversity in financial services, promote mutuals and create a more competitive banking industry."[6]

3 And there is evidence that the incidence and frequency of bank crises around the world has increased over time – see for example Eichengreen and Bordo, 2002.

4 Haldane, Andrew G. (2009a), 'Rethinking the Financial Network', Speech delivered at the Financial Student Association, Amsterdam, April, pp. 18-19

5 Ayadi R et al, Investigating Diversity in the Banking Sector in Europe – The Performance and role of Savings Banks, 2009, p. 3.

6 The Coalition: Our programme for Government, HM Government, 2010, p. 9

Broader lessons for corporate plurality

2.14 The crisis in financial institutions has been plain for all to see, the Commission's view is that the very issues faced by the 'one size fits all' approach to ownership the financial sector is also apparent in other parts of the economy. There are wider systemic weaknesses in the way ownership is expressed.

2.15 The global economy is a complex system with many interconnected organs. As The Economist notes: Just as an ecosystem benefits from diversity, so the world is better off with a multitude of corporate forms.[7]

2.16 We have seen over the last 30 years how the larger PLC has become the dominant business form in the UK. The corresponding lack of corporate plurality contrasts with the UK's main European competitors, each of which has a lower proportion of listed firms.

2.17 Ultimately we are interested in diversity of ideas and business models. Homogeneity in ownership structures leads to narrowing in ideas and business models. For instance, there is evidence that firms which are not governed by the private equity business model have 'mimicked' strategies associated with private equity to raise efficiency levels. This underscores a general point: there is likely to be herding around a business model or strategy that is perceived to be successful – regardless of the ownership structure in place.

2.18 One estimate suggests that half of the British private sector economy is not traded on the stock market. The problem, at present, is that the alternative corporate forms are insufficiently understood by managers, professional advisors and policy-makers, and therefore their potential to contribute to a growing and sustainable economy is being thwarted by the PLC-oriented mono-culture in relation to policymakers.

2.19 Family-ownership, which accounts for 60% of European businesses and a quarter of the continent's top 100 businesses, represents a sizeable proportion of the non-listed British economy also, representing 31% of UK GDP. The chief problem faced by family-owned firms is business succession: less than 30% of these companies survive into a third generation of family-ownership. The temptation to sell into private equity ownership or to list is therefore all the greater. But this is because they often lack the guidance, access to finance and the governance mechanisms required to find sustainable alternatives including selling to employee trusts.

2.20 Britain has an under-acknowledged, under-supported medium-sized enterprise sector, whereas Germany has long recognized its 'Mittelstand' of privately-owned, medium-sized firms as crucial to its competitiveness. Firms which turn over £10m-100m make up only 1% of all firms in the UK, but create 16% of the total UK employment and accounting for 22% of total business revenue. They also derive a higher proportion of their revenue from investments in innovation than either small or large firms. Many of these firms are family-owned, and therefore suffer dilemmas of business succession that the UK business infrastructure - in particular the provision of equity and debt - leaves them entirely ill-equipped to create innovative businesses.

2.21 If policy-makers are concerned to 're-balance' the UK economy away from the South East, and away from services and financial services, it is this British Mittelstand that will need nurturing in future. An analysis and accompanying proposals follows in a later section.

7 Schumpeter, The eclipse of the public company, Traditional listed firms are facing competition, The Economist, August 19th 2010, p. 58

2.22 For the market as a whole to benefit requires that the various corporate models each enjoy the necessary critical mass, defined as the degree of market share necessary to enable that model to operate successfully and thus to provide real competitive pressure on the other players within the market.

2.23 All too often in the UK the plc is regarded as the 'natural' way of running significant business. This means that the media, regulators and political leaders focus on the requirements of the shareholder owned company to the detriment of other types of corporation.

2.24 At present Britain has a poor record of growing businesses. Small businesses struggle to grow to medium-sized. Meanwhile, the medium-sized sector struggles to match the productivity that characterises the German equivalent.

2.25 Co-operatives and mutuals are notable players in particular markets such as food retail and financial services, but represent only a very small proportion of the overall business economy. They labour under antiquated legislative structures, are not well understood by the rest of the business community and are seen as old fashioned. Yet as customer focused businesses, these firms can offer an alternative ownership proposition.

'The presence of diverse business forms is good for competition and choice for the consumer.'

2.26 The presence of diverse business forms is good for competition and choice for the consumer. More importantly perhaps, their existence acts to mitigate risk in our business economy.

2.27 Yet regulators and policy makers have consistently failed to take seriously the mutual corporate form. At least in part, this is because of its inability to easily raise capital, despite the fact that this reduces their risk appetite and thus means that a financial services sector with a strong mutual sector will have a greater diversity of risk appetite, which is a positive outcome in terms of creating a stable and robust financial services sector – as reported in IMF and other research.[8]

2.28 There are many examples of the positive role that differently owned businesses can and do play in aiding a plurality of corporate forms, but these positive impacts could be greatly enhanced given the right environment and political goodwill. The benefits of creating a more diversified corporate sector include greater stability, more accountability to consumers, reduced systemic risk, and more competition.

8 Hesse, H. and Cihák, M. (2007), Co-operative Banks and Financial Stability, IMF Working Paper No. WP/07/2

Ownership and purpose

2.29 It is the business purpose, derived directly from the ownership type that most influences the behaviour of a firm, and its relationship with its owners.

2.30 A better understanding by policy makers and the general public of the core purpose of each corporate form would enable a more sophisticated approach to balancing the needs of each in our economy. It would help to eliminate bias built upon ignorance of indifference.

2.31 But different corporate models do not just exhibit a difference in ownership structures – they can also show a difference in business models.[9] Having a diverse set of institutions and therefore a diverse set of business models increases competition because it is generally the case you get more competition not by just adding more firms with the same business model but by also adding firms with different business models to those which are already there. Thus the competition effect is greater with different business models rather than just having yet another institution of the already dominant form.

2.32 This point about business models also feeds into the issue of systemic stability. Across Europe, stakeholder value banks in general performed better in the crisis than did shareholder value banks and that is partly – there are also other reasons – due to their different business models and the fact that they manage risks differently. In addition, another major reason for promoting corporate plurality relates to risk aversion. What one wants is a diversity of appetite for risk within the system.

2.33 On appetite for risk, for example, one of the features of a mutual and of many stakeholder value banks is that they cannot easily inject external capital, and this tends to limit their risk appetite.[10] This feature of mutuals limits their risk appetite and thus means that a financial services sector containing a critical mass of mutual organisations will have a spread not only of business models but also therefore of appetites for risk.

Missed opportunities for non-PLC growth

2.34 By virtue of being owned by their members, not by shareholders, mutuals are able to enshrine a purpose at the heart of their governance structure, other than maximisation of profits. Research on the employee-owned sector indicates that it is more resilient in the long-term.[11] The sector was less affected by the recent recession, and emerged more quickly from it. Its record of job creation is less cyclical than shareholder-owned corporate forms.

2.35 As Chapter Three describes, there are a series of inter-locking institutions which offer implicit support for the PLC model of the firm. More recently, changes in taxation and cheap money supply led to a boom in private equity ownership, which has since died down. Alternative forms of ownership, which defend long-term organisational purpose on the part of companies – often over and above the pursuit of profit maximisation – also depend on a supportive infrastructure, in the form of suitable regulations, finance, professional advice, managerial education and cultural norms.

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9 That is why Ayadiet al. (2009 and 1010) refer to 'shareholder value' versus 'stakeholder value' banks, because there are fundamental differences in the business models between these two broad categories.

10 Ibid

11 Reinventing the Firm, William Davies, Demos 2009

Equal treatment for debt and equity

2.36 There is a case for examining the structure of incentives given to different ownership forms, notably the tax advantages enjoyed by debt. The role of debt has taken on more urgency in light of the economic crisis. The Commission recognises that borrowing is central to economic well-being, enabling companies to smooth investment and production in the face of variable sales while shifting risks to those most able to bear them.

2.37 However the build-up of private debt creates dangers: as debt levels go up, so the probability of defaulting increases with borrowers capacity to repay increasingly sensitive to changes in sales and interest rates. Beyond certain levels, it can become a brake on growth, producing dangerous levels of volatility.[12] Other arguments further point out that debt bias provides a less direct form of monitoring of management than does equity.[13] Similarly, it erodes the tax base which has become a greater problem with the emergence of hybrid financial instruments, international differences in statutory corporate income taxes and more active tax planning.[14] Finally, debt bias penalises innovative growth firms which typically face barriers to external debt resulting in too much investment by mature firms and the misallocation of talent.[15]

'The current tax deductibility of debt interest offers an advantage for firms to finance their investments by debt'

2.38 There are several ways in which the playing field between debt and equity could be made more level: eliminating or reducing interest deductability i.e. levelling down or allowing firms to deduct from profits an allowance for corporate equity i.e. levelling up.

2.39 The first approach is traditionally associated with calls for a comprehensive business income tax (CBIT). It has the advantage of broadening the tax base - the assets and income available to be taxed- and potentially allows for reductions to the headline rates of corporation tax. The drawback is that it would require careful introduction, especially for firms with pre-existing debt. Thus, it could only be implemented over a relatively long-time scale; otherwise it may aggravate financial distress. Another concern is that banks would be under-taxed relative to nonfinancial companies as only interest expenses and not interest income received on outstanding loans to other firms- would be taxed under a CBIT. Without international co-ordination, this may have knock-on effects for the efficiency of international lending markets. The alternative to full neutrality would be to impose a limit on the interest rate to which deductions are granted. This would offer greater flexibility but would be accompanied by greater complexity.

2.40 Under the second approach, interest deductibility would be complemented by giving relief to equity finance. As well as curbing the debt bias, the tax system would be more neutral to marginal investment decisions. This approach favoured by the Mirrlees Review already operates in different guises in countries such as Brazil, Latvia and Belgium.[16] The hitch is its cost to the public finances, estimated by the IMF to be around 0.5 per cent of GDP for an average developed country.[17] However, limiting

12 Cecchetti, S, Mohanty, M and Zampolli, F (2011), The real effects of debt , BIS Working Papers 352, Bank for International Settlements
13 Ruud A. de Mooij (2011), Tax Biases to Debt Finance: Assessing the Problem, Finding Solutions IMF Staff Discussion Note
14 Ruud A. de Mooij (2011), Tax Biases to Debt Finance: Assessing the Problem, Finding Solutions IMF Staff Discussion Note
15 Tirole, J., (2006) The Theory of Corporate Finance Princeton University Press
16 IFS (2011) Tax By Design especially chs. 17 and 18.
17 Ruud A. de Mooij (2011), Tax Biases to Debt Finance: Assessing the Problem, Finding Solutions IMF Staff Discussion Note

'The Commission considers that giving relief to equity finance, taxing profits only above the normal return to capital invested is the best way forward.'

any allowance to new investments and introducing other changes to the tax system would help reduce this cost in the short-run; while any additional investment and employment that would result from the allowance would lower the long-run fiscal costs. Another attractive feature is that employees are likely to be the main beneficiaries of the allowance as they typically bear the brunt of taxes on corporate income.[18]

2.41 Clearly transitional issues would need to be addressed such as the tax treatment of group shareholdings and multinationals and hybrid instruments that have characteristics of debt and equity as well as restrictions imposed by EU law;[19] however, these are relatively minor technical and administrative issues that are significantly outweighed by the benefits of putting debt and equity closer on a more equal footing. The Commission considers that giving relief to equity finance, taxing profits only above the normal return to capital invested is the best way forward.

18 Arulampalam, W., M.P. Devereux, and G. Maffini (2010) The Direct Incidence of Corporate Income Tax on Wages IZA Discussion Paper 5293

19 http://www.publications.parliament.uk/pa/cm201011/cmselect/cmtreasy/753/753vw29.htm

Chapter 3

The Public Limited Company

The listed public limited company (PLC) is a limited liability company that sells shares to the public under United Kingdom company law.

Advantages

The Public Limited Company combines principles of stewardship, engagement and commerciality into the ownership and governance of large corporations, while ensuring that these firms are accountable both to their shareholders and to society at large.

Disadvantages

Promoting shareholder value is the dominant business objective of PLCs. Sometimes this has compromised other corporate objectives.

Recommendations

Ownership of strategic business

The Commission favours continued openness to foreign ownership as part of a diverse ownership structure. However, the government should extend the provisions of the Enterprise Act to define the strategic public interest powers of the Secretary of State. Currently, the Enterprise Act identifies defence, financial stability and aspects of media and news provision as specific areas where a public interest intervention may be considered. The Secretary of State has the power to add to this list, with the consent of Parliament. The Commission believes that the government should be pro-active in considering additional sectors to be of strategic public interest, allowing the government the latitude to make interventions that reflect the public interest.

Fiduciary obligations of company Directors

Directors fiduciary obligations should be widened so that directors should have a 'duty of stewardship' to deliver this purpose rather than at present simply 'have regard' to any interest other than their fiduciary obligations. Directors should be required to declare what they consider is in the best interests of the business if it is to meet its purpose, and for this to have safe harbour standing in law so that they are protected from being challenged over their judgements.

A stewardship obligation

Investment institutions should have a stewardship obligation alongside their fiduciary obligation.

The government should consult with interested parties about the extent to which fiduciary duties are too narrowly defined and offer a redefinition to include stewardship responsibilities. As a starting point all institutional investors should be required to sign, comply with and implement the Stewardship code. In particular investment institutions should provide a guide to what returns they are seeking and how they exercise their stewardship responsibilities.

More engaged pension funds

Pension funds and other long-term end assets owners should be encouraged to take more long term control over the terms for the management of their beneficiaries' money. Excessive competition for investment mandates, promising immediate improvements in investment performance, exacerbate the already strong tendencies for short termism. One example of such encouragement is the International Corporate Governance Network's Model Mandate Initiative.

London Listing Rules

London Stock Exchange listing rules should reinforce these measures and be rigorously enforced. In particular the United Kingdom Listing Authority (UKLA) should use the powers that it already has to ensure that companies seeking a listing have at least 50% of shares freely traded so that public shareholders are not in a minority with all the risks that entails.

Stock Lending

All institutional shareholders should declare transparently their policy towards stock lending including how much stock was lent and to whom during the financial year.

Transparency of agents

Advisory firms are necessarily oriented to promoting deals and transactions. Boards will be guided by the advice they receive from such firms. In practice advisors will be appointed by Boards on management recommendations. The Commission believes that advisors must be demonstrably the servants of the Board rather than management, and that the bias to recommend a transaction should be out in the open. In particular the Commission calls for:

- Greater transparency in the fees paid to agents that will enable owners better to judge their value for money.
- Remuneration of agents should be independently approved by Boards.
- Potential conflicts of interest should always be declared to owners.

Takeovers in PLCs

Takeover rules should not give an advantage to firms from countries where firms are less strictly governed than in the UK

- The conduct of offeror boards needs to be as effectively scrutinised as much as offeree boards
- There should be greater transparency in the behaviour of institutional shareholders in an offer period
- All company advisors need to be demonstrably independent
- Boards should be legally able to act with discretion as to the interests of the company, and their judgements and recommendations protected by a safe harbour provision
- Takeovers should be subject to tougher rules to prevent market dominance together with a strategic public interest test for foreign ownership

Improving trusteeship

Given the current part-time and lay nature of trusteeship, there is a vital need for the greater professionalization and education of fund trustees. This could include a 'trustee toolkit', which would be of particular interest to member nominated trustees and could be promoted through their networks, or where relevant, the underlying trades unions.

Helping pension funds to exert ownership rights

We recommend that serious consideration is given to the establishment of "aggregation platforms," in particular as not-for-profit mutuals, to aggregate or pool the voting rights of individual and institutional shareholders. Essentially shareholders would give the voting rights accompanying their shareholding to the mutual who would engage on their behalf with the companies and other entities in which they invest to promote their long-term value. The pooling of voting rights would give the new platforms considerable more leverage than any individual investment institution; and by charging each member a small fee would create the resource to pay for the monitoring – a business model to ensure better stewardship. Leadership should be initially provided by long term pension funds who should pioneer the development of the new platforms. Individuals with the right skills and credibility employed by the new aggregation platforms should carry out intervention on behalf of corporate owners at senior management and board director level. Making realistic and realisable demands of companies, informed by significant hands-on experience of business management and strategy setting is critical to the good ownership of our public companies. This proposal has the potential to transform the current situation of "ownerless corporations" and achieve significantly improved communication and effectiveness in engagement. It would address environmental, social, governance and strategic issues that are important to pension fund beneficiaries and promote long-term sustainable value by delivering beneficial change at companies and in public policy.

Communicate better with policy holders

It is becoming technologically possible to canvass the opinions of the pension fund beneficiaries and the other ultimate owners directly. We recommend that pilot schemes are developed and, subject to their success, that such consultation becomes the norm.

Improving the PLC AGM

We believe that the combination of recommendations above will lead to better engagement and attendance at the AGM. As these changes go forward, we believe that there may be scope for further reforms including:

- Enlarging the capacity for shareholders to put forward advisory as well as mandatory resolutions for debate
- Enlarging the areas and reducing the voting thresholds at which shareholders can introduce such resolutions
- Utilising technology to link back to underlying beneficiaries for voting input/guidance

'The Public Limited Company (PLC) is one of the great engines of innovation, wealth creation and progress.'

The evolution of the PLC

3.1 The Public Limited Company (PLC) is one of the great engines of innovation, wealth creation and progress. The PLC was at the heart of the 'golden age'[20] of prosperity, which ran from 1945-1973. At its best, it combines principles of stewardship, engagement and commerciality into the ownership and governance of large corporations, while ensuring that these firms are accountable both to their shareholders and to society at large. As a mechanism for the sharing of risk and reward, and the management of large-scale business investment, the PLC is an unrivalled model.

3.2 Aspects of the PLC form date back to 1600, when the first joint stock company, The East India Company, was incorporated in England. The joint stock company allowed groups of merchants to club their capital together and share risk at greater scale than any one merchant could do. The word "company" derives from the same Latin root as the word "companions" – companions sharing risk. The crown granted a licence to trade to deliver a declared business purpose, according the company privileges but also accompanying obligations: the East India Company, for example, was given a monopoly on East Indian trade but required to carry its trade only on English vessels.

3.3 Most of the defining characteristics of the PLC only developed much later, in the late 19th century. The listed corporation became a vehicle whereby many thousands of investors could pool their capital in a single business, and receive dividends as a reward for their risk. This enabled businesses to access capital and share risk on a scale never previously witnessed. However incorporating as a PLC still in a sense involves earning a licence to operate in which legal privileges are associated with obligations to adhere to government rules and law. The critical characteristics of the PLC are listed below.

Characteristics of the PLC

Limited liability: The institution of limited liability, which dates back to the mid-19th century, ensures that the owners of a company are liable for the equity capital which they invest, but not for the full losses of the company. This ensures that creditors cannot pursue shareholders for their losses and shareholders are not fully liable for the 'social' costs of business failure.

Separation of ownership and control: PLCs are run by professional managers, acting on behalf of their shareholders. Managers and Directors have a fiduciary duty, laid down in law, to act in the interests of their shareholders, which is assumed to be the greatest financial return.

Shareholder voting rights: In recognition of their contribution of capital, shareholders receive voting rights, in direct proportion to their share of equity.

Stock market listing and reporting: In order to sell shares on a stock market, PLCs must abide by requirements of listing. They must publish regular accounts.

20 Eric Hobsbawm, The Age of Extremes: The Short Twentieth Century, 1914-1991 London, Michael Joseph, 1994

Benefits and justifications

3.4 These various elements are combined in various ways to produce a particular balance between public and private interests. The Ownership Commission recognises that the PLC model has a number of clear advantages over other ownership and governance forms:

3.5 **Access to external capital:** The PLC, supported by stock markets, facilitates a capacity to raise external capital and achieve growth on a scale that no other model of ownership or governance can systematically match. This in turn offers economies of scale and reduction of transaction costs that gives productivity advantages to large businesses over SMEs.

3.6 **Professional management:** The separation of ownership and control, which is a feature of PLCs (though not exclusive to PLCs) facilitates higher performance, by virtue of delegating management of assets and investment decisions to a professional class of managers. This has potential advantages which private ownership and family ownership often lack.

3.7 **Democratisation of ownership:** The flotation of corporations on the stock market means that households are able to share directly or indirectly in the wealth creation of large businesses. Shareholdings also translate into voting rights over the management of corporations. The election of non-executive directors, as representative of 'outside' interests in the boardroom, is viewed as a force for greater accountability and transparency. At various points in history, including the 'progressive era' of early 20th century America, and mid-1980s Britain, the expansion of share ownership has been presented as a basis on which to promote property-owning democracy.

3.8 **Transparency of reporting:** PLCs are held to account by the accounting requirements of the stock exchanges which they are listed on. Stock markets, and associated companies law, potentially become mechanisms for ensuring accountability of PLCs to society, and not only to shareholders.

> *'The Commission believes that in a growing number of cases the operations of PLCs have become distorted beyond what society and sometimes even owners intend.'*

Issues with the PLC's purpose

3.9 We have identified a number of benefits and justifications associated with the PLC model of the corporation, which potentially combine to lend it public legitimacy.[21] Yet the character and behaviour of the PLC is heavily subject to the character and behaviour of its owners. Promoting shareholder value above any other goal has become the dominant business objective of most if not all PLCs. In the process, they have lost sight of the original justification for listing companies on the stock market.

21 CIMA – 'Maximising Shareholder Value – Achieving Clarity in Decision-Making – Technical Report 2004

Ownership Trends

3.10 In 1964, individuals owned 54% of UK shares. Today this is down to 10%.[22] This drop corresponds to the rise of institutional shareholders, namely pension funds, mutual funds, unit trusts, hedge funds and insurance companies. It is estimated that 75% of shares issued on British stock markets are held by collective investment vehicles.[23] UK Pension funds are currently a declining share of the total: a third of shares were held by pension funds in 1992, but this is now down to 12%.[24] The consequence of these trends is that institutional investment vehicles have considerable power over companies, and could be harnessed to serve the broader social and political interests of those for whose money they are responsible.

3.11 The plurality of institutional investors reflects their philosophies of ownership and investment, risk appetites and decision-making structures. Some institutional investors have the capacity and propensity to act as stewards of the companies they invest in; others are focused on transactional ownership, buying and borrowing equities in order to sell them for profits over very short time periods. But it is also important to recognise that various approaches to ownership may be exhibited by a single institutional investor, buying some shares for the long-term and others for the short-term.

3.12 The rise in institutional ownership, and commensurate decline of individual share-holdings, has had contradictory effects. On the one hand, it has produced a more clearly identifiable set of owners, who are potentially able to express and exert their interests more clearly. Whether these owners prioritise shareholder value or stewardship, they are certainly more vocal and influential than the more passive individual owners who held the majority of shares through much of the 20th century. They therefore have a responsibility to apply pressure on PLCs, on behalf of the millions of 'indirect owners' who are ordinary pension, insurance and ISA plan-holders.[25]

3.13 On the other hand, there is a risk that these owners do not care to understand the nature of the businesses that they invest in, and potentially de-stabilise them. Some Chairmen on occasion, have complained that shareholders typically judge a business on accounting information alone and there is a tendency to therefore undervalue matters of 'substance'.[26] Research on the voting behaviour of shareholders demonstrates that there is often very little scrutiny of the long-term business rationale for managerial decisions (including executive remuneration) so long as it appears to be promoting shareholder value.[27] There remains a problem of incentives, whereby shareholders who do not concern themselves with long-term performance or social responsibility of a PLC can effectively free-ride on others who do. The worst case scenario is that all shareholders are looking to each other to hold managers to account – and that no-one does so.

3.14 The rise of institutional investors has resulted in increasing layers of agency that further distances beneficial owners. There is increasing use of intermediaries – investment consultants, 'funds of funds', trustees, external asset managers and others – sitting between an owner and an asset. Layers of agency contribute to the dislocation between the ultimate beneficial owners of shares and the boards of companies, but the investor is vulnerable to the decisions and actions of their agents directly in how they manage funds, and at a separate level, the processes within boards of companies themselves.

22 ONS Share Ownership Survey 2008 (12 % in August 2011 according to a Financial Times article on 7 December 2011 by Matthew Vincent titled 'Dream of wide share ownership foiled' using figures from Capita Registrars

23 Ibid

24 ONS Share Ownership Survey 2008

25 See Davis (2009) The New Capitalists.

26 Business Industry and Skills (2010) A Long-term Focus for Corporate Britain

27 TUC (2009) TUC Fund Manager Voting Survey

3.15 Investment funds, insurance companies and pension funds own large proportions of the listed companies that we rely on for so much employment and wealth creation. Yet long-term investment strategies now require co-ordination across a longer chain of intermediaries, to produce agreement on how to measure performance, what information to take into account, what investment manager to use etc. The need to mobilise such support and agreement across diverse actors is a distinctive constraint on such strategies and favours short-term objectives for which there generally exists more robust and abundant data.[28]

3.16 The strategies used by Institutional investors to maximise returns and manage risk may also potentially harm committed ownership. As many PLCs have become viewed in primarily financial terms by executives and investors, so new forms of investment have arisen which have even less engagement with a firm's business purpose. Instead, lending and shorting of shares, use of leverage to increase return on equity, and high frequency trades, make up an accepted set of techniques for extracting financial returns, without any form of engagement in business concerns at all.

Passive investment strategies: These tend to reproduce and track the broad market index such as the FTSE 100, and have become increasingly popular. For instance, so-called exchange-traded funds (ETFs), have grown explosively over the last decade and now hold over a trillion dollars in assets. This is potentially positive for PLCs, as passive investors seek long-term gains in the equity market, and do not seek to trade in and out of individual stocks. However, these funds typically compete on the basis of low cost and tracking error performance: how far prices depart from the returns of benchmark indices. As such, they are largely disengaged from voting of shares, and are found to allocate some of the fewest resources to stewardship activities.

Active investment strategies: These tend to trade in and out of shares, to exploit market inefficiencies and informational asymmetries. There is an increasing premium on speed with strategies increasingly focussed on capturing fractions of profits from trading shares in companies between different trading platforms at hyper-fast speeds.

Diversification: All investors rely on the erstwhile benefits of diversification to mitigate risk. Today, it is not uncommon for portfolios to hold hundreds, if not thousands of stocks. But diversification is a double-edged sword: used sensibly and moderately, it improves welfare. But when it is used in excess, the results are less positive. There is evidence that after 20-50 stocks, diversification does not lead to significant improvements in terms of reduced portfolio volatility. At the same time, it can create monitoring problems and harm an "ownership" mindset. This ambivalence is well expressed by Warren Buffet who observes that "a policy of portfolio concentration may well decrease risk if it raises, as it should, both the intensity with which an investor thinks about a business and the comfort level he must feel with its economic characteristics before buying into it." *

* This box draws on "Why Stewardship is proving elusive for institutional investors" Simon Wong (2010) Butterworths Journal of International Banking and Financial Law

28 The Future of Long-Term Investing (2011), World Economic Forum

3.17 The manner in which shares are traded is important because it has consequences for systemic stability, risking extreme volatility and extreme illiquidity if process and sentiment move in one direction. It also adds significant transaction costs into the system, potentially reducing the overall value of a pension to its holder.

3.18 Rapid, transactional investment strategies have grown in influence over the last few decades: in 1945, stock was held on average for four years; today it is 2 months. Moreover, 35% of all European trades are high frequency trades (HFT) and in the United States, it is two thirds.

3.19 This is underpinned by the use of 'contracts for difference', derivatives which allow investors to bet on a change in stock price without owning the underlying shares.[29] Notably, hedge funds, who act primarily to exploit market volatility, are believed to be responsible for upwards of 30% of equity trades, despite owning less than 5% of traded equities at any one time.[30]

3.20 Temporary lending of shares to a third party involves holding given collateral as security against a default, and receiving a fee for lending the equity. Pension funds will make a steady income from this practice. The problem is that once loaned, the shares may be used to short sell against the interests of the beneficial owners' interests.

Shareholder value, incentives and ownership

3.21 The rise of shareholder value prioritisation in the US and the UK was primarily a response to the perception that executives were motivated by self-interest and those of vested interests within the company, rather than the interests of shareholders. The critical question of 'corporate governance' (as it was known by the 1990s) became how to deal with the 'principal agent' problem, which arises as a result of the separation of ownership and control: how could the interests of managers be better aligned with those of shareholders?

3.22 A variety of mechanisms have been used to align management incentives with shareholder interests, including the linking of executive remuneration packages linked directly to stock price, hostile takeovers to penalise executives who do not deliver share performance and a greater readiness to fire underperforming executives whose average tenure in office has fallen.

3.23 The theory that managers and shareholders interests can best be aligned if managers are incentivised to maximise shareholder value rests heavily on the assumption that market prices faithfully embody a company's "true value". Any increase in the share price benefits short-term and long-term owners alike. There is now extensive evidence that stock market prices often depart substantially from reasonable estimates of fundamental economic value – often because of brute uncertainty, herd behaviour and speculative activity. The present day value placed on future earnings, as commented earlier, is very much lower than it should be if the discount rate was applied rationally. Andrew Haldane and Davies report that "Short-termism is both statistically and economically significant in capital markets. It appears also to be rising. In the UK and US, cash-flows 5 years ahead are discounted at rates more appropriate 8 or more years hence; 10 year ahead cash-flows are valued as if 16 or more years ahead. The long is short. Investment choice, like other life choices, is being re-tuned to a shorter wave-length." The authors believe: "This is a market failure. It would tend to result in investment being too low and in long-duration projects suffering disproportionately. This might include projects with high build or

29 Ethical Corporation (2006) Special Reports: Finance – hedge funds and private equity – trading down corporate responsibilty

30 Tomorrow's Company (2009) Tomorrow's Owners; Ethical Corporation (2006) put the figure at 50% of equity trades.

'Because investors already factor the likelihood of good performance into the share price, actually improving real performance will seldom beat expectations that race ahead of reality'

sunk costs, including infrastructure and high-tech investments. These projects are often felt to yield the highest long-term (private and social) returns and hence offer the biggest boost to future growth."[31]

3.24 The decline of long term investing by some institutions described earlier and rise of short term transactional investment has helped create two parallel markets: a real market in which the PLC operates and a market in the expectations of how that will be received by the financial markets. For example economist Roger Martin describes a real market –one in which "products are designed and produced, revenues are earned, expenses are paid and real profits show up on the bottom line" and an expectations market - one in which "investors assess the real market activities of a company today, and on the basis of that assessment, form expectations as to how the company is likely to perform in the future – the consensus view of all investors and potential investors as to expectations of future performance shapes the stock price of a company".[32]

3.25 In the past, CEOs inhabited the real market and were paid for performance in that real market; however, the rise of stock options has changed this balance, inducing managers to focus on the expectations of the market and raising expectations of future performance from the current level. Clearly, where markets expectations are correct, stock options contribute to aligning the interests of managers with owners, reducing the scope for managerial opportunism and improving outcomes for shareholders. However, it is not uncommon for expectations to race ahead of reality and consequently for managers to come under unrealistic pressures. In some cases, improving the real performance of a company will not increase shareholder value unless improvements also meet or exceed analyst earnings expectations[33]. Thus a company will typically see its stock perform better if it earns £1 a share when the market judgement is 98p than if it earns £1.05 when the opinion of the market is £1.08p a share. In other words, superior relative returns in the expectations market (+2p vs. -3p) is better than absolute superior performance in the real market (£1.05p vs. £1).[34]

3.26 The result is that CEOs can spend too much time managing expectations rather than managing the real business. One study finds a majority of managers would avoid pursuing a project that offered long-term value creation, if it was damaging to short-term earnings and 75% would sacrifice economic value in return for smooth earnings.[35] Alternatively managers might attempt to talk the analysts down in order to secure more achievable forecast levels - again a questionable use of scarce managerial time and effort. This preoccupation seems to be increasing it is no coincidence that in recent years (1994-1997) companies have beaten consensus analyst estimates 70 per cent of the time rather than the historical average of 50 per cent (1983-1993). This peculiar precision suggests that CEOs understand how the game works regardless of the consequences for long- term health and value of their companies.

3.27 In this context it is not surprising that over-emphasising short-term shareholder value creation at the expense of other benchmarks of success has also drawn criticism from some unlikely quarters: Jack Welch, former CEO of General Electric, has pronounced that it is "dumb" to think that the

31 Haldane, A & Davies, R. "The Short Long." Speech presented at the 29th Société Universitaire Européene de Recherches Financières Colloquium: New Paradigms in Money and Finance?, Brussels (May 2011). http://www.bankofengland.co.uk/publications/speeches/2011/speech495.pdf.
32 Martin R, Fixing the Game: Bubbles, Crashes, and What Capitalism Can Learn from the NFL, Harvard Business Review Press, 2011
33 Bartov, Givoly and Hayn
34 "The Rewards to Meeting or Beating Analysts' Earnings Forecasts", E. Bartov, D. Givoly, and C. Hayn (2002) Journal of Accounting and Economics, 33-2,
35 "The Economic Implications of Corporate Reporting" (2005) J. Graham, C. Harvey and S. Rajgopal Journal of Accounting and Economics 40

sole purpose of a company is to maximise value for its shareholders. Your main constituencies are your employees, your customers and your products."[36]

3.28 One of the consequences of the emergence of these two markets is that PLCs' reliance on the stock market as an external source of new capital has declined. Meanwhile the practice of 'stock buy-backs,' in which retained earnings are used to buy shares back from the stock market to inflate their price, has grown since the 1980s – by June 2011 share buybacks in the UK for the previous six months totalled $871m. This compares to a share buybacks worth a total of $2.6bn in 2010.[37]

3.29 Many incentive systems used to reward and discipline asset managers and managers exacerbate these trends. Many fund trustees evaluate their fund managers' performance relative to benchmark indices and offer only short-term contracts. This is compounded by the widely-used ad valorem approach that calculates fees on the basis of assets under management rather than outperformance - and induces investment managers to grow by chasing new money rather than by extracting greater value from existing assets through superior performance.

3.30 Any solution should be premised on extending the performance review period to reflect the realities of the entire market cycle and lessening the reliance on relative returns through the use of supplementary measures such as internal rates of return for exited investments.

3.31 A complex web of norms, codes and laws aims to ensure that PLCs are managed in the interests of their shareholders and, directly or indirectly, the public. In the UK as elsewhere, many of the laws and assumptions informing corporate governance matters have been a direct response to corporate scandals and wrongdoings. The UK Corporate Governance Code (formerly the Combined Code) sets out standards of good practice in relation to board leadership and effectiveness, remuneration, accountability and relations with shareholders. Grant Thornton[38] estimate that over the past decade straight compliance to the code among FTSE 350 companies has almost doubled to 50% achieving a quiet revolution in corporate governance.

'A complex web of norms, codes and laws aims to ensure that PLCs are managed in the interests of their shareholders'

3.32 The advantage of this approach is that it is not legalistic or excessively prescriptive, nor does it get in the way of innovation or those with ambition to do more. Its Achilles heel is enforcement. As former City minister Lord Myners has noted 'The ISC (Institutional Shareholders Committee) is still advocating a self-governance model, which is shown to have failed"[39]. An important study found[40] that the UK Corporate Governance Code's comply or explain approach has resulted in far more compliance than explanation, failing to provide the intended corporate governance flexibility. In reality shareholders and stakeholders discount the role and importance of explanations, only paying attention to the headline issue of whether an organisation has complied. It also means that the distinction between good and bad explanations is ignored. They speculate that this may reflect reluctance on the part of shareholders to expend the effort to assess explanations for any deviations, or to engage in costly monitoring until performance actually suffers. One finding has similarly found[41] that British investment institutions have tended to intervene only when a company is seriously underperforming and that excepting a crisis the institutions generally stay on the sidelines.

36 Welch condemns share price focus, Financial Times, March 12 2009
37 Corporate Governance and the global financial crisis (International perspectives by William Sun, Jim Stewart and David Pollard – August 2011)
38 Grant Thornton's annual analysis of the governance practices of the Uk's FTSE 350 companies
39 Myners says ISC code is not strong enough, Financial Times, http://www.ft.com/cms/s/0/b4e7de06-d2e9-11de-af63-00144feabdc0.html#axzz1nadJeGSw
40 Aridhar Arcot, Valentina Bruno, and Antoine Faure-Grimaud
41 Bernard S. Black & John C. Coffee, Jr., Hail Britannia?: Institutional Investor Behavior Under Limited Regulation, 92 Mich. L. Rev. 1997, 2078 (1994)

Improving stewardship and responsible behaviour by pension funds and other institutional investors

3.33 Pension funds and insurance companies invest the savings of many millions of citizens directly and indirectly in the shares and debt of many thousands of public companies. These citizen-savers are therefore beneficial corporate owners. They are often also stakeholders of those same public companies in which they invest, whether as employees, customers or suppliers. The aggregate interests of these citizen-owners coincide with that of the public interest as they are interested in the long-term stable and sustainable value created by the many thousands of companies in which they invest.

3.34 Unfortunately, the financial intermediaries – such as investment managers, investment banks, and investment advisers – who handle and advise upon pension fund and insurance companies' transactions and investment strategies are not always properly translating and representing the interests of citizen-owners. Furthermore, owing to misaligned or conflicting interests with those of their clients, the financial intermediaries often represent poor stewards of the companies in which they invest on their clients' behalf, either failing to demand sufficient accountability or promoting short-term decisions consistent with their own interests.

3.35 The citizen-owners and their pension fund trustee or insurance company representatives are effectively disenfranchised and unable to exercise influence. As a result, public companies often act as if they didn't have owners to whom they are accountable and many take poor and short-term decisions.

3.36 The financial intermediaries – such as investment managers, investment banks, and investment advisers dominate their relationships with their clients, whether these are pension funds or listed companies. As a result, they are generally able to dictate the terms of these relationships to their own advantage. This has led to 'overtrading' or excessive transactions, whereby the incomes of traders and those other intermediaries whose revenues are driven by the frequency of transactions, are able by providing poor or conflicted advice to promote a high frequency of such transactions to their own benefit, but to the detriment of their clients.

3.37 The effect of such a short-term focus on transactions is two-fold. Firstly, there is a substantial transfer of value from the citizen-owners and public companies to the intermediaries and secondly the intermediaries are uninterested in the stewardship of the assets underlying the transactions (even though good stewardship is in their clients' interests.)

3.38 Where pension fund trustees are interested in stewardship, but are unable or unwilling to pursue this through their investment managers for the reasons given above, they find it very difficult to undertake the task on their own. This is because their individual shareholdings will represent a relatively small proportion of the equity and they will have insufficient or inexpert resource as a single fund.

3.39 There is a further local problem in that the decline of defined benefit pension schemes in the UK has presented an obstacle to stewardship. That is, the trustees of the now commonplace replacement defined contribution schemes are unwilling or unable to spend savers' money on stewardship services or to spend their time in promoting good stewardship amongst their investment managers. There is a similar issue with 401K schemes in the US.

3.40 The solutions to these problems may be relatively simple –

- Fiduciary duty – trust law already describes a duty for pension fund trustees to look after the financial interests of the pension fund's beneficiaries. However, this is almost universally interpreted in a short-term way, leading to actions such as stock-lending and supporting the situation of excessive transactions through 'supplier control' described above. The UK Government could issue guidance on the interpretation of fiduciary duty making clear that this should be considered from a longer-term perspective, leading to less value lost through excessive transactions and more gained through good stewardship.
- Longer term mandates – as described above, investment mandates currently promote short-termism to the detriment of good stewardship. This includes the commonplace quarterly assessment of investment managers' performance. Pension funds and other long-term end assets owners should be encouraged to take more control over the terms for the management of their beneficiaries money. An example of such encouragement, is the International Corporate Governance Network's Model Mandate Initiative.[42]
- Education of trustees – given the current part-time and lay nature of trusteeship, there is a good case for greater professionalisation and education of trustees. In the context of stewardship, this could include a 'trustee toolkit', which would be of particular interest to member nominated trustees and could be promoted through their networks or, where relevant, the underlying trades unions.
- Enfranchisement of beneficiaries (citizen-owners) - Pension funds and other long term savings vehicles should use web based technology to canvass the opinions of their beneficiaries directly and provide them with information on the stewardship of the assets in which they invest. Such views and information could be provided through a collective engagement platform (see below).
- Aggregation of pension fund ownership –pension funds are very well aligned as long-term investors, with many investments in common and without the conflicts that exist amongst their investment managers. They are therefore able to share stewardship resources and pool their common investments in order to implement good ownership on behalf of their beneficiaries. The Commission supports the establishment of a formal collective of international pension funds to jointly own and fund an engagement platform, possibly as dedicated not for profit mutuals. Such an aggregation of resources and ownership rights would provide a stable, consistent and knowledgeable share-owner voice to the benefit of listed companies and the wider economy.

3.41 The regulatory force of the UK Stewardship Code is aimed at the intermediaries (investment managers) but stewardship is not their ultimate responsibility. The investment management industry is signing up to the Code because it feels compelled to do so – it is part of the FSA's regulation of the industry – but perhaps unsurprisingly it is not yet implementing the Code. Indeed it seems unlikely to do so in any material way, without a change in its relationship with its clients.

3.42 Some fund managers are failing to implement the Code because they face real conflicts of interest. For example, the proper job of a fund manager is to gather client assets and grow the capital value of those assets. To do that well, many fund managers meet with the company's executives to gather information to make well informed investment decisions. Most fund managers do not want to spend time engaging with the company to challenge its executives over share options or environmental policy. They want to have a good relationship with the company chief executive and the finance director to ensure they continue to receive good information rather than antagonise them. There can be a conflict between what most investment managers are paid to do, which is to produce short-run investment returns for

42 International Corporate Governance Network's Model Mandate Initiative

their clients and what they are required to do on stewardship by the regulators. Many funds have a compliance department that works to iron out such potential conflicts.

3.43 The Commission believes that the Government should make adherence to stewardship codes a responsibility of the end asset owners, such as pension funds and insurance companies. This will lead to better stewardship by funds, their intermediaries and agents.

'The Commission believes that decision making in companies should seek to both represent and serve the owners...'

Takeovers

3.44 Takeovers introduce new challenges for both owners and managers of companies. Managers must act in the interest of shareholders and always within the bounds of the Companies Act and Takeover Code. Owners may find their long term investment under challenge as short term profit taking opportunities take centre stage.[43]

3.45 The reasons for the growth of merger activity are many and various. Companies aspire to growth and there are only two basic ways of achieving it- organic development or merger/acquisition. Growth has both offensive and defensive advantages. Whatever the theory about take-overs being a remedy for inefficient management, the market actually works mainly one way – big companies buy smaller ones, not vice versa, so the big ones face a much shorter list of probable predators.[44]

3.46 Another concern is that many mergers and acquisitions do not add value while takeover pressures may lead to a reduction in R&D expenditures as companies feel less secure about their future and independence.[45]

3.47 The Commission believes that decision making in companies should seek to both represent and serve the owners; structures governing ownership, including takeover rules, should seek to represent the genuine stakeholders. In principle, this points to measures that increase both the transparency of decision making and the disclosure of relevant information that will affect outcomes for all stakeholders including the ultimate owners.

3.48 In practical terms this means that the Commission is interested in steps that increase communication and the understanding of decisions as well as the decision making process itself. More than in any other country, mergers and takeover are frequent in the UK. The term 'take-over' tends to be used when management control is clearly vested in the acquiring company which can either be agreed by the target company or opposed: a merger is when the management positions and control are more equally shared between the two parties to the merger.

3.49 In some respects the UK is at a continuing competitive disadvantage against countries in which such pressures are not so severe. The UK is vulnerable against those who play with different rules, or whose ownership systems make takeover harder so managements do not have to live in fear

43 The determinants of merger waves, Klaus Gugler, Dennis Mueller and B. Burcin, Yurtoglu, 2004 Working Paper University of Vienna)

44 Key Drivers of Good Governance and the Appropriateness of UK Policy Responses, Filatotchev et al, 2007, King"s College London, and Mergers and Acquisitions in Europe, Martynova and Renneboog, 2006, Tilburg University, Centre for Economic Research.)

45 See R. Bruner (2005) Deals from Hell. Stein, Honore, Munari & Van Pottelsberghe de la Potterie.

of the market for corporate control being too easily manipulated: these tend to have more latitude for investments which take longer to pay off.

3.50 In particular it is an open question whether it is in the UK's interest for public companies to be more open to takeover than in any other comparable jurisdiction. At the very least the conduct of offeror boards needs to be as effectively scrutinised as that of offeree boards. This in our view needs to be addressed in better general corporate governance.

3.51 We would also note that changes to corporate governance applicable all of the time and not just in takeover situations would avoid some of the shortcomings of stewardship that result in takeover offers being made as a last ditch solution.[46]

3.52 We would support the additional transparency afforded by introducing disclosure of acceptance and scheme of arrangement voting decisions for all holders of more than a critical percentage of shares. We think this percentage should be set at 0.5 % as a useful step in the direction of greater transparency tending to afford more accountability.

> *'There is widespread and we believe warranted concern that the interests of owners are not as well served as they should be by the current takeover system.'*

Foreign Ownership

3.53 Foreign ownership of shares issued by British companies has risen to 42%, up from just 7% in 1964.[47] Foreign investors still held only a sixth of UK shares in 1993, indicating that the internationalisation of ownership has largely occurred over the past 20 years.[48] The large increase since 1994 partly reflects the growth in international mergers and acquisitions, as well as refinements to the classification of holdings, including the incorporation of securities dealers' data.[49]

3.54 The UK has a very open corporate sector, with few restrictions on foreign ownership in comparison to its competitors. This is one of the attractions for international investors. Indeed, it is important to distinguish between attitudes concerning foreign interests and inward investment. There are many excellent examples of foreign owners investing strongly in UK industries, safeguarding jobs and contributing taxes to the Exchequer.

3.55 Indeed, the Commission accepts that the UK's openness to foreign capital and investment is one of the strengths of the British economy and that a more protectionist stance would damage prospects for growth and prosperity. The nationality of the owner is less important than the quality of the stewardship that owners follow. However, engaged stewardship can also be significantly harder to achieve, when ownership of shares is cross-national.

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46 Key Drivers of Good Governance and the Appropriateness of UK Policy Responses, Filatotchev et al, 2007, King"s College London, and Mergers and Acquisitions in Europe, Martynova and Renneboog, 2006, Tilburg University, Centre for Economic Research.

47 ONS Share Ownership Survey 2008

48 Tomorrow's Owners, Stewardship of tomorrow's company, http://www.forceforgood.com/Uploaded_Content/tool/30102008153435518.pdf

49 Share Ownership Survey 2008, Office for National Statistics

3.56 Yet there are also risks attached with the growing internationalisation of ownership. There is strong evidence of a ‘home bias’ resulting from foreign takeovers, whereby high skilled jobs and long-term ‘green field’ investment activities are either relocated to or retained in the country of the owner. Furthermore, the UK is among those countries with comparatively 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.

3.57 The Commission favours continued openness to foreign ownership as part of a diverse ownership structure. However, the government should extend the provisions of the Enterprise Act to define the strategic public interest powers of the Secretary of State. Currently, the Enterprise Act identifies defence, financial stability and aspects of media and news provision as specific areas where a public interest intervention may be considered. The Secretary of State has the power to add to this list, with the consent of Parliament. The Commission believes that the government should be pro-active in considering additional sectors to be of strategic public interest, allowing the government the latitude to make interventions that reflect the public interest.

Safeguarding National Interests

The Committee on Foreign Investment in the United States (CFIUS) is an interagency committee that serves the President in overseeing the national security implications of foreign investment in the economy. Public and congressional concerns about the proposed purchase of commercial port operations of the British-owned Peninsular and Oriental Steam Navigation Company in six US ports by Dubai Ports World sparked a firestorm of criticism and congressional activity concerning CFIUS and the manner in which it operates.[50]

Australia[51] and Canada[52] both have Foreign Investment Review Boards. The Boards examine proposals by foreign interests to undertake direct investments make recommendations to their Governments' foreign investments policy.

When the American food giant PepsiCo was thought to be interested in buying up the French dairy company Danone the French government came up with 11 strategic commercial sectors[53] that should be protected from foreign takeovers.

Russian legislators have limited foreign investment in 42 strategic sectors,[54] including energy, mass media and aerospace by giving a Russian commission of economic and security officials a veto over any deal in which a foreign company wants to buy control - more than 50 per cent - of Russian companies in the named sectors.

As was noted by Deakin, ‘UK companies listed on the Stock Exchange are subject to the ‘Takeover Code’; and they can be vulnerable to hostile takeover bids. In America or Japan they can normally use a ‘poison pill’, which acts as a deterrent, to protect the company against an opportunistic bid whereas here there are no pre-takeover defences like this.

50 From the Congressional Research Service - http://www.fas.org/sgp/crs/natsec/RL33388.pdf
51 The Australian Foreign Investment Review Board http://www.firb.gov.au/content/default.asp
52 Holden M, The Foreign Direct Investment Review Process in Canada and Other Countries, Parliament of Canada, http://www.parl.gc.ca/content/LOP/ResearchPublications/prb0713-e.htm
53 Patriotism and protectionism in the EU, Tim Franks BBC Europe correspondent, Paris, http://news.bbc.co.uk/1/hi/4837150.stm
54 Russia moves to control foreign ownership, http://www.cbc.ca/money/story/2008/03/21/russia-ownership.html, CBC News, March 21 2008

3.58 The consensus view in the UK at present is so constrained that 'There can be no debate about whether British laws and culture allow owners to discharge their responsibilities fairly: ownership rules are a given, and if disproportionate numbers of British companies are sold to foreigners, then too bad. There is a natural order of things that cannot be seriously challenged.' [55]

3.59 There are important advantages to foreign ownership but just in terms of plurality there may be concerns about its sheer disproportionately in some sectors. In these circumstances it may be appropriate for the provisions of the Enterprise Act[56] to be extended in order for the Competition Authorities to satisfy themselves in a case where an entire sector might fall into foreign ownership that the UK will not suffer strategic damage. The presumption should be openness, with a careful eye that overseas ownership does not become disproportionate.

London Stock Exchange Listing

3.60 The Commission wishes the London Stock Exchange (LSE) to retain its pre-eminent position in the global market and the highest reputation that a listing affords companies. The Commission has examined the LSE listing requirements and concluded that the exchange would benefit from clarifying these further.

London Stock Exchange Listings

According to the LSE, the key benefits of admission to a public market are[57]:

- providing access to capital for growth, enabling companies to raise finance for further development, both at the time of admission and through further capital raisings;
- creating a market for the company's shares, broadening the shareholder base;
- placing an objective market value on the company's business;
- encouraging employees' commitment and incentivising their long-term motivation and performance, by making share schemes more attractive;
- increasing the company's ability to make acquisitions, using quoted shares as currency creating a heightened public profile – stemming from increased press coverage and analysts' reports – helping to maintain liquidity in the company's shares;
- enhancing the company's status with customers and suppliers

3.61 In particular, the level of free float should be examined in any listing application. If majority control is vested in one owner he or she can determine the valuation of the company, the terms of exit or the terms for any merger or buy-out. The National Association of Pension Funds, which represents some 1,200 pension schemes with collective assets of around £800bn, has argued that companies joining the FTSE 100 or FTSE All Share index should be required to ensure that at least half their shares can be freely traded. The Commission supports this and recommends that the listing rules insist on this provision.

55 Will Hutton, Them and Us, Conclusion, Page 388
56 Enterprise Act 2002, HM Government, http://www.legislation.gov.uk/ukpga/2002/40/pdfs/ukpga_20020040_en.pdf
57 A guide to listing on the London Stock Exchange, London Stock Exchange, http://www.londonstockexchange.com/home/guide-to-listing.pdf

Chapter 4

Beyond the PLC

4.1 The dominant corporate ownership type in the UK is the PLC. This is reflected through media commentary, public discourse and crucially through Government policy.

4.2 Discussions of corporate governance, company legislation and business regulation revolve around the behaviours of the largest listed companies. This is not necessarily the result of a positive decision to promote the PLC form above all other types of corporation, rather it reflects the fact that other corporate forms are less well understood and in many cases disregarded.

4.3 In policy terms the PLC has crowded out other forms of ownership. This has meant that the opportunity for other corporate forms, particularly private firms and employee and consumer owned businesses, to grow and contribute to the economy has been restricted. The way ownership is considered unimportant in the UK damages plurality and choice, and does not encourage innovation and entrepreneurship.

4.4 In practical terms, this has led to uneven legislation, with non mainstream corporate forms working under out of date corporate law. It has inadvertently led to tax advantages being enjoyed by some forms at the expense of others. It means that business advisors and financiers are less familiar with the range of corporate bodies that are available and results in an increasing bias towards a PLC monoculture.

4.5 An overall strategy for corporate ownership, an 'ownership policy' is required to deal with this. Such an approach would facilitate a suite of corporate forms, enabling businesses with different purposes to flourish and the UK economy to benefit.

4.6 The following section examines privately owned businesses, that are not listed and therefore do not have tradable shares. Such firms include a wide range of corporate types, including family owned firms, companies with the potential to be publicly listed, partnerships, private equity and joint ventures.

4.7 Different types of mutuals add to the plurality of UK corporate ownership. Later in this chapter, employee owned firms and customer owned firms are examined in detail.

4.8 This chapter examines the following in turn:

- Private equity
- Partnerships
- Family owned business sector
- State owned businesses
- Sovereign Wealth
- Employee owned firms
- Mutuals

Private Equity

Private equity is medium to long-term finance provided in return for an equity stake in potentially high growth unquoted companies.[58]

Advantages

Private Equity can be seen as a positive, though temporary phase in the ownership life of a business

Disadvantages

Private equity is not an appropriate ownership structure for some public services.

The ultimate business purpose of private equity (to exit) may conflict with the interests of wider stakeholders.

4.9 Private equity emerged to buy out firms from their public listing on stock markets and improve their underlying performance. The usual aim is to cash out the investment after a period through an initial public offering or a trade sale, and for the company to become a PLC again at the same time as rewarding the private equity partners.

4.10 Prior to the financial crisis, Private Equity was a large and growing form of ownership. As the boom approached its climax, 1.2 million people in Britain worked for private equity-controlled businesses: in 2007 the total buy-out market was valued at £46.5billion. Yet by 2009, that figure had collapsed to some £6billion.[59]

4.11 Private equity firms play a significant role in ownership of the largest unlisted private companies in the UK. A research report on the largest 100 private companies produced by Fast Track notes that private equity firms own 42 of the biggest 100 companies, and a further four are backed by private equity (where private equity firms hold minority shares of between 20-50%). Less than 0.4% of the private sector workforce is employed in the 100 fastest-growing private equity-backed companies in the UK.[60]

4.12 According to the FAME database, there are 1,009 private companies in the UK majority owned by private equity. In 51 of the top 100 private equity-owned companies by employees only, almost 170,000 people are employed (0.63% of the private sector workforce), generating just 0.22% of national turnover.[61] The FAME estimate of employees, count, and turnover is presented relative to all firms held on FAME, resulting in slightly different estimates of the value of private equity-owned firms to the economy (accounting for 0.45% of employment, 0.05% of companies, and 0.45% of turnover).

4.13 The British Venture Capital Association estimates 2.8 million people work for private equity-backed companies (almost 12.5% of the workforce), generating just under 10.5% of turnover.[62] (However,

58 A Guide to Private Equity, The British Private Equity and Venture Capital Association http://admin.bvca.co.uk//library/documents/Guide_to_PE_2010.pdf
59 Them & Us, page 245, Figures from Nottingham University Business School's Centre for Management Buy-out Research, at http://www.nottingham.ac.uk/business/cmbor/privateequity.html
60 The Sunday Times Deloitte Buyout Track 100 2012.
61 Data relating to the top 500 private equity-owned companies (by employment) are excluded because data for the top 500 were very similar to the top 100 by employment, suggesting there are companies for which data is missing.
62 Institute for Family Business, The UK Family Business Sector, London: 2008

it is unclear as to whether the definition of private equity-backed is the same (25-50% ownership) as the Fast Track report).

4.14 Private equity funds look to buy a controlling share in a company for a short period, typically 4-5 years (though in current market conditions sometimes longer) before selling it on. They either purchase companies from other private owners (founders, families, other private equity companies) or occasionally from the stock market, as in the high profile case of Boots pharmacists in 2007 and Manchester United in 2005, or divisions of large public companies.

4.15 Private equity ownership typically involves close engagement in the management of a firm, reuniting ownership with control, and thereby reversing a key feature of the PLC. Private equity owners are untroubled by the need for continual market scrutiny of their profits quarter by quarter.

> *'Private equity emerged to buy out firms from their public listing on stock markets and improve their underlying performance.'*

4.16 Proponents of private equity and venture capitalists adhere to the view that they are committed, engaged owners who transform the productivity of the companies they buy and support. One study from the London School of Economics showed that private-equity managed firms were 'run better' than family-, private-, or government-owned firms, and even 'slightly better' than PLCs, although the difference was not statistically significant.[63] This qualitative study was based on a particular view of what defined 'good' management: the management of the equity of incentives, ability to hit targets, willingness to sack poor performers and introduction of leaner production processes.

4.17 The industry itself revealed that the fourteen biggest private –equity deals between 2005 and 2007 offered 330 per cent returns, half of which came from debt and almost a third from rising stock markets. Less than a fifth could be explained by managerial improvements – what could be classified as productive entrepreneurship.[64]

4.18 Private equity also includes venture capital, which is intended to provide support (and often business advice) to very small, potentially high-growth start-ups, in innovative sectors. Venture capital is crucial to the dynamism and innovation of economies, as it enables entrepreneurs to make the highly uncertain journey between development of an idea and accessing a market.

4.19 The main criticism of private equity ownership is that it is over-reliant on debt financing. Indeed, debt funding of acquisitions is actively encouraged by the 100% tax write off that such borrowing attracts.

4.20 Private equity ownership will also be an inappropriate corporate form in some cases. For example, where the asset being managed is part of the social service fabric of the UK, private equity may not be a valid form of ownership. This is because the ultimate business purpose of private equity (to exit) may conflict with the social objective of the service being provided, as for example in residential care homes.

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63 Nick Bloom, Raffaella Sadun and John Van Reenen (2009) 'Do Private Equity Owned Firms Have Better Management Practices?', LSE Centre for Economic Performance Occasional Paper No.24.

64 Martin Arnold, 'Profits of Buy-out Groups Tied to Debt', Financial Times, 14 January 2009 http://www.ft.com/cms/s/0/da3c8954-e217-11dd-b1dd-0000779fd2ac.html#axzz1n26b2NG3

4.21 Private equity does provide further diversity in the ownership of UK companies. However private equity is probably too dependent on the economic cycle, rising asset prices and the easy availability of credit to provide more than a partial contribution to Britain's ownership deficit. Our proposals to make equity capital as tax privileged as debt will take away some of the incentives for private equity, while it is unlikely that an overstretched, undercapitalised banking sector will offer private equity firms credit on such advantageous terms and on such scale as it did in the run-up to the 2008 credit crunch. There are already signs that private equity is retreating to a more normal scale in which added value through better management rather than financial leverage is delivering results. The Commission welcomes this development.

'There are already signs that private equity is retreating to a more normal scale in which added value through better management rather than financial leverage is delivering results. The Commission welcomes this development.'

Partnerships

The Partnership Act 1890 defines a partnership as "the relationship that subsists between two legal entities carrying on a business in common with a view to profit."[65] "In a partnership, two or more people share the risks, costs and responsibilities of being in business. Each partner is self-employed and takes a share of the profits. Each partner shares in the decision-making and is personally responsible for any debts that the business runs up."[66]

Advantages

Partnerships are a successful model with a number of distinct advantages especially in terms of privacy and flexibility.

Disadvantages

In a partnership, it can be slower to get consensus on challenging issues. Not all partners have the same aspirations and self-interest can outweigh any larger responsibility they may feel towards the partnership. Although this difficulty could be mitigated if there is a strong leadership team which is sensitive to partners' views.

4.22 Historically there has been little regulation in this area, partnerships have been informal with little requirement for external reporting and complete flexibility and privacy in how they operate. Perhaps two reasons for this are the inherent intellectual equality between professionals within a partnership as well as the initial requirement for less capital than other business forms. However, in large, well-established partnerships access to capital is as much of an issue as in other forms of business.

The move to Limited Liability Partnerships

4.23 As The Economist notes: "Private partnerships were wonderfully flexible but lacked the vital ingredient of limited liability: partners could lose everything they owned if the business failed."[67]

4.24 After the collapse of the Maxwell business empire and other high profile cases of corporate failure, businesses began to ask for a form of Limited Liability in the UK which was felt to be a safer way of operating.

4.25 In 2000 the Government passed the Limited Liability Partnerships Act which introduced the concept of limited liability partnerships into law. It created an LLP as a body with legal personality separate from its members. Unlike normal partnerships the liability of members of an LLP on winding up is limited to the amount of capital they contributed to the LLP.

4.26 Whilst an LLP must be more transparent, there is still a great degree of flexibility in how it works and how profits are divided. As a result "partnerships can now offer limited liability and issue tradable shares. They are more durable than before, since they are no longer destroyed when one partner leaves. They also escape the double taxation that plagues the corporate sector: corporations have to pay corporate taxes and then their shareholders have to pay taxes on their dividends."[68]

4.27 According to the Financial Times "The benefits of [an LLP] include limited liability for members and the retention of the "tax transparency" of a partnership. An LLP can also grant charges to secure loans made to it, which may reduce the need for members to give personal security."[69]

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65 www.gillhams.com/dictionary/481.cfm UK legal entities explained
66 Partnerships, Legal structures explained http://www.businesslink.gov.uk/bdotg/action/detail?itemId=1073789609&type=RESOURCES
67 The eclipse of the public company, The Economist, August 19th 2010
68 ibid
69 www.ft.com/cms/s/0/cb7a168c-b76f-11df-8ef6-00144feabdc0.html

4.28 Particularly in larger firms a partnership structure can generate a stronger sense of engagement, one that might be more discernable than in a similar sized plc. According to Andrew Ross Sorkin when Goldman Sachs first considered a flotation in 1996 "Resistance to the idea of an IPO was strong, as the bankers worried it would upend the firm's partnership and culture."[70] However, it is important not to overstate this stronger sense of identity and engagement which can often be replicated in other corporate structures.

4.29 An inherent advantage of the partnership is that any profit which is earned is shared between a far smaller number of people than what may be the case in a plc where profits must be distributed amongst a large number of shareholders.

4.30 Partners enjoy complete flexibility as to how their partnership operates and there is a great deal of privacy about how the firm operates. Partners are able to allocate profits, losses and gains as they see fit. Whereas in a plc account balances and details about the company's directors, including their names and contact information must be made available upon request, this is not usually the case in a partnership.

4.31 In a partnership there is a recognition of the importance of stewardship and it may be that partners adopt a longer-term approach to decision making than their plc counterparts.

4.32 In a partnership some of the weaknesses of the plc model are easier to avoid. For example, the potential loss of control or overall ownership to outside actors is less likely.

4.33 In a partnership, it can be slower to get consensus on challenging issues. Not all partners have the same aspirations and self-interest can outweigh any larger responsibility they may feel towards the partnership. Although this difficulty could be mitigated if there is a strong leadership team which is sensitive to partners' views.

4.34 The scale of a partnership could change its effectiveness. Particularly in a larger firm time and skill must be spent on partner relations in order to ensure that relationships vital to the overall corporate structure are maintained.

4.35 A further possible stress on this model is around investment and capital which can be more difficult to secure than in a plc. However, this can be partly mitigated by moving to a Limited Liability Partnership.

4.36 For employees who are not a partner there can be a sense of distance. However, the perception of division between the workforce and the partners can also be a force for good in that it can be aspirational and encourage strong performance.

4.37 The added privacy in a benefit but there is an interrelated risk, partners run the risk of becoming self-interested which could lead to under-performance. But as the company belongs to the partners, they are less likely to tolerate coasting.

4.38 In a partnership firms cannot give share options as a longer-term incentive. This is clearly an area that is less attractive for some staff.

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70 Chapter Two, Too Big to Fail, Andrew Ross Sorkin, Allen Lane, 2009

Family Owned Business Sector

Family owned businesses are those firms that are majority owned by members of the founder's family and where at least one representative of the family or kin is formally involved in the governance of the firm.

Advantages

The family business sector is important to corporate plurality in the UK
Family firms with high levels of owner engagement are argued to be more successful.

Disadvantages

In comparison to other EU countries, the UK has significantly fewer large family owned businesses.

Typically, a UK family owned business is more likely to sell the company than its EU equivalent.

Recommendations

Expanding a British 'mittelstand'

Britain needs a much larger and vibrant "mittlestand" of medium sized family owned companies. The Government should explore the cost and feasibility of re-structuring Entrepreneur's Relief to provide greater relief for long term investment in companies. The government should reinstate a Corporate Venturing Incentive to enable large firms to benefit from investing in small firms. We warmly support the creation of the Business Growth Fund, but believe that it should form the cornerstone of a new and much larger institutional framework for channelling equity into the British "mittelstand" and its growth companies. In particular it should become the foundation of a new "3i". We welcome the creation of " Catapaults" (the technology transfer and information centres) but they need to be expanded quickly into a national network along German lines, at least ten times their current numbers. And lastly we note that Britain only trains 2,000 apprentices to level four each year; a vibrant British Mittelstand will require twenty or thirty times that amount.

Promoting investment in SMEs

The Commission supports the introduction of a new Individual Savings Account (ISA) type to help develop a retail market for bonds issued by medium sized business. The government should go further. Bank loans to British SMEs should be rolled together as Structured Investment Vehicles to enjoy a partial Treasury indemnity against default: this would create a new class of high quality bond asset in which such ISAs could be invested and even the Bank of England could purchase. Following the Mirrlees Review we also recommend that the government should move to introducing a rate of return allowance (RRA) so that only savers should only pay tax on their equity investments on returns over and above the average.

'Family firms with high levels of owner engagement are argued to be more successful.'

Defining Family Ownership

4.39 Data does not exist to clearly identify non-listed private sector firms. Instead, different interest groups have developed a range of definitions that interpret different corporate types according to their special interest. We use the terminology of family owned businesses to describe unlisted corporations that do not sit within the other categories we have described in this chapter. this means that we have chosen to diverge from the European Commission definition of family businesses referenced below in two respects:-

- We exclude self-employment
- We exclude listed companies that meet the broader European Commission definition

In April 2010, the European Commission adopted the following definition of family businesses:

A firm, of any size, is a family business, if:

(1) The majority of decision-making rights is in the possession of the natural person(s) who established the firm, or in the possession of the natural person(s) who has/have acquired the share capital of the firm, or in the possession of their spouses, parents, child or children's direct heirs.

(2) The majority of decision-making rights are indirect or direct.

(3) At least one representative of the family or kin is formally involved in the governance of the firm.

(4) Listed companies meet the definition of family enterprise if the person who established or acquired the firm (share capital) or their families or descendants possess 25 per cent of the decision-making rights mandated by their share capital.

This definition includes family firms which have not yet gone through the first generational transfer. It also covers sole proprietors and the self-employed (providing there is a legal entity which can be transferred)

4.40 Using this definition, the Institute for Family Business (IFB) calculates that family owned firms contribute over 30% of total GDP. This figure, however, includes a significant number of owner-operated businesses with no employees. For the sake of clarity, the Commission prefers to consider such self-employment separately from its considerations of corporate form.

4.41 Family owned firms in the UK tend to be smaller than in the rest of the European Union and have less financial infrastructure to support them.

'Family owned firms in the UK tend to be smaller than in the rest of the European Union and have less financial infrastructure to support them.'

JCB (J C Bamford Excavators Limited)

JCB is one of the world's top three manufacturers of construction equipment. It is a family-owned company and was founded in 1945 by J C Bamford. The current Chairman, Sir Anthony Bamford is a family member.

The firm employs around 7,000 people on 4 continents and sells its products in 150 countries.

The Staffordshire-based company saw revenue increase to £2 billion in 2010, compared to £1.35 billion in 2009. Growth was strongest in the 'BRIC' countries and other developing economies, but some established markets, notably the UK and Germany, also performed strongly.

In 2011 JCB invested more than £20 million in modernising and increasing capacity at its 11 UK plants. The company also invested in a new 350,000 sq ft factory in Sao Paulo, Brazil, for the manufacture of backhoe loaders and tracked excavators, which will become operational in 2012. The company has also opened an engine manufacturing plant in India which went into production in 2011.

Source: www.birminghampost.net/birmingham-business/birmingham-business-news/other-uk-business/2011/06/21/sales-up-by-50-per-cent-at-jcb-65233-28910099/#ixzz1mw32ojtV

'A key observation is that in other countries, the sector is not limited to SME firms and includes many larger sized enterprises.'

European comparisons

4.42 International statistical comparisons put the UK in line with other European countries in terms of the overall economic importance of family firms. The European Commission commissioned an Expert Group report on Family Business. This report underlined how across Europe family business forms a strategically vital part of the economic fabric of our economies. The report also drew attention to the diversity of the sector, emphasising that family firms not only cover the full spectrum of industries, but the same applies in terms of size.[71]

4.43 A key observation is that in other countries, the sector is not limited to SME firms and includes many larger sized enterprises. Germany's Mittelstand, of which the majority are family controlled businesses, is perhaps the best example of how family businesses are often leaders in their chosen industries.

4.44 The UK has proportionately fewer large (top 1000) family firms than other main EU economies where family control of large firms is more prevalent in both the quoted and private sector. There is a greater tendency for UK family firm owners to sell the firm (to another company or through a listing – rarely, in the UK, to the employees), rather than retain ownership.[72]

71 European Commission Expert Group 2009 http://ec.europa.eu/enterprise/policies/sme/promoting-entrepreneurship/family-business/family_business_expert_group_report_en.pdf

72 Life Cycle of the Family Ownership: London Business School 2010

Ownership status of largest 1,000 firms in leading EU Countries

This table reports percentages of ownership types for the largest 1,000 firms by sales in France, Germany, Italy and the U.K. in 1996, i.e. the TOP 4,000 sample. Numbers may not add to 100 percent due to rounding. These are the latest figures available.

Ownership types (in percent)	Germany	France	U.K.	Italy	Total
Multiple blocks	4.4%	2.0%	0.3%	2.0%	2.1%
Family	35.9%	38.4%	10.9%	47.9%	33.1%
Foreign	18.4%	20.6%	33.9%	27.6%	25.2%
Other	2.1%	3.2%	2.8%	2.2%	2.6%
State	12.1%	8.8%	1.0%	12.5%	8.5%
Widely held	9.9%	8.9%	27.4%	5.6%	13.0%
Widely held parent	17.2%	18.2%	23.7%	2.3%	15.4%
TOTAL number of firms	**923**	**970**	**980**	**954**	**3827**

(Source: The Life Cycle of Family Ownership: International Evidence, Oxford 2010)

4.45 At the firm level family businesses generally are considered to perform neither better or worse than non-family firms, but they do have characteristics that make them distinctive. For example while on average they tend to be smaller than their non-family competitors in terms of net worth, they have higher levels of retained profits. Arguably the main distinction of a family firm financially is their balance sheet strength with respect to low relative levels of borrowing.

4.46 One consequence of the average low leverage in the sector is that during the recession there were lower comparable failure rates for family firms, as many sector firms had a financial cushion to help them ride through a harsh trading environment they were facing.[73]

4.47 The 2010 Global PwC Family Business Survey highlights family firms' positive confidence in their competitive position. With a supply of surplus cash available to the majority of respondents sector firms are well positioned to take advantage of opportunities for investment and growth.

4.48 SMEs have a higher propensity to invest in innovation[74]; however amongst those firms investing in innovation, family businesses invest less intensively. This is explained by the fact that such businesses have longer time horizons but they are also more conservative and risk averse. Large-scale innovation investments constitute a double-edged sword for firms as they create strong growth-opportunities but at the same time carry a high risk of failure.

4.49 An earlier IFB Report Responsible Ownership (IFB, 2007) highlighted the strategies deployed by successful sector role models to achieve business success. The building blocks that are visible in many of the UK's most successful family firms include:

- Clear and powerfully articulated vision for the family and the firm
- Defined succession planning
- Encouragement of the next generation to prepare for ownership
- Governance structures that have a key role on unifying the family owners and give clarity strategically to the business via the board

73 Nottingham University Business School- 2010 UK Family Business Benchmarking report

74 S. A. Zahra (2005). Entrepreneurial risk taking in family firms. Family Business Review, 18, 23-40; Gómez-Mejía, L. R., Hynes, K. T. Núñez-Nickel, M. and Moyano-Fuentes, H. (2007). Socioemotional wealth and business risk in family-controlled firms: Evidence from Spanish olive oil mills. Administrative Science Quarterly, 52, 106-137; Nicolas Classen, Martin Carree, Anita Van Gils and Bettina Peters "The Role of Family Ownership in Research, Innovation and Productivity of SMEs: A Stepwise Econometric Analysis" mimeo;

4.50 In an IFB report in collaboration with Tomorrow's Company the structure of successful and sustainable family businesses is analysed.[75] The Family Business Stewardship model is described in terms of four different forms of capital, where family capital plays a key role along with people, financial and social capital. The benefits that derive from family capital can include a strong sense of owner's emotional attachment to the business. When this is translated into a clear vision and strong set of values that are shared with the board and management the organisation benefits through having a clear purpose.

4.51 The engagement of family business owners who take an active, interested and involved stance offers good potential for an organisation that is backed by a strongly motivated management who are guided by a clear mission. This is often referred to as the "socialisation" of the organisation and its employees; the best family firms are often good exemplars of this approach.[76]

4.52 Family firms encounter particular problems over business transfer; ownership has to be passed down through the generations of the family for the company to remain a family firm. Government estimates[77]that 100,000 businesses in the UK may be affected by business transfer failure, either closing, or becoming less effective. When businesses fail because of ownership transfer problems, economic capital such as knowledge, established contacts and other intangible assets are destroyed, jobs are lost and economic growth is reduced.

4.53 This is an area of concern for the sector as otherwise sound businesses can fail due to lack of support at crucial times in their development. The IFB would like to see better use of public resources to give owners more information about best practice and also a better partnership between Government and the sector's trade bodies to promote a stronger family business sector.

4.54 And where the next generation does not want to continue the business, the option of an employee buy-out should be promoted – which in the UK is not the place at present.

4.55 A related challenge is management. Primogeniture, a relic from feudal times and the structure of the inheritance tax system strongly favour the transference of businesses to family members and in particular eldest sons. For instance, family-owned businesses in the UK enjoy inheritance tax exemptions of 100 per cent compared to 50 per cent in France and only 33 per cent in Germany.

4.56 However, this bias can create numerous problems: any company that casts its net for talent so narrowly will overlook better potential candidates; while those who expect to take over the company by birthright may invest less energy in acquiring relevant skills than those who earn their position by dint of their own efforts.

4.57 Supporting these concerns, work by the London School of Economics Centre and McKinsey found that management scores were almost 20 per cent lower in family-owned firms run by eldest sons than ones that were professionally managed.[78] It also found that 50 per cent of family-owned businesses in the UK were managed by eldest sons, a striking contrast with Germany and the US where the figure was 30 per cent and 10 per cent respectively.

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75 Family Business Stewardship: IFB and Tomorrow's Company, 2011
76 ibid
77 The UK Family Business Sector pp20-21
78 McKinsey Quarterly (2006) "Who Should and Shouldn't Run the Family Business" Number 3 pp. 13-15.

The German Mittelstand

Introduction

4.58 Family-owned businesses form of the bulk of the Mittelstand, a unique piece of Germany's industrial landscape that drives a significant share of the country's economic activity.[79] Ranging from 100 to 499 employees, these medium-sized firms employ 22 per cent of all employees and account for 21 per cent of Germany's total revenue. Put differently, they employ twice as many employees and are responsible for two-thirds more revenue than medium-sized firms in the UK.[80]

4.59 What makes the Mittelstand special? More than any quantitative definition, firms are distinguished by certain convictions and attitudes reflecting important historical and sociological influences. The very term Mittelstand can be traced to the Middle Ages where the estates or Stande –nobility, craftsmen, traders and farmers- were assigned special obligations. Today it marks out the position of entrepreneurs in society that has obvious affinities with the idea of a middle class but, critically, is infused with pre-industrial significance. These traces still resonate and can be seen in the sense of responsibility that many Mittelstand firms feel towards the local community and region: quite remarkably, 70 per cent of firms are based in the countryside.

4.60 Strong local ties obscure other qualitative aspects that bind Mittelstand firms. Typically firms concentrate on profitable niche markets – often in engineering- for which high quality and customer-specified products are demanded. Karcher (high pressure cleaners), Utsch (license plates), Liebherr (cranes), Viessmann (oil heating systems), Tente (castors for hospital beds), Trumpf (laser cutting), Endress and Hause (measurement and control systems in the food industry) are some of the better documented cases.[81] "Don't dance where the elephants play" characterises the strategy of many Mittelstand firms that seek to insert themselves into supply chains rather than rush into head-to-head competition with the large multinationals: around 90 per cent of firms operate in the business-to-business market.[82]

4.61 With changing cost structures, enabling technologies such as IT and falling trade barriers, many Mittelstand firms have taken advantage of the unbundling and fragmentation of productive activities. Some have pooled the demand of customers across different countries and industries to create economies of scale and scope while others have built up specialised capabilities and knowledge that are unavailable to vertically integrated firms to become better and more efficient in a more defined set of activities. These strategies make Mittelstand firms ever more important in global production networks while inducing industries to push ahead with additional fragmentation, further cementing their importance.[83]

'Family-owned businesses form of the bulk of the Mittelstand, a unique piece of Germany's industrial landscape that drives a significant share of the country's economic activity.'

79 Bernd Venohr and Klaus E. Meyer (2007) "The German Miracle Keeps Running: How Germany's Hidden Champions Stay Ahead in the Global Economy", Working Papers of the Institute of Management Berlin at the Berlin School of Economics/

80 CBI (2011) "Future Champions – Unlocking Growth in the UK's Medium-Sized Industries"

81 "Entrepreneurship and the Ecosystem: The Success of the Mittelstand and the Role of Education, R&D Centers and Government –What was successful in Germany", Friedrich Bornikoel, TVM Capital Presentation May 25 2011

82 "Mittel-management Germany's midsized companies have a lot to teach the world" Economist November 25 2010 http://www.economist.com/node/17572160?story_id=17572160

83 Dan Brenitz (2007) Innovation and the State: Political Choice and Strategies for Growth in Israel, Taiwan and Ireland, Yale University Press

Institutional preconditions

4.62 Worldwide, policymakers and business leaders recognise disruptive innovation as being a driver of growth, looking to emulate high profile examples such as Silicon Valley as the standard model. But Mittelstand firms show that the overall economic significance of this model, as well as its promise in particular situations, can be overstated. Incremental innovation can be at least as or even more valuable than disruptive innovation in glamorous, new industries. However to compete on the basis of incremental innovation means that there has to be an appropriate ecosystem of intermediate institutions to generate such innovation – which rely on trust and nonmarket relationships that mitigate risks such as hold-up and moral hazard that are often association long-term, highly illiquid investments.

4.63 Extensive co-ordination among firms facilitates buyer-supplier relationships, allows collaboration to refine and develop technologies, and encourages joint efforts to create marketing, information gathering and training systems. While such arrangements have the potential to create rigidities that inhibit firms from adjusting to shocks or exploiting new opportunities -drawbacks that became evident in Germany in the early 1990s- they provide the commitment necessary for firms to make continual, uncelebrated yet cumulatively significant improvements to products and processes in order to stay ahead of competitors.[84]

4.64 In Germany, there is such a network of supportive institutions and policies that has breathed life into this logic.[85] For instance, the German dual system of vocational training mixes practical firm-based training and theoretical instruction in specialised colleges. The system works because considerable care is taken to ensure that entry to apprenticeships is rigorous, thereby challenging the prejudice dominant elsewhere that the vocational route is a leftover for the less able. For instance, around two-thirds of an age cohort undertakes an apprenticeship by the time they are 25 and there are regular and sometimes severe problems with over-demand and under-supply.[86]

4.65 Firms have also benefitted from Germany's rich skein of Fraunhofer Institutes that provide both research to develop new, relevant technologies and the advice to help firms throughout the supply chain apply these technologies to their work.[87] While similar initiatives exist around the world, the 59 Fraunhofer Institutes scattered around the country are able to mobilise resources on a much larger and more ambitious scale. Essentially they act as horizon scanners and assemblers of funding packages for the difficult steps in the innovation process – the risky period between inception of an idea but before its commercial applicability becomes probable; their total aggregate budget is around 2 billion euro. As they are highly decentralised, they are particularly effective at catering to the industrial and business strengths of each region.

4.66 The success of the Mittelstand is also attributable to the role of the Kreditanstalt für Wiederaufbau (KfW), Europe's largest 'promotional' bank with a balance sheet of nearly EUR 450 billion which is 80 per cent state-owned. The KfW assists firms across Germany with a mix of traditional loans, investments, mezzanine and export finance.

4.67 Over the decades support for Mittelstand has included the modernisation of both the public savings banks and credit cooperatives through the development of a "three tier" associational banking structure. This has allied local banks with institutions at the regional and national level, thereby helping overcome the scale disadvantages of small size while preserving their comparative advantage in proximity to the customer and local economy. Similarly the banking sectors' long-term lending capacity has been strengthened by offering special tax incentives and exemptions from minimum-reserve

84 Richard Whitley (2002) "Developing innovative competences: the role of institutional frameworks", Industrial and Corporate Change 11(3): 497-528
85 Sigurt Vitols (1997) "German Industrial Policy: An Overview", Industry and Innovation, 1997, 4(1): 15-36.
86 The Wolf Report (2011) Review of Vocational Education
87 Ulrich Schmoch (1999) Interaction of Universities and Industrial Enterprises in Germany and the United States-A Comparison, Industry & Innovation 6(1)

requirements to long-term, mainly fixed-interest household deposits at banks; finally special credit agencies have played a valuable role in long-term finance for the Mittelstand –and have been prominent in guiding and advising banks, including private ones how to lend long-term.

4.68 Germany's eight stock exchanges have established their own markets for Mittelstand bonds. These efforts are still at an early stage of maturity: issues are small and illiquid; there is no true market-making; and few of the issuers have a track record.[88] However, they give firms the opportunity to make a return on investment over a longer time frame and choose likeminded investors, all while maintaining control of their equity. Recent survey data indicates that as many as one in four medium-sized companies intend to issue at some point in the future. The outcome of this experimentation will have important consequences for medium-sized firms elsewhere that have traditionally been frozen out of corporate bond markets. In the UK, the minimum issuance size has hovered around £100m -too high for most medium-sized firms- and been constrained from coming down any further.[89]

4.69 Finally, labour market regulation has had an important bearing on the performance of the Mittelstand.[90] Industry-wide agreements over wages and working condition, significant constraints on employee dismissals and generous welfare benefits have served to compress wage differentials across firms and occupations.

4.70 This has benefitted the Mittelstand since it has a much smaller labour cost gap to close relative to large firms than in other industrialised countries so it can compete for the best new talent on a more equal footing. It also means, given that real wage levels are moderate to high, that mittelstand firms have to compete on quality rather than price. Lastly, extensive rights to promote voice in the workplace provide reassurance that workers' views on sensitive issues such as restructuring and layoffs will be taken into account, thereby increasing employees willingness to invest in firm-specific knowledge which is otherwise of little value, a point we discuss at greater length in the chapter on employee ownership.[91]

Implications for the UK

4.71 The Mittelstand has thus evolved in a specific cultural, economic and institutional context and cannot be transplanted wholesale to other environments. Copying institutions is not a matter of following a blueprint; rather the strength of institutions grows with time, adaptation, their effectiveness as well as their perceived fairness. Nonetheless, there is much that can be learned from the Mittelstand. The fact that Mittelstand-style firms are found in places as diverse as the United States, especially the Midwest and northern Italy suggests that, applied sensibly, parts of the model are replicable.[92]

4.72 The success of the Mittelstand has prompted soul-searching in the UK about the weak standing of its own medium-sized businesses.[93] Clearly the UK has some extremely successful medium-sized firms, which dominate global markets in their field, so the picture is not all doom and gloom: between 2002 and 2007, around 6 per cent of the UK's medium-sized firms (so-called gazelles) accounted for more than 60 per cent of job creation. But the flip side is that many are struggling to grow at all: around 65 per cent of mid-sized firms experience less than 1 per cent per annum employment growth from 2004-2007, and over half had reduced employment by more than 1 per cent per annum over this period.

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88 "Financing Germany's Mittelstand: A crisis-born fledgling" Economist, Nov 3rd 2011. http://www.economist.com/node/21535175

89 BIS (2010) Financing a Private Sector Recovery

90 Rachel Griffith and Gareth Macartney (2009) "Employment Protection Legislation, Multinational Firms and Innovation", IFS Working Paper W10/01

91 Osterloh M., Frey B., Zeitoun H. (2011) "Voluntary Co-determination Produces Sustainable Competitive Advantage", in Sacconi L., Blair M., Freeman E., Vercelli A. (2011) Corporate Social Responsibility and Corporate Governance: The Contribution of Economic Theory and Related Disciplines, Palgrave McMillan

92 Bob Hancke ed. (2009) Debating Varieties of capitalism: A Reader, Oxford University Press

93 CBI (2011) "Future Champions – Unlocking Growth in the UK's Medium-Sized Industries"

'The success of the Mittelstand has prompted soul-searching in the UK about the weak standing of its own medium-sized businesses'

4.73 There is particular scope to close the productivity gap between medium-sized firms and large firms: between 2002 and 2009, the productivity of medium-sized firms grew by an average of 5 per cent, a rate that is much nearer to that of small firms (4.8 per cent) than larger firms (5.6 per cent). If this gap can be closed, medium-sized firms can take advantage of strong tailwinds for further expansion as a larger proportion of them are found in sectors with high productivity growth.

4.74 Lack of global demand and aversion to risk makes it improbable that all medium-sized firms will swiftly become high-growth gazelles. More realistically, many should be aspiring to reach a more productive steady growth trajectory. Rough estimates suggest that raising both the number of gazelles and the productivity of currently stagnant firms could contribute an additional £20bn to £50bn to the economy a year by 2020 - or an extra 0.1 per cent to 0.26 per cent of GDP growth. To achieve the lower estimate, it would be necessary to raise the number of gazelles in the economy by one per cent and assist 25 per cent of stagnant firms to reach a steady state of growth; while to hit the more ambitious target, the number of gazelles would need to be increased by 3 per cent and 50 per cent of stagnant firms successfully helped to a steady state of growth.

4.75 The potential prize is considerable, especially as the Government contemplates ways to rebalance the economy and mitigate the worst effects of the crisis. Medium-sized firms are located in all regions of the UK and employ proportionately more people in parts of the country that have been reliant on the public sector. Likewise, the fact that medium-sized firms derive a larger percentage of revenues from innovation than either smaller or larger firms in theory makes them natural bedfellows with policymakers determined to put ingenuity and knowledge to productive use.

4.76 But for all this, medium-sized firms have been neglected Cinderellas at the policy ball spurned in favour of large firms that collectively account for the highest proportion of revenue and small firms that are collectively the UK's largest employer. Caught between a rock and a hard place, medium-size firms find themselves too big to qualify for initiatives such as the Enterprise Finance Guarantee and reduced corporation tax but too small to enjoy the in-house expertise to negotiate a complex legal and tax environment.

Crafting a policy response

4.77 The CBI in its Future Champions Report calls for reform on three fronts to address this historical neglect:

4.78 First, more should be done to raise the profile of medium-sized firms: recruiting more of their executives to the Prime Minister's Business Advisory Council –at the time of writing, only one member of the council was a medium-sized firm; inviting more medium-sized firms on trade delegations and improving the evidence base on the sector – these initiatives aim to instil a sense of identity and confidence that the Mittelstand offers German firms.

4.79 Second, greater support should be given to medium-sized firms to build up their skills and competencies: establishing a diagnostic along the lines of the British Quality Foundation to allow firms to understand and benchmark their management performance; encouraging large firms to collaborate

with medium-sized firms in their supply chain and even invest in them to the extent that they are well informed about growth prospects of different partner; broadening the scope of R&D tax credit to include innovation-intensive activities such as design; and better targeting of export advice – each of these measure would require significant changes in the way medium sized firms are managed but would put them on a stronger foundation to grow.

4.80 Third, barriers to the supply of finance should be tackled: in part the problem stems from lack of awareness about the funding landscape rather than the lack of options per se; but reinstating a Corporate Venturing Incentive, allowing large firms to deduct the cost of investing in medium-sized from their tax liabilities and taking steps to develop the public debt market for medium-sized firms, including the possible introduction of a new ISA savings type to underpin a retail market for bonds would ensure that a more diverse and tailored range of lending options, whether working capital or growth capital, is available for different needs.

4.81 These are important and feasible initial building blocks but the Commission would go further. Britain needs to develop its own network of intermediate institutions that will provide a better ecosystem in which our middle sized companies can flourish. There are some tentative beginnings. The government has launched four "catapaults[94],- technology transfer centres overtly based on the Fraunhofer example, and aims to create more: while the five large British banks (excepting Santander) have created a £2.5 billion Business Growth Fund aimed at capitalising British SMEs. Similarly there is the beginning of a much more carefully designed and revived apprenticeship programme.

4.82 But none of this is being done with on sufficient scale, sufficient purpose or sufficient sense of permanence. The Business Growth Fund along with a small scale venture capitalist industry supported by generalist banks supplying credit on conventional credit-scoring techniques if a far cry from the German system.

4.83 We urge the Business Growth Fund is further expanded and turned into a greatly scaled up version of the old 3i. We propose the introduction of a Treasury indemnity on securitised new lending to SMEs[95], which will help to accelerate credit flows to SMEs. We propose the establishment of 20 catapaults by 2020 and 40 by 2030. And lastly we note that Britain only trains 2,000 apprentices to level four each year; a vibrant British Mittelstand will require twenty or thirty times that amount.

4.84 In addition there is a strong case for examining the structure of incentives given to different ownership forms, notably the tax advantages enjoyed by debt which particularly impacts on medium sized companies. The Commission recognises that borrowing is central to economic well-being, enabling companies to smooth investment and production in the face of variable sales while shifting risks to those most able to bear them. However the build-up of debt creates dangers: as debt levels go up, so the probability of defaulting increases with borrowers' capacity to repay increasingly sensitive to changes in sales and interest rates. One study finds that once corporate debt goes beyond 90 per cent of GDP, it becomes a brake on growth, producing dangerous levels of volatility.[96] Other arguments further point out that debt bias provides a less direct form of monitoring of management than does equity.[97] Similarly, it erodes the tax base which has become a greater problem with the emergence of hybrid financial instruments and more active international tax planning.[98] Finally, debt bias penalises innovative growth firms which typically face barriers to external debt resulting in too much investment by mature firms and the misallocation of talent.[99] Such arguments have been greatly magnified in the light of the financial crisis.

94 Andersen B, Brinkley I, Hutton W, "Making the UK a Global Innovation Hub", Big Innovation Centre, 2011
95 Hutton W, Peasnell K, "Credit Where It's Due," 2011
96 Cecchetti, S, Mohanty, M and Zampolli, F (2011), "The real effects of debt", BIS Working Papers 352, Bank for International Settlements
97 Ruud A. de Mooij (2011), "Tax Biases to Debt Finance: Assessing the Problem, Finding Solutions" IMF Staff Discussion Note
98 ibid
99 Tirole, J., (2006) The Theory of Corporate Finance Princeton University Press

State owned businesses

State ownership in the UK includes a range of government controlled businesses, assets and public service providers.

Advantages

It is a long standing form of ownership that ensures that maintains a clear link between service providers and taxpayers through elected politicians.

Disadvantages

Publicly owned businesses have sometimes proved to be less efficient than their counterparts in the commercial sector.

Recommendations

Safeguarding the public interest in independently provided public services

The Commission welcomes the principle of introducing enhanced and decentralised autonomy over core public assets in areas like health and education along the lines of foundation trusts, and the experimental introduction of employee mutuals into the public sector. However these should not be seen as transitional means for privatisation in areas the public consider should be run in the public interest like health. The public interest should be protected through asset locks and the ongoing constitutional obligation that forms of governance should maximise public accountability to the full range of stakeholders.

Encourage multi-stakeholding in independently provided public services

The participation of the whole range of stakeholders is essential in public service providers that are spun out of the public sector. Government should encourage Foundation Trust style models of multi-stakeholder ownership to be extended across the public sector where independent organisations are being considered.

State ownership in the UK

4.85 The privatisations of the 1980s & 1990s rapidly reversed this long process, with Government promoted public share issues the preferred model for divestment, in a process that was replicated across the world. This resulted in the creation of a new wave of plcs, which continue in the most part to trade today.

4.86 Initially, many of these plcs held monopolies, but most markets were subject to new competition, which has resulted in sharper price competition in many areas such as telecoms and energy supply, but ring-fenced franchises in others, such as railways and domestic water supplies.

'The Commission welcomes the principle of introducing enhanced and decentralised autonomy over core public assets in areas like health and education along the lines of foundation trusts'

'The process of privatisation of services became synonymous with the creation of new plcs, through an initial public offering.'

4.87 The process of privatisation of services became synonymous with the creation of new plcs, through an initial public offering. Partly, this was driven by the desire to raise capital receipts from the sale of Government owned businesses, but it was also seen as a way to drive better performance and commercial behaviour through this well understood corporate vehicle.

4.88 Only in recent years, with the creation of Foundation Trusts for example, have alternative ownership forms been adopted for the ownership transfer of public sector businesses. The 'default' government choice of transferring ownership through a stock market listing has been a significant factor in establishing the plc monoculture referred to before.

4.89 Apart from some notable actions by Government,[100] the process of continuing privatisation continued until the government intervention in financial services following the 2007 banking crisis, where the Treasury stepped in to re-capitalise the failed plc banking sector. It has been significant, taking £66 billion of public stake in the plc banks. But it was clear from the start that the Government's preferred exit from this situation would be a re-sale of banking shares to the public market – and to return these assets to their former status.[101]

4.90 Today, the Government still retains ownership in a number of commercial businesses, including Royal Mail and Post office Ltd[102], among others.[103] These interests are managed by the Shareholder Executive.

The Shareholder Executive (ShEx)

The Shareholder Executive was set up in September 2003 to work with shareholding departments in Government to improve fundamentally the Government's capabilities and performance as a shareholder.

It is responsible for a portfolio of Government owned or part owned businesses. The businesses include those where ShEx has a clear shareholding mandate or a seat on the board. Its involvement in each business varies across the Portfolio Unit depending on our agreed role and ability to have the greatest impact.

The businesses are actively reviewed through a formal Investment Review cycle as well as ongoing day-to-day monitoring. Key areas of focus include business performance and strategy, management composition and remuneration, financing and, where appropriate, changes in Government's shareholding

100 Such as the nationalisation of Railtrack plc for example

101 So far, however, the only sale of nationalised banking stock, the former Northern Rock plc, has been sold into private ownership led by Virgin Group and its private equity backers.

102 Legislation (Postal Services Act 2011) has recently been passed to part privatise the Royal Mail and to turn Post Office Ltd into a new mutual.

103 www.bis.gov.uk/policies/shareholderexecutive/structure/portfolio-unit

The future of state ownership

4.91 Key questions for the current Coalition Government are around the scope and size of the state and the future provision of public services. Today, aside from the rescued banks, there is no evidence of a Government led agenda for the transferring of the remaining state owned businesses into publicly listed companies.

4.92 The direction of travel for the previous Government from 1997 onwards had been towards more independent, business focused albeit state-funded enterprises. This led to the transfer from state control of more than half of the country's hospital trusts, which are now NHS Foundation Trusts. In education, the link between schools and local authorities has been broken for the many new Academies and Trust Schools and other local government services were transferred into new corporate bodies.

NHS Foundation Trusts

NHS foundation trusts (FTs) were established as part of a wider NHS reform agenda, through the Health and Social Care (Community Health and Standards) Act 2003, which was consolidated into the National Health Service Act 2006.
They are:

- a new type of company, 'public benefit corporations' specific to the NHS;
- authorised and regulated by an independent regulator, (Monitor);
- accountable to their local communities through a system of local ownership with members and elected governors - the governors being elected by the members;
- they can borrow money within limits set by the regulator, retain surpluses and decide on service development for their local populations;
- free from central government control and strategic health authority performance management;
- required to lay their annual reports and accounts before Parliament each year.

There are currently 137 authorised NHS foundation trusts. To date, over 1.7 million individual members of the public and employees of Trusts have joined these trusts as members.

4.93 The Coalition's plans have continued this process of creating independent bodies to provide public services. The Coalition Government's policy agenda[104] has also heralded a rapid growth of new business-like employee owned and community owned providers, created from state and municipal bodies.

104 Coalition Agreement: Our Plan For Government: HM Government May 2010

'We've already begun to see how voluntary, charitable and social enterprises can deliver services efficiently, responsively, cohesively and deploy great innovative strength in public service.'

The Coalition Government's Approach

Speech by Rt Hon Francis Maude MP

It used to be thought that there was a simple binary choice in how public services were delivered. On the one hand they could be delivered by the state; by staff employed directly by a public sector agency. On the other they could be privatised. Outsourced. Delivered for-profit by commercial suppliers.

There's nothing wrong with either model. Both can be brilliantly successful. But the world is opening up. We both need to be and want to be more open to different ways of doing things. We've already begun to see how voluntary, charitable and social enterprises can deliver services efficiently, responsively, cohesively and deploy great innovative strength in public service.

And there's another model now. One that can transform the way services are delivered. That can release entrepreneurial vigour into the economy. And that can transform the lives not only of the citizens that use the services but of the staff who provide them. By forming themselves into a mutual, a coop, (public servants have transformed what they do) spinning themselves out of the public sector, and taking control of their lives and of the services they provide.

17 November 2010

4.94 Since then, the Government has established a Mutuals Taskforce to promote employee ownership of public sector services and a service to help support state employees who wish to spin out their service into an independent employee owned business.[105]

4.95 Another example of the Government's approach is the plan to re-constitute Post Office Ltd as a mutual, which the Commission welcomes.

105 http://mutuals.cabinetoffice.gov.uk/

Post Office Mutual

The Department for Business Innovation & Skills has consulted on proposals to transfer Post Office Ltd into a new mutual.

The mutual would be incorporated as a body constitutionally committed to trading for the public benefit; whose profits are primarily re-invested; and whose assets are protected for future generations.

It would be empowered to enter into contracts with sub-postmasters, multiple post office operators and employees that incentivise and reward their performance.

It would have full power to enter into joint ventures and other commercial relationships. The members (owners) of Post Office Mutual will include those receiving the service (customers and community) and those delivering it (employees, sub-postmasters and multiples). Government will no longer be an owner, but will have a contractual relationship with it.

There are a range of possible mechanisms for membership, including direct open membership, a form of representative ownership via selected individuals, and a trust.

The various constituencies of owners will be represented in the governance through a representative body. The members would meet annually to receive an annual report and accounts, and otherwise when necessary to approve any change to the constitution.

The representative body would comprise a majority of elected representatives of the constituencies of members, and a minority appointed by other interested parties that might include consumer groups, and voluntary or charitable organisations.

The role of the representative body will include contributing to the forward planning of services and strategy, and monitoring the performance of those holding responsibility for delivering the purpose.

The business and affairs of Post Office Mutual will be managed by a board of executive and non-executive directors. Non-executives will be in the majority (Source: Co-operatives UK).

Evidence on the performance of the increased autonomy in the public sector

4.96 Evidence on the performance of autonomous institutions such as academy schools and foundation trusts is inconclusive after taking into account mean reversion effects (i.e. academies) and selection biases (i.e. foundation hospitals).

4.97 The National Audit Office[106] has observed that the desire to roll out academies to very diverse environments along with the pace of expansion may strain the capacities of relevant monitoring/regulatory bodies such as the Young Persons Learning Agency. The experience of foundation trusts is that some measures – a wider mix of non-executive directors, self-certification for regulatory purposes – have certainly energised governance processes; but there remain doubts over whether they have genuinely impacted on core rather than routine issues. Moreover, the aspiration to promote "social ownership" of autonomous organisations remains work in progress.

106 National Audit Office, The Academies Programme, Report by the Comptroller and auditor General, HC 288 Session 2010-2011, 10 September 2010

4.98 Research by the think tank Bruegel found that performance in international university rankings is correlated with institutional autonomy (premised on the use of boards of governors etc). While the evidence is that budgets exert the largest influence on performance, autonomy also enhances the performance universities get from their investments.[107]

Accountability

4.99 Public ownership is often a good thing: it permits assets to be used for the public good without trying to capture every future eventuality in contracts with private suppliers (see below) . Some economic activities will always be provided by the state; we can think of local government or government departments. However, some parts of the public sector have benefitted from giving autonomy over a publicly owned asset and this has worked rather well. Some examples of this are the BBC, NHS Foundation Trusts and Universities.

4.100 State owned enterprises were always considered accountable to the taxpayer via the political control exercised by Parliament through relevant Government Ministers. Once services have been transferred into the commercial sector, this direct relationship is lost. Typically, Government has appointed independent Regulators[108] in order to manage competition between providers and look after the interests of consumers.

4.101 Securing the trust of key stakeholders including customers and employees is critical to the success of any business. Equally critical is that the ownership and governance structure of a business includes effective mechanisms which drive the organisation to continually improve and succeed. This is most easily illustrated in a privately-owned company, where the directors have to account to their shareholders for their performance in running the business, and ultimately can be replaced if that performance is unsatisfactory – in that example, usually because the directors are not delivering a satisfactory return on investment. Effective accountability is a driver of the success of any business.

4.102 In any public service environment, a range of stakeholders can be identified. These will be users, staff, commissioners and a whole range of other partner organisations. Each of these individuals and organisations has, to a greater or lesser degree, a stake in the service being provided. It is important that the providing organisation has the correct relationship with each stakeholder. It may be that there is merely a requirement for information sharing or that it should be a more hierarchical relationship with real decision-making capacity. There is no one size fits all solution for this and each type of service will need to be considered separately.

4.103 Outsourcing creates new challenges for traditional values such as accountability. One argument is that a well-defined contract, monitored and enforced by government, will preserve these values.[109] Clearly activities –for example those that involve routinised or commoditised production like back office processing of data or administering congestion charging – lend themselves to contracting out. They underpin easily specified and measurable outcomes, along with more competition, which fuse the benefits of public accountability with private initiative.

4.104 But where functions cannot be specified in a contract with much precision or escape clear evaluation or cannot only be sourced from monopoly providers, risks emerge. For example, the Public

107 Why Reform Europe.s Universities., Philippe Aghion, Mathias Dewatripont, Caroline Hoxby, Andreu Mas-Colell and Andre Sapir (2007) Bruegel Policy Brief, Issue 2007/04.

108 Across financial services, health, utilities, transport etc.

109 John Donahue (2008) The Warping of Government Work, Harvard University Press

Private Partnership for the London Underground was bedeviled by the challenge of designing efficient and effective contracts that could cope with myriad eventualities, leaving the way open for impossibly difficult wrangling over how to interpret the contracts that ultimately contributed to the PPP's collapse. Profit-maximising private firms often have incentives to reduce costs regardless of the consequences for the non-contractible quality of the public good and its impact on welfare.[110]

4.105 Many public goods exhibit characteristics that conspire against complete contracts. Public service outcomes may take years to be revealed, and even then be very difficult to accurately attribute; while organisations serve more than one goal through the tasks they perform. For instance, providing a good education is much more difficult to define compared to the production of widgets or the supply of electricity. It involves assisting students pass standardised tests but also encouraging a spirit of curiosity and creativity while instilling a strong work ethic.

4.106 The Commission believes that it is important that taxpayer funded public services remain accountable to the public. It is essential therefore that any services that are spun out of state control have adequate mechanisms for the representation of key stakeholders. There are already very good examples of well designed structures that facilitate business efficiency, high quality service provision and meaningful accountability to the public.

4.107 Government should ensure through the combination of an asset lock and strict legal obligations on how public assets are used that no single groups of stakeholders such as employees are able to capture control of service providers without adequate accountability to the public.

'The Commission believes that it is important that taxpayer funded public services remain accountable to the public.'

110 Hart O and Moore J, (1998),'Incomplete Contracts and Renegotiation', Econometrica

Sovereign Wealth

A Sovereign Wealth Fund is a state-owned investment fund composed of financial assets such as stocks, bonds, real estate, or other financial instruments funded by foreign exchange assets.

Advantages
Sovereign Wealth Funds can adopt long term strategies as they are less likely to be under pressure to exit investment positions

Disadvantages
Sovereign wealth funds depend upon the political stability of their sponsoring nations.

4.108 'A Sovereign Wealth Fund (SWF) is a state-owned investment fund composed of financial assets such as stocks, bonds, real estate, or other financial instruments funded by foreign exchange assets. These assets can include: balance of payments surpluses, official foreign currency operations, the proceeds of privatizations, governmental transfer payments, fiscal surpluses, and/or receipts resulting from commodity exports. Sovereign Wealth Funds can be structured as a fund, pool, or corporation. The definition of sovereign wealth fund exclude, among other things, foreign currency reserve assets held by monetary authorities for the traditional balance of payments or monetary policy purposes, state-owned enterprises (SOEs) in the traditional sense, government-employee pension funds (funded by employee/employer contributions), or assets managed for the benefit of individuals.' [111]

4.109 'According to The Sovereign Wealth Fund Institute[112], common Sovereign Wealth Fund Objectives include:

- Protect & stabilize the budget and economy from excess volatility in revenues/exports
- Diversify from non-renewable commodity exports
- Earn greater returns than on foreign exchange reserves
- Assist monetary authorities dissipate unwanted liquidity
- Increase savings for future generations
- Fund social and economical development
- Sustainable long term capital growth for target countries
- Political strategy

4.110 'It is estimated that SWFs control around $ 3 trillion of assets under management. Typically sovereign wealth funds invest in low risk assets – such as highly rated corporate debt and OECD-based blue chip companies – and often in the financial and energy sector at least until the onset of the crisis. This is explained by many sovereign wealth funds' simple goal of preserving national wealth and smoothing national consumption and investments. Among their portfolio of 200 securities, Singapore's Temasek and GIC invest nearly 85% of their funds in the top 25 companies by market cap while 91% of Norway's sovereign wealth fund's investments are in the top quarter of their stocks by market cap.[113]

4.111 'In the run-up to the crisis, there was a widespread anxiety that SWFs might make investments for political and strategic reasons that had little do with securing a commercial gain. Consequently some

111 The Sovereign Wealth Fund Institute, http://www.swfinstitute.org/what-is-a-swf/
112 ibid
113 Christopher Balding A Portfolio Analysis of Sovereign Wealth Funds." SSRN, http://ssrn.com/abstract=1141531, 2008

SWFs were encouraged to sit on the side lines and not participate in issues such as corporate governance. In some cases, this may have denied firms the input and participation of valuable long-term shareholders and contributed to under-performance of firms.

4.112 'In this regard, one significant change over the past few years has been the signing of the Santiago Principles which establishes a framework for sound and transparent governance. Acceptance of these principles by SWFs in some cases has been a precondition for being granted access to additional foreign markets to make investments.

4.113 'It is worth noting that most sovereign wealth funds invest in low risk assets – such as highly rated corporate debt and blue chip stocks – and often in the financial and energy sector (at least, until recently). This is explained by many sovereign wealth funds' long-term goal of smoothing national consumption and investments. Roughly 85% of Singapore's Temasek fund is invested in the top 25 market cap companies out of their entire 200 securities while 91% of Norway's sovereign wealth fund's investments are in the top quarter of their stocks by market.

Case study on sovereign wealth –Temasek

Temasek is a corporation funded by the Singapore government. Its goal is to make returns via Wealth Added, which takes into account dividends, the appreciation of equity and capital investments.

Temasek states that it does not exist to drive the Singaporean economy, though it does make money for the government. It argues that it behaves as any institutional investor. The fund undertakes detailed work on the companies that it holds stakes in, and discusses strategy on a regular basis with management. Their actions do invariably strengthen the companies of Singapore.

The size of the stake Temasek would take in an individual firm varies from case to case, but typically for large listed companies it takes no larger stake than other shareholders would have. Temasek argues that it has influence but no further rights, however in the Singaporean regime, managers of local companies are likely to pay very close attention to the opinions of Temasek, over and beyond its influence as a shareholder.

Some Temasek representatives sit on the boards of major portfolio companies but it is the exception rather than the rule, often historic and coincidental.

Temasek does have a view on executive remuneration in the companies it has stakes in. Alignment of incentives are important and should be long-term.

Temasek can be seen as a dispassionate catalyst. 'Not having to exit the market changes everything, it permits you to be a good owner.'

'The well meaning catalyst doesn't need to go in heavy handed but can make reasonable suggestions, it is easier to persuade if you're talking about observations of best practice, providing a catalogue of things to look at rather than being prescriptive.'

'It is worth noting that most sovereign wealth funds invest in low risk assets – such as highly rated corporate debt and blue chip stocks...'

Employee owned firms

Employee ownership refers to the ownership of a company, directly or indirectly, in part or in whole by some or all of its employees.

Advantages

Employee ownership is associated with at least equivalent - and very often better - levels of business performance and productivity, compared to conventionally-owned firms.
Employee engagement is typically easier to achieve in employee owned companies, resulting in lower staff turnover and absence levels, and higher wellbeing and knowledge-sharing.
Employee ownership facilitates greater long-termism in managerial decision-making and organisational culture.

Disadvantages

Without access to equity investors, wholly employee owned firms do not have access to external capital and raise funds from retained profits and loan instruments.
Employee ownership is impeded by the lack of clear legal models for this ownership form, combined with shortage of professional expertise to advise founders and owners on possible models.

Recommendations

Incentivising Employee Ownership

Employee participation and ownership should be positively encouraged, primarily through increasing understanding of Employee Benefit Trusts, and addressing their current tax inefficiency. A Trust-based model of employee ownership is proven to be the most sustainable, and avoids the downsides of share ownership models, in which employees risk both their capital and their employment in the same business. Tax relief on contributions to Employee Benefit Trusts was abolished in 2003, meaning that profits are taxed twice as they enter and exit Trusts. Tax relief is still available on HMRC-approved Share Incentive Plan Trusts, so long as shares are distributed to employees within 10 years of them being placed in the Trust. We recommend that this 10 year limit is removed, thereby preserving the system of HMRC approval for legitimate Trusts, but enabling businesses to become permanently owned via Trusts on behalf of employees.

A level playing field for employee ownership

A number of further steps can be taken to overcome the disadvantages faced by employee owned firms at critical times in their business lifecycle, including creating taxation and regulatory equivalence with other types of companies, especially at the time of ownership succession.

- Individuals wishing to transfer their shares to an employee trust should be able to benefit from statutory reliefs to take advantage of limiting the tax liability on any gain
- Loans to genuine employee benefit trusts should not be caught by the close company rules that treat such loans as distributions
- A modified form of profit related pay should be introduced, which we call an "Employee Ownership Bonus," targeted towards genuine employee owned companies

A duty to consider employee engagement

There is evidence that greater participation and ownership by employees benefits productivity in business. Companies should systematically disclose their approach to employee involvement, and how they have discharged their obligations to ask employees about such involvement.

Facilitate employee trusts

Awareness and understanding of employee ownership is very limited, beyond the use of employee share ownership schemes. Very few accountants, lawyers, auditors or financiers recognise the model as a basis on which to establish a company or to facilitate the exit of existing owners. We recommend that the Department for Business, Innovation and Skills develops a small number of templates of employee ownership models, and routes to achieving them, which could serve as a starting point for advisors, founders and owners, who are otherwise unaware of options or confused by them. An 'off-the-peg' model of indirect (i.e. Trust-based) ownership, with supporting information on the duties and best practice of Trustees, would further support expansion of this sector. Combined with the restoration of tax relief, we believe that this information could quickly filter into professional advice networks.

About Employee Ownership

4.114 Employee ownership refers to the ownership of a company, directly or indirectly, in part or in whole by some or all of its employees. For the purposes of this section, we are referring to businesses with ownership by a broad cross-section of employees, including rank-and-file employees, generally through a formal plan offered by the employer.

4.115 The Employee Ownership Association adopts the following terms to define different aspects of employee ownership:

- 'Employee ownership'– companies where employees own a controlling stake in the business, ie more than 50%, via a trust, shares, or a combination of the two
- 'Co-ownership'– a wider definition which includes employee owned companies but also those where staff own a substantial but minority stake in the business, say more than 20%.
- 'Employee share ownership' [ESO] – a narrower definition, referring to companies where, although many employees may individually own a direct share in the equity, the combined total they hold may be a very small proportion of the total.

4.116 The Employee Ownership Association's own estimates put the size of the 'co-owned' sector – companies with significant employee ownership – at around £30 billion annually in combined turnover.

4.117 The employee-owned sector comprises an array of differing ownership models. There are three main forms that employee ownership can take:

- direct ownership where employees own individual shares in their company
- indirect ownership where shares are held collectively on employees' behalf, such as in a trust.
- hybrid models, an amalgam of direct and indirect ownership.

4.118 In addition, employees can be owners of a company alongside other owners. The founder may retain an ownership stake, there may be external investors who hold shares in the company, and employee ownership can co-exist with an element of community ownership.

Direct ownership

4.119 Employees can be offered shares in their company. These shares can be gifted, freely offered, or purchased. Owner managers often make the gesture of gifting shares to employees, usually a token amount at the time of an employee buy-out. The owner may apply conditions on these shares, e.g. they must not be sold externally, or should be forfeited on leaving. HM Revenue & Customs provide a tax-

effective vehicle - the Share Incentive Plan – which enables employees to receive free shares or purchase shares in their organisation. Up to £3,000 of shares may be freely offered to employees annually under this scheme, and up to £1,500 of shares can be purchased. Once a qualifying period has passed, the shares can be sold without being subject to income or capital gains tax. Employees can also buy shares directly in their company. This is often used as a way to raise part of the funding required to finance the employee buy-out, although shares can be offered to employees on an ongoing basis. Share purchase by this means does not attract significant tax efficiencies.

4.120 Direct share ownership can be seen to provide employees with a tangible stake in their organisation. Effort can be linked to reward, and the individual employees' stake in the company can be seen to grow as the business succeeds. However, at some point, all shareholders need an exit. Employees may want to leave the company, they may retire or they may die. Exit means that there will always have to be a future purchaser for shares and therefore a need for capital. If the size of direct shareholding is significant, then this can present issues for a business. For this reason, it is more usual to combine direct ownership with some form of indirect ownership

Indirect ownership

4.121 The most common form of indirect ownership is to use a mechanism such as an Employee Benefit Trust [EBT] to hold the shares on the employees' behalf. The Trustees of the EBT represent the beneficiaries; the employees, effectively acting as the shareholders. The EBT does not usually require the payment of dividends on their shareholding. This dividend can be waived and the cash paid out to employees as bonus, or used for the benefit of employees.

4.122 The Trust Deed can be used to reinforce the governance of the company, ensuring that the vision and mission are upheld. The Trust Deed can also be used to define the future of the business. For example, many employee-owned companies use the Trust Deed to protect the business from future asset stripping, or ensure the longevity of the employee ownership, by stipulating that the interests of future employees are considered alongside those of present ones. Many companies use an EBT to hold all the shares. The John Lewis Partnership is owned in this way. An EBT can also be used for share distribution but as there are no tax advantages in so doing; it is more usual to deploy other methods of share sale and purchase which can exist alongside the EBT.

4.123 A number of further steps can be taken to overcome the disadvantages faced by employee owned firms at critical times in their business lifecycle, including creating taxation and regulatory equivalence with other types of companies, especially at the time of ownership succession.

- The first disadvantage applies in stage 1 of the life cycle of an employee owned business: succession, i.e. the transfer from individual to collective employee ownership. In a normal sale of shares to another company, there are various statutory reliefs that the owner can take advantage of to delay or minimise the tax liability on any gain. Such reliefs are simply not available where individuals wish to transfer their shares to an employee trust. Levelling the playing field in this area would remove a major barrier to conversion to employee ownership.
- Stage 2 in the life cycle is the financing of the employee trust. Loans to genuine employee benefit trusts should not be caught by the close company rules that treat such loans as distributions and tax them at a rate of 25%. These tax rules were designed to counter tax avoidance in private companies but end up catching out genuine funding of employee benefit trusts.
- These two changes would achieve a step change difference in the attitude of professional advisers that advise clients on possible routes to exit to the possibility of sale to an employee owned structure.

- The third stage in the life cycle is encouraging and incentivising the employee owners. Here, many employee owned companies cannot take advantage of tax advantaged share schemes available to other companies and this represents a further example of tax inequality. Introducing a modified form of profit related pay, which we call an "Employee Ownership Bonus," targeted towards genuine employee owned companies would be again a way of levelling the playing field.

Hybrid models of employee ownership

4.124 Many companies find a hybrid model, combining direct and indirect ownership, provides a better fit for their needs. The EBT will often hold a majority of the shares, at least 50.1% but usually significantly more, of the shareholding, to ensure stability of ownership in the company and obviate the need to finance significant exit. Tax effective share schemes, such as the Share Incentive Plan, are used to distribute shares to employees. Some employee owned organisations also have executive share schemes in place such as Enterprise Management Incentive plan.

Origins

4.125 The Commission has adopted a broad definition, but believes that a business should only be described as employee ownership once it exceeds 50% of the stock. Therefore, the existence of ESO (common to most companies in the UK) is unlikely to constitute 'employee ownership', by this definition.

4.126 At present there is no 'off the peg' legal model, through which companies can be established or re-established as employee-owned. Founders or existing owners who wish to place their company in the ownership of employees typically have to invent a company form to suit their particular needs, often without much guidance from professional advisers.

4.127 A common reason for a company becoming employee owned is business succession, when owner managers decide to sell the business to their employees. Employee ownership can also result from existing owners opting for this business model, or when a private partnership is looking to broaden ownership to cover most or all employees. The threat of closure or insolvency can lead to an employee buy-out where there remains potential for a viable business. A fresh wave of interest in employee ownership has been unleashed by Government policy to introduce employee owned mutuals into the provision of public services.

The Potential benefits of employee ownership

4.128 Independent research produced for the Employee Ownership Association in 2010[114] identified the following benefits in a study of the worldwide evidence about the impact of employee ownership:

- There are productivity gains from employee ownership, particularly when ownership is combined with participation in decision-making.
- Businesses owned by employees perform as well as businesses operating under other models of ownership
- Employee owned businesses are at least as likely, and sometimes more likely, to survive difficult economic conditions that non-employee owned businesses.
- Employees in employee-owned businesses tend to be more entrepreneurial and more inclined to innovate.
- Employee commitment and job satisfaction tends to be stronger in employee owned businesses

114 Matrix Evidence in 2010 – 'The Employee Ownership Effect'

More productive work

4.129 Most studies have found that employee-ownership has a positive effect on employee productivity.[115] Employee ownership is associated with greater willingness and ability to contribute innovative ideas. Studies have found that production worker influence on innovation in work processes, new products, and marketing did have a substantial and significant effect on the sales-per-employee advantage of employee owned firms, holding firm size constant. In other words, the greater the influence of workers on the company's operations and innovations, the greater the sales per employee.

4.130 One of the most consistent findings of research on employee ownership is that it must be accompanied by additional forms of employee participation, if productivity gains are to be realized.[116] A culture of shared ownership must be fostered, as well as the legal instruments of ownership; yet that culture is difficult to achieve on its own, without also being supported by legal ownership.

4.131 Employee ownership is likely to be especially suitable for small and medium-sized enterprises, often as a path for business succession. Medium-sized enterprises (50-500 staff) rely more heavily on innovation than other firms, and benefit from ownership and governance models that enable them to pursue long-term goals.[117] Employee ownership supports knowledge-sharing in such innovation-intensive industries, and overcomes problems of motivation and commitment.[118]

4.132 In a study for the John Lewis Partnership published in 2010, Cass Business School compared employee owned businesses with non-employee owned businesses in their report Model Growth and produced the following findings[119]:

- The employee owned model offers particular advantages to small and medium sized businesses. Employee owned businesses with fewer than 75 employees do significantly better than non employee owned businesses of the same size measured by both Profit before Tax and Profit before Tax per employee
- Employee owned businesses experienced greater employment growth than their non employee owned counterparts in the period of economic growth from 2005 – 2009 (an average increase in employment of nearly 7.5% per annum compared with less than 3.9% in non employee owned businesses). During 2008-09, employee owned businesses increased employment numbers by 12.9% compared with 2.7% in non employee owned businesses.
- Employee owned businesses are more resilient. Performance is more stable during business cycles, displaying less sales variability. In recession times of 2008-09 the sales growth in employee owned businesses was 11.08%, a significant improvement on non employee owned businesses which produced a growth figure of 0.6%.
- Employee owned businesses add more value to output and human capital than non employee owned businesses. In 2008-09, employee owned businesses improved their value added by 33% whereas non employee owned businesses improved their performance by just over half as much (17%).

4.133 The report found that, despite these benefits, employee owned businesses face more regulatory and policy challenges than non employee owned businesses, and often have difficulties in obtaining favourable finance terms. Lack of specialist support from business advisers during transition is also a problem.

115 ibid
116 Bryson & Freeman (2008) 'How does shared capitalism affect economic performance in the UK?', NBER
117 CBI (2011) Future Champions
118 Michie & Sheehan (1999) 'No innovation without representation? An analysis of participation, representation, R&D and innovation',Economic Analysis: Journal of Enterprise and Participation, 2: 2
119 EOA (2010) Model Growth.

Employee satisfaction and engagement

4.134 Several studies have found that employee owners have more positive attitudes than their non-owning counterparts but it is less clear that this is directly a reflection of ownership itself. For example, Buchko[120] found that while employees did not benefit from simply being owners, they did benefit from the rights that flow from ownership such as increased say in decisions that affect them and their jobs, and from increased rewards for their work.

4.135 Research conducted recently by Napier University Business School found that staff wellbeing in employee-owned firms is higher than that in equivalent non-employee-owned firms.[121] This was conducted by surveying employee-owners and their firms on a range of indicators, such as intention to leave, staff turnover and sick days taken, and comparing this to existing data sets from across the economy more broadly.

4.136 Reduced staff turnover is one clear benefit of employee ownership.[122] One study looked at a US firm, where employee ownership was increasing from 22-80%, and discovered that reported intention to leave the company declined dramatically.[123] This enables employee owned firms to retain tacit knowledge, build trust and avoid the inefficiencies that go with high levels of staff turnover.

'...staff wellbeing in employee-owned firms is higher than that in equivalent non-employee-owned firms.'

Longevity and sustainability of organisations

4.137 Higher survival rates of employee-owned businesses could provide a stronger indication of the benefits to an enterprise of being employee-owned, although it could also suggest a greater commitment to independence or more flexibility in the face of a down-turn. The evidence is limited, but of four studies that provided empirical evidence, two studies found that employee-owned businesses were more likely to survive as enterprises than non-employee owned businesses, and one found that the performance of the employee-owned model is more stable over business cycles.

4.138 One of the main attractions of employee ownership, from the perspective of company founders and family-owners, is that it potentially preserves the identity of a company beyond a single generation of owners. It avoids the disruption and uncertainty that goes with ownership transfers, as encountered by partnerships or private equity ownership.[124]

4.139 Using Standard and Poor's data on the level of employee-owned stock among all US public companies between 1988 and 2001, one study compared the likelihood that an employee-owned business will disappear in a given year with the same risk for all companies and non-employee owned companies matched to employee-owned ones.

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120 Buchko, A. A. (1992a). Effects of Employee Ownership on Employee Attitudes: A Test of Three Theoretical Perspectives. Work and Occupations, 19, 1, 59-78. Buchko, A. A. (1992b). Employee Ownership, Attitudes, and Turnover: An Empirical Assessment. Human Relations, 45, 7, 711-733

121 R. McQuaid – research to be published by the Employee Ownership Association

122 M. Festing et al (1999). Financial participation in Europe – determinants and outcomes. Economic and Industrial Democracy, vol 20 No. 2

123 EOA (2010).

124 For case studies with regard to this point see W. Davies (2009) Reinventing the Firm, Demos

4.140 The hazard rates – the likelihood of not surviving – were lower for companies with more than five per cent of stock owned by employees than for companies with less than five per cent of stock owned by employees. These findings were broadly the same whether the comparison was with the matched companies or all companies. Using a simple measure of whether a company continued to exist several years after the study began, another study also found that employee-owned firms had a higher survival rate than their non-employee owned counterparts.

4.141 It is important to recognize the risk involved in the lack of diversification under employee share ownership schemes, where such models may encourage employees to place too much of their wealth in the company. This was spectacularly evident in the Enron and WorldCom collapses, which saw employees' stock holdings wiped out.[125] This risk is mitigated by the use of share trust vehicles and indirect employee ownership. Firms such as John Lewis Partnership do not require (or permit) employees to invest their own savings in the business.

4.142 One other tension and challenge is that as employee owned firms grow in size and complexity, they lose some of the advantages that make some so effective. Increasing size could put greater distance between front-line employees and senior management while making it more difficult to maintain inclusive decision-making without sacrificing the speed and flexibility. As employee owned businesses grow and scale up their operations, they may introduce more managerial controls and put in place structures that reduce the advantages of employee involvement and participation.

Primary obstacles to employee ownership

4.143 Employee ownership is hampered by a lack of clarity regarding the legal forms which support it and by financial constraints. Companies whose shares are held in trusts, such as in EBTs, are financially dependent on retained earnings and bank loans. However, there is currently low level of understanding of these models amongst banks, and also by professional experts (lawyers, accountants and auditors) who advise founders and managers.

4.144 The tax system currently disadvantages employee ownership and employee buy-outs in a number of ways. EBTs lost their tax advantages in 2003, due to abuses being carried out. However, this now means that companies owned via these trusts are taxed twice on their profits – once when they are paid into the trust, and again when they are distributed to employees. In the absence of tax relief, every £100 of employee trust shares cost £139 in company cash, which is a punitive premium. As a result, fewer employee buyouts can be financed and, of those that do get started, a higher proportion will unravel prematurely.[126]

4.145 The Commission believes that the government could do a great deal to further public and professional understanding of employee ownership, and to create a more level playing field for employee-owners and employee buy-outs, via the tax system.[127]

125 Risk and Lack of Diversification under Employee Ownership and Shared Capitalism, Joseph R. Blasi, Douglas L. Kruse, Harry M. Markowitz

126 N. Mason (2009) A Matter of Trust: How to create more employee owned businesses. Employee Ownership Association.

127 For a fuller description see N. Mason (2009) A Matter of Trust: How to create more employee owned businesses. Employee Ownership Association.

John Lewis Partnership, the Employee Owned Business

John Lewis Partnership [JLP] was set up as a fairer way to do business, a lot of writing, thinking and planning went in to deciding what structural form would best achieve this goal.

The construct eventually formed to achieve this is an Employee Benefit Trust. In this model shares are held very tightly by 4 people in trust for the benefit of employees, which are known in the firm as 'partners'. Employees are referred to as the owners of the business but they do not have actual legal ownership in terms of a share certificate.

All 81,000 permanent staff are partners who own 35 John Lewis shops across the UK, 274 Waitrose supermarkets, an online and catalogue business - johnlewis.com, a production unit and a farm with a turnover of nearly £8.4 billion last year. Partners share in the benefits and profits of a business that puts them first.

- The Partnership's ultimate purpose is the happiness of all its members, through their worthwhile and satisfying employment in a successful business.
- Because the Partnership is owned in trust for its members, they share some of the responsibilities of ownership as well as its rewards: profit, knowledge and power as outlined in its constitution.

Though governed by a trust, JLP is still held in a plc form and is subject to company law. Unlike most companies JLP, has a written constitution which states how the company should be run along its key principles.

First, is a right to profit. Partners have a right to share a dividend called the Partnership Bonus.

Secondly, partners have a 'right to knowledge.' Essentially this means that they have a right to know what is going on within the firm. Thirdly, partners have the right to power – they are able to hold management to account and indeed ultimately have the power to sack the Chair, although this has never occurred to date.

The Partnership aims to make sufficient profit from its trading operations to sustain its commercial vitality, to finance its continued development and to distribute a share of those profits each year to its partners, as well as enabling it to undertake other activities consistent with its ultimate purpose.

Mutuals

The UK mutual sector consists of building societies, co-operatives, friendly societies, and mutual insurers. The majority of members of mutuals belong to these organisations and most of these types of mutual have been around for 150 years or more.

Their purpose is to serve their members, who also participate in the business as customers or producers.

Advantages

Globally, mutuals and co-operatives have been highly successful business models, though the sector is smaller in the UK than elsewhere.

Mutuals contribute to a plurality of business forms. They are designed to engage their owners in the governance of the business, and establish structures that facilitate this.

The different business models pursued by these mutuals provides greater choice and competition for consumers.

This greater diversity mitigates against the systemic risk in the UK economy that is brought about by the dominance of listed companies.

Disadvantages

The demutualisations of the last two decades have led to a loss of corporate diversity thus weakening the plurality of the UK economy.

Mutuals must generate capital for growth from their trading, they have no shares to sell and hence no access to equity markets. This restricts their ability to grow and thus compete with other forms of enterprise.

Legislation governing mutuals is restrictive and requires updating.

Recommendations

Option for permanent mutuals

The mutual form should be re-founded, with a new emphasis on preserving the basic principle of mutual ownership. Mutuals should have the opportunity to choose a legally binding corporate form that enshrines the principle of disinterested distribution, as is common in other EU states.

Updating mutual legislation

Mutuals should enjoy consistent and timely legislative equality. When company law is updated, relevant provisions in mutual corporate forms should automatically be considered for parallel modernisation.

Capital raising in mutuals

New capital instruments are required for customer owned mutuals. These instruments should permit and encourage both individual members and institutions to invest in mutuals. Mutual ownership should be incentivised as much as equity ownership.

- Mutual ownership should benefit from the same incentives as listed share ownership. Tax incentivised savings and investments such as Individual Savings Accounts (ISAs) should be extended to include new capital instruments in consumer mutuals that may be offered to their members.
- The Financial Services Authority should permit co-operatives to issue bonds that may be offered to their members who wish to invest in the business, in a similar way that member certificates are issued by Rabobank in the Netherlands, for example.
- In negotiations with the European Commission on Capital Requirements Directive IV (CRD 4), which governs the access to deposit-taking activities and establishes the prudential requirements institutions need to respect, the Government should support the Building Societies Association & the European Association of Co-operative Banks to ensure that building societies and co-operative banks' particular capital structures are understood and treated fairly, in a regulation that applies across all deposit taking corporate bodies.
- The Government should support the building society sector's case to designate a new core Tier 1 instrument for building societies as a new type of deferred share.
- Mutual insurers and friendly societies should issue bonds for consumers that are invested in holdings that could be of practical use to the economy. This might include investment in long-term capital instruments that support infrastructure projects, or community-based investment projects, or in providing the seed capital that would enable the creation of new mutuals. Government should incentivise this kind of investment by enabling it to qualify for tax-efficient savings such as ISAs.

About Mutuals

4.146 The story of the mutual sector is entwined with the history of UK corporations. The creation of the joint stock company in Victorian Britain was paralleled by the establishment of specific legal forms to permit the registration of corporations that would exist to serve their owner members, rather than stock-holders. Mutuals were established in a deliberate effort to provide an alternative business form.

4.147 From 1850 to 1900, mutuals rapidly came to dominate food retail, mortgage lending and personal insurance business. For many years, these mutuals would continue to grow. So successful would they be, that the simple idea of running a business in order to serve its customers would be adopted around the world. It is outside the UK that this business form has continued to evolve and flourish.

4.148 Since the Second World War, UK mutuals have been eclipsed in size and influence by the public limited company. As local bonds have become less important, larger, capital driven corporations have come to dominate the market place. Hampered by their lack of access to capital, their desire to remain rooted in their founders' communities, and the ever-present threat of demutualisation, mutuals have reduced in significance. Their response has been to consolidate amongst their number, halting decline, but in need of new opportunities.

4.149 Though less influential today, mutuals continue to offer an alternative way of doing business that is particularly well suited to a more socially driven and transparent business world. New technologies offer greater accessibility to mutual structures, as members are able to more easily interact with their businesses.

4.150 As serious questions are raised about the market and capital driven economy, mutuals should be experiencing a new lease of life. As this section shows, this requires a re-embracing of the values that made the sector great. It also requires an overhaul of centuries old rules on capital and legislation governing the sector. By taking action now, we can deliver a new mutualism for the next 100 years.

The Purpose of Mutuals

4.151 To qualify to incorporate as a mutual, the founders must satisfy the relevant regulatory body[128] that their business purpose complies with the terms of the relevant legislative framework.[129]

4.152 All mutuals are established for a shared member purpose, but generally access to their goods or services is open to anyone, as is membership. They are all owned by their members; this ownership is expressed commonly – no individual can take away their 'share' of the assets, unless the mutual bond is broken through demutualisation. There are no equity shareholders and mutuals do not belong to the government.

4.153 The demutualisations that have occurred in the financial services sector illustrate how, once the bond of mutuality is broken, the nature of the business is fundamentally changed. Not one of the demutualised building societies has survived as an independent plc.

4.154 All mutuals operate some form of democratic voting system, with each member valued the same - one member one vote. This contrasts with shareholder owned companies where votes are distributed according to capital ownership. Mutuals adopt forms of representative governance, but these vary between types. For example in a building society, though members elect the Board, the candidates are nominated by the existing Board and include executives, and in a consumer co-operative, Board members are usually elected directly from the customer membership but do not include any executives.

4.155 All mutuals share these features, to a greater or lesser degree, depending on the sector they operate in, their individual circumstances and the distinct purpose of the organisation. The crucial point is that there is no external capital interest or ownership from outside.[130]

In total, there are more than 18,000 mutuals operating in the UK today, turning over a combined £110 billion annually. More than 1 million people work in mutual businesses ranging in size from the largest, the £14 billion Co-operative Group to the smallest community enterprise.

Together, mutuals contain a total of 60 million members; it is calculated that at least 1 in 3 adults in the UK is a member of at least one mutual organisation. Globally, mutuals employ more than 100 million people and have over 800 million members.

Source: The Mutuals Yearbook 2011, Mutuo

4.156 Mutuals in the UK today make up around 5% of economic activity and provide 3.5% of total employment.[131]

4.157 In particular markets, mutuals are more significant. Mutuals account for approximately 8% of food retail trade,[132] and in the financial services industry, building societies account for 19% of mortgage balances and in the market for deposits, financial mutuals hold 35% of cash ISA balances.[133]

128 The Financial Services Authority is responsible for ensuring that registrations of co-operatives, building societies and friendly societies are appropriate.
129 E.g. the Building Societies Acts, Co-operatives and Community Benefit Societies Acts, and Friendly Societies Acts
130 Inevitably, there are a small number of exceptions to this rule, where hybrid structures have been established with external capital provided, such as in the case of Kent Reliance Provident Society (successor to the building society).
131 Mutuals Yearbook 2011, Mutuo
132 The Co-operative Group and Somerfield - £1.565bn acquisition July 16, 2008 http://www.co-operative.coop/corporate/Press/Press-releases/Headline-news/The-Co-operative-Group-and-Somerfield---1565bn-acquisition/
133 Mutuals Yearbook 2011, Mutuo

The mutual sector in numbers 2011

Sector	Number	Members	Jobs	Revenue
Building Societies	47	25,000,000	42,000	3,700,000,000
Co-operatives	3,339	10,290,000	159,000	24,230,000,000
Co-operative Trust Schools	159	-	-	0
Credit Unions	424	808,700	980	39,000,000
Clubs and societies	11,600	7,000,000	20,000	463,000,000
Employee Owned Businesses	250	-	130,000	30,000,000,000
Football/Rugby Supporter Trusts	170	270,000	214	11,000,000
GP Co-ops and Mutuals	34	-	7,500	120,000,000
Housing Associations	1,694	6,727,000	170,410	14,039,000,000
Leisure Trusts	101	-	21,400	739,000,000
Mutuals Insurers & Friendly Societies	56	8,500,000	17,200	7,800,000,000
NHS Foundation Trusts	136	1,900,000	481,060	30,700,000,000
Total	**18,010**	**60,495,700**	**1,049,764**	**£111,841,000,000**

Source: The Mutuals Yearbook 2011, Mutuo

The decline and renaissance of mutual business

4.158 These figures represent great change over the last few decades, prior to which mutuals were more prevalent in British business. The dual effects of declining business performance in the co-operative sector and demutualisation in the financial services sector have been the main factors in leading to a decline in market importance.

4.159 Over the last 50 years, the mutual sector has declined in size. The co-operative dominance of the retail sector, where it had represented over 30% of trade reduced considerably under strong competition from shareholder owned competitors.[134] Factors identified in this include the relative inability of the small scale co-operative businesses to compete in terms of modernisation and capital investment and poor management and weak governance structures driving those businesses.

4.160 In the financial services sector, which had been dominated by mutuals, the growth of the industry opened up opportunities for new entrants and products, and then the more recent demutualisation of large mutuals led to their conversion to stock owned companies and the subsequent shrinking of the sector.

4.161 A Parliamentary Inquiry in 2006[135] concluded that demutualisation in the financial services industry had restricted consumer choice and reduced diversity among financial service providers. Over time, demutualisation pay-outs to members were outweighed by subsequent higher charges, and this experience was particularly stark in the former mutual insurers.

4.162 The current consolidation in the financial services sector led by the Co-operative Banking Group for example, may go towards arresting this trend through mergers and acquisitions.[136]

134 Stuart Eliot, (1983) "The crisis in the Cooperative Movement", International Journal of Retail & Distribution Management, Vol. 11 Iss: 4, pp.8 - 14
135 Windfalls or Shortfalls? The true cost of demutualisation: All Party Parliamentary Group for Building Societies and Financial Mutuals March 2006
136 As noted above, the merger with Britannia Building Society has increased the trading base of Co-operative Financial Services, and at the time of writing, The Co-operative Group is the preferred bidder for the significant portion of Lloyds TSB business that is being sold under European competition rules. The assets to be sold account for a 4.6% share of the UK current account market.

4.163 Less evidently, the societal factors within communities that had given rise to these mutuals declined in importance from 1945 onwards, with community loyalty to particular businesses wearing down over time as consumerism rose. These factors were particularly relevant to locally based mutual businesses. By the late 20th century, it no longer made any sense to people to join something to access basic goods and services.[137]

4.164 Most recently, the decline in co-operative trading fortunes has been arrested and significantly, begun to reverse. The market share of co-operative retail trade has grown from its nadir of 4% to 8% in just ten years, and profitability in the sector, notably led by the Co-operative Group, has doubled.[138]

'The co-operative and the other mutual trading models were highly successful business models. The cost of capital was low, because members did not receive equity distributions out of profits. '

137 Mills, C Funding the Future: An Alternative to Capitalism, Mutuo 2009

138 The Co-operative Group and Somerfield - £1.565bn acquisition July 16, 2008 http://www.co-operative.coop/corporate/Press/Press-releases/Headline-news/The-Co-operative-Group-and-Somerfield---1565bn-acquisition/

Case Study

The Co-operative Group

The Co-operative Group is a unique family of businesses, owned by over six million members, who together have a say in how these businesses are run. Twice a year the members receive a share of the profits that they have helped create, based on how much they have spent with the businesses and how profit has been made in that year.

In 2009 the Co-operative Group acquired the Somerfield business making the Co-operative Food the fifth largest food retailer in the UK and in the same year, The Co-operative Banking Group merged with Britannia creating the most diversified mutual in UK financial services.

The enlarged Group has an annual turnover of £14 billion, with 105,000 employees serving around 20 million customers a week in some 5,000 food, travel, pharmacy, banking and funeral branches and through online shopping.

4.165 In parallel, financial services mutuals fared relatively well through the 2008/9 economic downturn and have shown mutual businesses to be resilient and not in need of the large scale government support provided to the mainstream banking sector.[139]

The Mutual Business Model

4.166 Mutuals tend to be thought of as businesses which have a different ownership and governance structure, but they also operate a different business model. Many mutuals were established as a response to market failure. The starting point for a mutual business is a group of people who do not have access to something. Individually, there is nothing they can do about it; but collectively, by pooling their interests, they can create a sustainable business. By doing so, they create a business operating for the benefit of anybody who wants or needs access to its goods and services.[140]

4.167 The co-operative and the other mutual trading models were highly successful business models. The cost of capital was low, because members did not receive equity distributions out of profits. They might receive a modest level of interest, but that was incidental to the main purpose of the organisation: to provide goods and services to people on a fair basis. Trading surpluses were generally used to build up the business. Prices could be lower, because there were no investors looking for a return.[141]

4.168 The fact that the traditional mutual business model worked is illustrated by history – a building society in practically every town in the country, millions of members of friendly societies, and a share of the retail market equivalent to that of Tesco today. These organisations succeeded because they were able to capture the needs of individuals, and channel them into delivering a viable business – for the benefit of anyone who needed it. They were driven by shared self-interest, not philanthropy. People supported them because that was the best way of securing what they needed.

139 Llewellyn & Michie, Promoting Corporate Diversity in the Financial Services Sector, 2010
140 Mills, C Funding the Future: An Alternative to Capitalism, Mutuo 2009
141 ibid

Accountability & Governance

4.169 What was at the heart of the success of traditional mutuals was the relationship which individuals had with their society, which was often a local business. These were organisations with open membership (so nobody could be excluded), which were owned by their members who were both the customers of the business and providers of its capital. Through the democratic arrangements, those responsible for running the business remained continually accountable to those they were serving. When it works, the mutual model results in a high level of trust between the business and its customers.[142]

4.170 Securing the trust of key stakeholders including customers and employees is critical to the success of any business. Equally critical is that the ownership and governance structure of a business includes effective mechanisms which drive the organisation to continually improve and succeed. This is most easily illustrated in a privately-owned company, where the directors have to account to their shareholders for their performance in running the business, and ultimately can be replaced if that performance is unsatisfactory.

4.171 Ownership by members results in very different governance arrangements from those of traditional business. All members are treated equally, and every member has one vote, regardless of their capital contribution and amount of trade. Members elect representatives to form boards or committees which have responsibility for overseeing the affairs of the mutual on behalf of its members.

4.172 Just as in a company, the board appoints executives to run the day to day affairs of the mutual. In the co-operative sector, such managers are not members of the board or committee: and in lacking any electoral mandate from the members, the executives remain the servant of the elected committee. Boards are usually entirely composed of non-executives.

4.173 In building societies and friendly societies, the executive directors are themselves subject to election to the Board, along with non-executive directors in a process more similar to company board elections, the main difference being that votes are one per member, rather than in proportion to their financial interest.

4.174 In the case of larger building societies some oversight is provided by credit rating agencies and wholesale funding providers, but the incentives for owners, and the ability of external investors, to hold management to account can be more limited than in plcs.[143]

4.175 At the same time as the much more high-profile developments of corporate governance in the PLC sector (the Companies Act 2006, the Cadbury report, Higgs report, and the Combined Code), mutuality has also been going through its own significant statutory evolution and change, via primary and secondary legislation, and the emergence of a number of codes of governance.[144] These adapt the rules for companies to the mutual ownership environment. However, it is notable that much of this has been driven by the sector itself, and government has been slow to legislate for these corporate forms.

'What was at the heart of the success of traditional mutuals was the relationship which individuals had with their society, which was often a local business.'

142 This is supported by public opinion surveys, including the 2010 YouGov/Baber Smith survey
143 Building Society Capital and related issues HM Treasury March 2010
144 AFM, BSA, Co-ops UK

'Whereas public limited companies seek to maximise profits and pay dividends to the external shareholders that own the business, mutuals instead seek to generate benefits for members and customers, for example, by providing more competitive rates on their products, and/or retain excess profits to strengthen their capital base.'

Business Performance

4.176 For many years, there has been a widely held view that mutuals are poor business performers, in comparison with proprietary firms operating in the same market. The evidence for this view is the relatively lower profitability of mutuals compared to share-owned businesses. The conclusion reached has been that mutuals are structurally unable to match the success of proprietary companies because they are not driven to do so by shareholders and that as a consequence their management is less dynamic and more 'pedestrian' in attitude.[145]

4.177 There is indeed evidence that can demonstrate that mutuals, in the past did not achieve the same return on capital employed as their share owned competitors.[146] Whereas public limited companies seek to maximise profits and pay dividends to the external shareholders that own the business, mutuals instead seek to generate benefits for members and customers, for example, by providing more competitive rates on their products, and/or retain excess profits to strengthen their capital base.

4.178 Return on capital employed is only one measure of a firm's success, and is only a measure that works for judging the comparative success of proprietary companies. This is because such companies exist to maximise the return on capital employed – profit is their reason for trading and so they can fairly be judged on how well they have managed to achieve this in their markets.

4.179 Yet this measure is problematic when comparing the performance of mutuals with such competitors. Firstly, these mutuals do not exist in order to maximise a return to reward risk taking investors – their business purpose is to provide a service to their members and customers. They would judge their performance on different criteria such as member satisfaction with their service and often product price.

4.180 Clearly, this does not mean that mutuals cannot suffer from poor management and leadership – just as in any sector, the reality is mixed. A common criticism of mutuals has been that their governance structures are less likely to act swiftly to replace poor managers, and although this may have been a factor in the decline of consumer co-ops, there is scant evidence of this in significant consumer mutual businesses today.

145 Myners Review of the Governance of Life Mutuals, HM Treasury, 2004
146 Report of the Co-operative Commission, 2001

A Co-operative Life Cycle Framework

The Co-operative Lifecycle

Using the example of an agricultural co-operative, the 'co-operative life cycle framework' suggests[147] that a producer co-operative will transition through 5 life phases, until ultimately it is required to either re-invent itself or dissolve.

Phase 1: Economic justification

Co-operatives are established as a result of the failure of the market to deliver required outcomes.

Phase 2: Organisational design

The organisational design of the co-operative constitution tests the scope and degree of member interaction through principal-agent relationships, collective decision making processes, and risk bearing responsibilities.

Phase 3: Growth, glory and heterogeneity

Over time, individual members of a successful co-operative may experience a divergence of interests. A co-operative possessing sufficient financial slack has an opportunity to attempt to appease multiple distributional coalitions in the short run. In the long run, however, this strategy can result in specific costs that erode the competitive advantage of the co-operative organisation.

Multiple opportunities for expansion are likely to be of interest to member patrons. However, each opportunity for expansion into new products or services also has the potential to exacerbate differences in member heterogeneity, polarising the membership.

If co-operative success is generated as a result of member allocated equity investments, without reward to this equity capital, members have an incentive to favour measures which force the co-operative to disgorge dividend rewards.

Phase 4: Recognition and Introspection

As the once healthy consequences of member heterogeneity diminish, the co-operative purpose and direction can become less focused and ill defined thus accelerating a self-reinforcing degenerative spiral. The end of this phase draws near when co-operative leadership presents or membership demands explicit action to remedy perceived and real challenges.

Phase 5: Choice

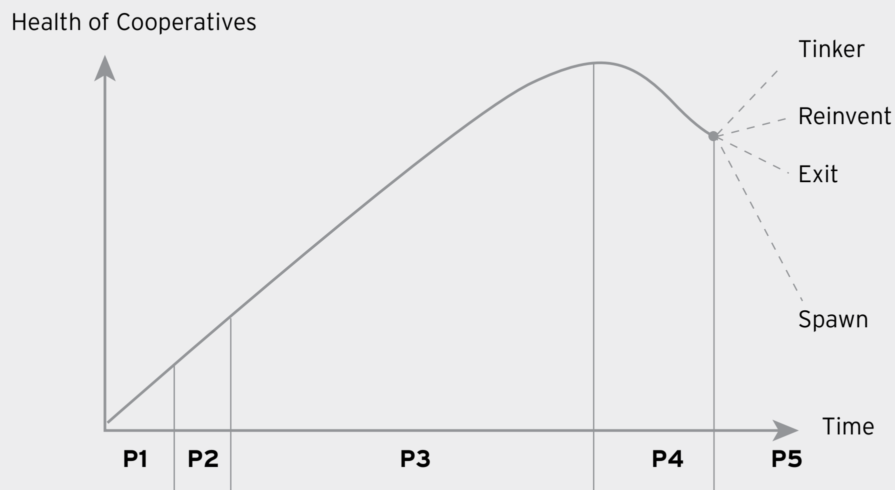
At this stage, if the full range of options is available, the member will choose to either: tinker, reinvent, spawn or exit. This is illustrated overleaf.

Conclusion

There is no overarching hypotheses to fit the widely disparate population of co-operatives. Instead, this framework suggests the relevance of theory and observations to a particular co-operative enterprise may vary depending on the co-operative's economic justification, organisational architecture, bundle of economic goods provided and development phase.

147 Michael L Cook, Molly J Burress, A Co-operative Life Cycle, June 2009

Life Cycle of a Co-operative



Phase 1 = Economic Justification
Phase 2 = Organisation design
Phase 3 = Growth-Glory-Heterogeneity Sarts

Phase 4 = Recognition & Introspection
Phase 5 = Choice

'Multiple opportunities for expansion are likely to be of interest to member patrons. However, each opportunity for expansion into new products or services also has the potential to exacerbate differences in member heterogeneity.'

Access to capital

4.181 Mutuals must generate capital for growth internally, they have no shares to sell and hence no access to equity markets. Ongoing capital in co-operatives consists of retained earnings and bank borrowings.[148]

4.182 The lack of access to external capital is a serious limiting factor on the growth and development of consumer mutuals. It is the direct result of the very nature of these organisations – the introduction of external capital without additional safeguards such as limits on voting rights and distributions, waters down the mutual purpose of the organisation.

4.183 However, the consolidation of business in the financial services sector and retail sectors, the two business areas where mutuals are most prevalent, has led to an inexorable squeeze on the sector. Consolidation between mutual businesses has been the short term response to this pressure and has created a small number of firms of critical size, better able to compete in their markets. But organic growth has remained a difficult challenge without access to new capital.

4.184 Legal limitations prevent many mutuals from raising significant capital sums from their members. Either the nature of the mutual (such as a building society) mitigates against the ability of the society to raise capital from members or specific limits on returns in co-operatives make such practices difficult.

4.185 Retained earnings account for a larger proportion of mutuals' capital. For example, currently, around 68 per cent of the building society sector's capital is made up of retained earnings, while the use of inorganic capital is generally limited to larger institutions, with smaller regional building societies generally capitalised exclusively from retained earnings.[149]

4.186 The building society ownership structure and legislative framework creates unique governance challenges for the sector; members' reserves constitute practically all top tier capital.

4.187 Some external capital instruments do exist. In building societies, over £2bn of deferred shares have been issued in the form of Permanent Interest Bearing Shares (PIBS) – primarily by the largest societies.[150] Unlike some of their counterparts in Europe, UK building societies have principally (although not exclusively) targeted such capital issuance at wholesale investors rather than members. Investors in instruments such as PIBS have limited voting capacity under the 'one member one vote' principle, in contrast to shareholders in a plc.

'Legal limitations prevent many mutuals from raising significant capital sums from their members. Either the nature of the mutual (such as a building society) mitigates against the ability of the society to raise capital from members or specific limits on returns in co-operatives make such practices difficult.'

148 For example, in 2008 the Co-operative Group bought the Somerfield chain of supermarkets for £1.57 billion, and raised much of the capital for this acquisition from bank lending, which is being repaid from retained earnings.

149 Building Society Capital and related issues HM Treasury March 2010

150 Source: KPMG Building Societies Database 2009

Case Study - Kent Reliance Provident Society

Kent Reliance Provident Society, krps is a new mutual organisation formed as a part of the transfer of Kent Reliance Building Society's business to a new bank, OneSavings Bank Plc on 1 February 2011. It is unusual among mutuals in that it has a hybrid ownership structure, with external equity ownership.

It is the parent organisation of OneSavings Bank Plc established with a substantial capital investment provided through J.C. Flowers & Co, a private equity firm. KRPS owns a 50.1% stake in OneSavings Bank, with JC Flowers owning the remaining 49.9%.

OneSavings Bank Plc trades as Kent Reliance, Kent Reliance Banking Services or simply krbs and the business of the former building society, savings accounts and mortgages, have been transferred to it. The membership of the building society, with certain exceptions, has been transferred to the provident society.

The provident society will also operate its own business, taking over some of the new bank's high street outlets and offering a range of its own services to its members.

4.188 Friendly Societies can trace their origins back to the late 1700s, when mutual insurance began to provide security for large numbers of working people. Like other consumer mutuals, the capital accumulated in these firms has been built up steadily and organically from retained earnings. This sector has been particularly affected by demutualisation and consolidation, with many life firms merging and others seeking stock market listings.

4.189 Mutual insurers hold significant volumes of capital: this money invested in equities, property, or gilts. Mutual insurers and friendly societies could issue bonds for consumers that are invested in holdings that could be of practical use to the economy. This might include investment in long-term capital instruments that support infrastructure projects, or community-based investment projects, or in providing the seed capital that would enable the creation of new mutuals. Government should incentivise this kind of investment by enabling it to qualify for tax-efficient savings such as ISAs.

Co-operative Capital

4.190 The mechanisms for funding co-operatives are more restricted than those for companies. It is not possible for co-operatives to have equity share capital, as understood in the company law context, because equity ownership is incompatible with the co-operative principles and would therefore be prima facie unregistrable; and it is not possible for societies for the benefit of the community because distributions of income and capital are not permitted.[151]

4.191 Co-operative societies, like building societies, were historically funded by their members, who were required to subscribe a minimum amount of share capital in order to be afforded full membership rights. This might be built up over a period of time, including by leaving undrawn dividends. Subject to the minimum capital requirements therefore, members were permitted to withdraw funds from their account and share capital was typically withdrawable.

151 The Funding of Industrial & Provident Societies, Mills C, Snaith I: Cobbetts

4.192 One of the consequences of this was that members' share capital remained static in value. Although it was risk capital, in the sense that it could be lost on insolvency in paying debts owed to creditors, it did not give members an undivided share in the value of the underlying business.

4.193 Whilst the co-operative carried on trading, members therefore had no expectation of any entitlement to more than repayment of their original capital. Their real interest was in the continuity of the existence of their society, providing goods and services to meet their needs.

4.194 As a direct result of this approach to funding and ownership, any undistributed surplus was retained as reserves and shown as such in the accounts, and although such reserves constituted members funds for accounting purposes, whilst the society remained a going concern, they did not "belong" in a traditional ownership sense to the members. They were more like assets currently held by the body of members, almost as trustees for the purposes of the society and of future generations. In this sense also, a society does not exist solely for the benefit of its current members.

4.195 An appropriate and sustainable basis of funding is a prerequisite for any business if it is to start up and survive, and the requirements for funding are likely to change or evolve over the life of the business. The restrictions in relation to funding of co-operatives which are created by legislation[152] are therefore fundamental to the future use of the co-operative form, and to the future viability of co-operatives.

4.196 One such provision of co-operative law affecting funding is a £20,000 limit on withdrawable share capital of a co-operative. There are particular situations where this limit causes problems for co-operatives, which are thereby prevented from having access to funds from members in order to invest for the future.[153] It is imperative that this artificial limit is raised.

4.197 There are further regulatory challenges for co-operatives. UK co-operatives are generally incorporated as industrial and provident societies (IPS) and consequently cannot undertake banking business directly. In order to accommodate UK legal and regulatory requirements, in 1971 what was previously the banking department of the Co-operative Wholesale Society had to be separately incorporated as the Co-operative Bank, a wholly-owned company subsidiary of a co-operative; the use of a company subsidiary is necessitated by UK national law and regulations.

4.198 For a banking business which is a subsidiary of a UK co-operative, this means that the bank is currently unable to attract qualifying Tier 1 investments without losing its co-operative nature.

4.199 This has serious consequences for financial service mutuals and co-operatives. Reserves built up from retained earnings are expected to remain the predominant form of capital overall for mutual and co-operative deposit-takers in the UK, yet from time to time some of them will need access to external capital for specific reasons of growth and investment.

4.200 Without additional capital raising instruments that will qualify as Tier 1, mutuals and co-operatives will be disadvantaged. Their business model will force them to retain more of their earnings as reserve capital.

152 The Co-operative and Community Benefit Societies Acts

153 For instance as in agricultural co-operatives but this is also true of the sector more widely

International examples of Mutual Capital

International examples of Mutual Capital

Mutual organisations across Europe raise capital in a variety of different ways. Some types of capital raised in Europe exhibit equity-like features and are available to institutional investors, whilst others are raised directly from members. Crucially, in these examples where capital classes are mixed, demutualisation is not permitted – members by law must retain a majority ownership in the business.

Mutuals in **France** are part owned by their members and have restrictions on raising external capital. The sector tends to operate at a local level (through 'Caisse locale'), whose members' collectively own regional banking institutions called 'Caisse regionale'. In the case of Credit Agricole, the Caisse Regionale own a 55 per cent equity stake of a listed national central body Credit Agricole SA, with the remaining shares owned by the public or Credit Agricole employees. The local institutions (Caisse locale) issue non-listed voting shares exclusively to their members. Regional Banks (Caisse regionale) can issue non-voting shares in two forms: listed shares available to any investor or unlisted shares available to members within Credite Agricole group. 15 out of the 39 regional Credit Agricole banks have issued listed shares. The national central body, Credite Agricole SA, is also listed and can issue shares to any investor. In France there is a cap on co-operative capital remuneration in national legislation. The cap is set annually by the Ministry of Finance and is based on the average return on ''private sector obligations.'' Distributions are not paid up to the full amount of the cap and are variable.

The Italian mutual sector comprises two types of institution, Co-operatives ('Banca di Credito Cooperativi') and Popular Banks ('Banche Popolari'). Generally, co-operatives are small regional institutions and Banche Popolari operate on a larger national scale – together they have around a 20 per cent share of the Italian banking market. Co-operativi can issue quasi-equity shares with variable coupons, however, they still operate on a one member, one vote basis. They are also heavily overseen by the Bank of Italy, who hold the right to make a 'declaration of failure' in crisis scenarios and in doing so prevent any withdrawal of these shares to maintain capital levels. The Banche Popolari can either be listed or unlisted. Unlisted institutions raise capital in a similar way to co-operatives. Listed institutions raise capital through equity, which provides them with permanent capital, although again voting rights are limited and not proportionate to the level of investment.

The **German** financial landscape includes mutual institutions such as Co-operatives and mutual banks (e.g. Sparkassen). Mutual institutions use capital such as 'silent participations' (a non-voting stake in institutions) and co-operative shares to capitalise themselves. Co-operative shares have Tier One status.

Based in the **Netherlands**, Rabobank is one of the largest co-operatives in Europe. It comprises a network of independent banks that collectively form the Rabobank co-operative. Rabobank issues capital in a number of ways including through member certificates (capital issued exclusively to members). The certificates' variable dividend represents the three-month average of the most recent 10-year Dutch State Loan + 1.5%, subject to a minimum of 5%. The total outstanding amount of Member Certificates is EUR 6.3 billion. They are classified as Core Tier 1 Capital.
http://www.rabobank.com/content/investor_relations/funding_programmes/bank_capital.jsp

The **Spanish** 'cajas' account for a significant 50 per cent of the retail market in Spain. Most rely on retained earnings and preference shares for capital. Since 2004, they have however also been able to issue 'cuotas participatives', a form of non-voting equity which are floated on the stock market.

Source: Building Society Capital and related issues, HM Treasury March 2010 (Crown copyright)

4.201 The ability to raise capital from members and listings – with protections on member rights – elsewhere in Europe, raises the question of whether the use of member capital should be considered for the UK mutual and co-operative sector, and if so what form this should take, and what legislative changes might be needed. It also raises the question of whether any of the specific capital instruments in issue in Europe could be adopted in the UK.

European Co-operative Law

4.202 The Statute for a European Co-operative Society[154] established common principles for the basis of registering co-operatives that will trade in more than one EU state. These principles are important as they draw upon the predominant themes for defining and regulating co-operatives across the EU.

4.203 The first big difference between the legislative frameworks prevalent in most EU states and the UK, is a significant issue of principle; the principle of 'disinterested distribution' exists as the norm among mutuals. This acts as a legal barrier to demutualisation by removing the incentive for current members to cash-out the value of the business. In effect, on a solvent winding up, assets and reserves in a mutual entity may only be transferred to another such body pursuing similar aims or to other general interest purposes. The assets cannot be transferred to a different corporate body such as a plc or private company, or distributed to members.

4.204 This type of provision is commonly applicable to co-operatives across many EU jurisdictions, but not available through legislation to UK registered co-operatives or mutuals. As a consequence, mutuals and co-operatives have constructed sometimes elaborate defences against demutualisation. Demutualisations of building societies that have occurred in the UK have been brought about by current members seeking to cash out the value of the organisation (or a proportion of its value) against its intended purpose.[155]

4.205 As has been noted above, demutualisations, particularly in the financial services industry have had negative effects on competition, choice and value. Such events have been avoided in other EU countries by the consistent application of the principle of disinterested distribution.

'Demutualisations of building societies that have occurred in the UK have been brought about by current members seeking to cash out the value of the organisation (or a proportion of its value) against its intended purpose.'

154 Statute for a European Co-operative Society, http://europa.eu/legislation_summaries/employment_and_social_policy/social_dialogue/l26018_en.htm
155 Windfalls or Shortfalls? – The true cost of demutualisation – All Party Parliamentary Group for Building Societies and Financial Mutuals, March 2006

The European Co-operative Society

A European co-operative society[156] (SCE) should have as its principal object the satisfaction of its members' needs and/or the development of their economic and/or social activities, in compliance with the following principles:-

- its activities should be conducted for the mutual benefit of the members so that each member benefits from the activities of the SCE in accordance with his/her participation,
- members of the SCE should also be customers, employees or suppliers or should be otherwise involved in the activities of the SCE,
- control should be vested equally in members, although weighted voting may be allowed, in order to reflect each member's contribution to the SCE,
- there should be limited interest on loan and share capital,
- profits should be distributed according to business done with the SCE or retained to meet the needs of members,
- there should be no artificial restrictions on membership,- net assets and reserves should be distributed on winding-up according to the principle of disinterested distribution, that is to say to another co-operative body pursuing similar aims or general interest purposes.

'...mutuals are used to maintaining a role within the markets in which they were created.'

Attitude to risk

4.206 Mutuals are often regarded as risk averse[157], and this is often traced back to their capital structure and restrictive business purpose. With no pressure from external shareholders to grow the capital value of the business, it is argued that management will be less attracted to diversifying acquisitions, mergers and new business streams. Consequently, mutuals are used to maintaining a role within the markets in which they were created.

4.207 The inability to inject external capital limits the risk appetite of mutuals and thus means that a financial services sector containing a critical mass of mutual organisations will have a spread not only of business models but also therefore of appetites for risk.[158]

Demutualisation

4.208 Since the 1980s, many demutualisations have taken place across a range of sectors – ranging from building societies and insurers to the AA, both of which were member owned. The case for demutualisation was made by those arguing that the change of status from mutual to share owned business would achieve the benefits of 'increasing efficiency, gaining access to capital for expansion; increasing commercial flexibility, unlocking the value of ownership rights and benefits for staff, customers and future shareholders.'[159]

156 ibid
157 Myners Review of the Governance of Life Mutuals, HM Treasury, 2004
158 Michie: Promoting Corporate Diversity in the Financial services Sector 2010
159 Australian Centre for Co-operative Research and Development (ACCORD) www.accord.org.au

The pressure to cash out

The producer co-operative – Ocean Spray

Ocean Spray is a co-operative owned by more than 600 cranberry growers across North America and Canada and over 70 Florida grapefruit growers. It employs more than 2,000 people worldwide.

The co-operative was formed in 1930 by three cranberry growers who shared a common goal of expanding the market for their crops through innovative products. The owners are all producers and suppliers of the raw materials for the company's products and the business is operated for their exclusive benefit. The owners receive shares in proportion to the produce that they supply.

Ocean Spray provides an example of how long term owners may prefer to maintain their long term ownership when faced with the alternative opportunity of cashing out through a trade sale or an IPO. Even so, the potential for de-mutualisation remains the "elephant in the room." Management estimate that, '2/5 of growers would cash out tomorrow, but 3/5 would not, and this is always subject to change.'

For the majority there is clearly a value in retaining control in the co-operative, as long as it continues to serve their long-term interests by retaining its purpose to serve cranberry growers. This has to be balanced against any one-off profit take from a sale.

As a co-operative, however, access to capital for expansion is an issue. There is a current need to invest $100m in N America and $80m for elsewhere. The co-operative could borrow but would need to remain balanced in terms of debt to equity. To invest in distribution or advertising immediately reduces the amount that can be paid to growers, so this is a permanent challenge.

The alternative approach was taken by a similar grower owned co-operative firm - Diamond Walnuts. As the re-named Diamond Foods, it listed in 2005. The stock price went from $15 to $62, it diversified and expanded. Previous owners of the co-operative still supply to Diamond, and are now paid the market commodity rate. This has disadvantaged smaller growers, which get a much lower price than from the co-operative, thus limiting their long term viability.

With the de-mutualisation of Diamond Foods, the long-term relative financial impact of the conversion will depend on an individual member's specific circumstances. If the stock price performed well growers stood to make significant capital gains.

In particular, members with diversified operations may have had more capacity and tolerance for risk than members whose livelihood depended solely on their production of walnuts. Members who were planning to cease growing walnuts soon were likely to find the conversion to be more attractive than those members who expected to produce walnuts for at least ten more years.

'Ocean Spray provides an example of how long term owners may prefer to maintain their long term ownership when faced with the alternative opportunity of cashing out through a trade sale or an IPO.'

4.209 Demutualisation was particularly prevalent in the financial services industry, which has seen radical changes caused by changing regulatory environments, technological innovation and the globalisation of financial system.[160]

4.210 Ten of the largest UK building societies were demutualised, accounting for over 70% of the sector's assets. By 2008, all ten had either lost their independence and been taken over by other banks, or had failed and been taken into public ownership.[161]

4.211 In these cases, the membership was persuaded by management to vote for conversion of their society into a company, resulting in a windfall payment to the members at the time. Until this point, members of mutuals had no expectation of capital gain from their membership – just that they would benefit by receiving services from it.

4.212 The experience of the demutualised building societies is instructive in considering the relative strength of the mutual business model.[162]

4.213 Although management argued at the time that their societies needed to convert into public limited companies in order to have access to the capital markets to be able to compete with high street banks, the result of converting to a company was in many cases, that the business was soon merged into other plcs, resulting in reduced choice of providers for customers, and higher prices.

4.214 It is also notable that in the process of demutualisation, managers enjoyed substantial increases in remuneration,[163] and members received windfall payments out of the reserves which had been built up over many previous generations. Any extra value created in the converted business was paid as a reward to shareholders and not customers, who it can be shown were subject to higher charges that over time outweighed the benefits of windfall payments to members.[164] This is particularly true in the case of the mutual insurance sector.

4.215 The story of Northern Rock[165], is itself salutary in considering the effect of conversion on the business. As a bank, Northern Rock grew exponentially through its new access to external capital and wholesale funding. Once this source dried up, the only option was for it to be nationalised by the UK Government in 2008. It is disappointing that the present UK Government was not able to fully consider the potential for re-mutualising Northern Rock.[166]

4.216 Consolidation has been a feature of the mutual sector for the last 100 years, with the number of mutuals reducing considerably through mergers within specific parts of the sector.[167] Before the advent of de-mutualisation rules as a result of new legislation in the 1980s, mutuals have mostly chosen the consolidation route over the alternative of dissolution.

160 Meador & Chugh, 2006 p.10
161 Windfalls or Shortfalls? The True cost of Demutualisation, All Party Group for Building Societies and Financial Mutuals
162 ibid
163 Shiwatoki, R K (2005) Building Societies' Demutualisation and Managerial Private Interest
164 Welch I, ACCA March 2006
165 The Remutualisation of Northern Rock, Llewellyn D, Michie J & Hunt P, Oxford University, July 2011
166 ibid
167 Britain Made Mutual 2010, Mutuo

Regulation

4.217 As noted above, mutuals are only permitted to register as corporations once they have satisfied the relevant regulator of their qualifying business purpose. This is an active process that has no equivalent for companies.

4.218 The overall regulation of the financial services industry itself acts as a barrier to the growth of the mutual sector. The capital requirements for new financial services businesses are a major hurdle for the creation of any new mutual. The manner in which mutuals raise capital through retained earnings means that without new capital instruments, new financial service mutuals are unlikely to be established.

4.219 Until now, regulation in the financial services industry is that it is made to cover all corporations without distinguishing ownership types, and thus does not take account of the special nature of mutually owned firms. As a consequence, they are forced to respond to a regulatory regime that does not take account of their different capital structure and business purpose.[168]

4.220 The Commission believes that Regulators should seek to create parity between mutuals, co-operatives and other banking entities. Current Regulatory[169] guidelines unfortunately do not accommodate the legal structure of UK co-operatives and amendments are required. In 2011, the UK mutual sector outlined a principles-based approach to future Europe led regulation of mutuals.[170] It argued that such modifications should not be based on existing national peculiarities or special pleadings, but on transparent, existing pan-European principles. The relevant principles are those already recognised in European law in the Statute for the European Co-operative Society, namely limited interest on capital, open membership and disinterested distribution.

168 For a more detailed discussion of this see Shaw & Coles evidence to the All Party Parliamentary Group for Building Societies and Financial Mutuals 2011

169 Capital Requirement Directive 4 & Committee of European Banking Supervisors

170 Modification of the core capital criteria proposed in Annex IV of the European Commission's February 2010 consultation document on CRD 4.

Chapter 5

Recommendations

There is no single magic bullet that will deliver better ownership. What we propose is an interconnected matrix of nudges, new protocols, better processes, the scaling up and deepening of some existing institutions together with the creation of some new ones, new capabilities and strengthened and clarified legal obligations that cumulatively will deliver more plural, engaged and stewardship-oriented ownership. The organising common theme in our proposals is that we want better to link the preferences and interests of the ultimate owner – whether investor, worker or consumer – with the organisation they own.

Our conviction is that if plurality, stewardship and engagement can be strengthened sufficiently then a different self-reinforcing dynamic will be created that will drive better ownership and corporate behaviours. As a general principle no corporate form should be disadvantaged as a result of the particular legislative or regulatory systems under which it trades – and similarly none should be especially advantaged. We have described the benefits of a variety of models and believe that none should be crowded out by tax, regulatory or legal advantages that are not available universally.

It is because good ownership matters that Britain needs its current and future governments to start thinking in terms of ownership policy. What follows brings together our proposals made over the report. It is by no means the last word, but we hope it stirs a long overdue debate.

Plurality

Recommendation 1:

Consistent ownership data

Over the two years we have taken evidence and discussed ownership we have become keenly aware of the paucity of hard data on varying ownership forms. We recommend that the Office of National Statistics systematically collects information about the shares in GDP of varying ownership types – the PLC, family firms, partnerships, co-operatives and mutuals, employee ownership, private equity and foreign ownership – and develops benchmarks with other leading OECD countries.

Recommendation 2:

Ownership impact assessments

The government should initiate ownership impact assessments to investigate the impact of any proposed legislative or regulatory change on the pluralism of ownership types.

Recommendation 3:

Option for permanent mutuals

Britain should reinvent the idea of the mutual, with a new emphasis on preserving the basic principle of mutual ownership. In particular mutuals should have the opportunity to choose a legally binding corporate form that enshrines the principle of "disinterested distribution", as is common in other EU states, so there can never be a benefit from cashing out because the assets must be transferred to another mutual. Mutuals have been something of a corporate Cinderella: they should be brought in from the cold so that for example when company law is updated, relevant provisions in mutual corporate forms should automatically be considered for parallel modernisation.

Recommendation 4:

Capital raising in mutuals

New capital instruments are required for mutuals to allow them to raise external capital otherwise their growth prospects are badly damaged. Mutuals should be able to issue bonds to members, count deferred shares as Tier One Capital if trading as a bank or building society or to raise capital for community/public investment and infrastructure projects. Mutual ownership should be incentivised as much as equity ownership. Tax incentivised savings and investments such as ISAs should be extended to include new capital instruments in mutuals.

Recommendation 5:

Expanding the British 'mittelstand'

Britain needs a much larger and vibrant "mittlestand" of medium sized family owned companies. The Government should explore the cost and feasibility of re-structuring Entrepreneur's Relief to provide greater relief for long term investment in companies. The government should reinstate a Corporate Venturing Incentive to enable large firms to benefit from investing in small firms. We warmly support the creation of the Business Growth Fund, but believe that it should form the cornerstone of a new and much larger institutional framework for channelling equity into the British "mittelstand" and its growth companies. In particular it should become the foundation of a new "3i". We welcome the creation of "Catapaults" (the technology transfer and information centres) but they need to be expanded quickly into a national network along German lines, at least ten times their current numbers. And lastly we note that Britain only trains 2,000 apprentices to level four each year; a vibrant British Mittelstand will require twenty or thirty times that amount.

Recommendation 6:

Promoting investment in SMEs

The Commission supports the introduction of a new Individual Savings Account (ISA) type to help develop a retail market for bonds issued by medium sized business. The government should go further. Bank loans to British SMEs should be rolled together as Structured Investment Vehicles to enjoy a partial Treasury indemnity against default: this would create a new class of high quality bond asset in which such ISAs could be invested and even the Bank of England could purchase. Following the Mirrlees Review we also recommend that the government should move to introducing a rate of return allowance (RRA) so that savers should only pay tax on their equity investments on returns over and above the average.

Recommendation 7:

Ownership of strategic business

The Commission favours continued openness to foreign ownership as part of a diverse ownership structure. However, the government should extend the provisions of the Enterprise Act to define the strategic public interest powers of the Secretary of State. Currently, the Enterprise Act identifies defence, financial stability and aspects of media and news provision as specific areas where a public interest intervention may be considered. The Secretary of State has the power to add to this list, with the consent of Parliament. The Commission believes that the government should be pro-active in considering additional sectors to be of strategic public interest, allowing the government the latitude to make interventions that reflect the public interest.

Recommendation 8:

Equal treatment for debt and equity

There is a case for examining the structure of incentives given to different ownership forms, notably the tax advantages enjoyed by debt. The role of debt has taken on more urgency in light of the economic crisis. The Commission recognises that borrowing is central to economic well-being, enabling companies to smooth investment and production in the face of variable sales while shifting risks to those most able to bear them. The Commission considers that giving relief to equity finance, taxing profits only above the normal return to capital invested is the best way forward.

Recommendation 9:

Safeguarding the public interest in independently provided public services

The Commission welcomes the principle of introducing enhanced and decentralised autonomy over core public assets in areas like health and education along the lines of foundation trusts, and the experimental introduction of employee mutuals into the public sector. However these should not be seen as transitional means for privatisation in areas the public consider should be run in the public interest. The public interest should be protected through asset locks and the ongoing constitutional obligation that forms of governance should maximise public accountability to the full range of stakeholders.

Stewardship

Recommendation 10:

Clarity of business purpose

It is critical that all businesses have a clear and defined sense of their purpose. This will permit investors, management and employees to have a shared understanding of the objective and direction of their firm. Purpose is also closely linked to ownership in that businesses with different end-purposes are likely to have different types of ownership structure. All corporate bodies should make a clear statement of the purpose of their business in their annual report.

Recommendation 11:

Fiduciary obligations of company Directors

Directors fiduciary obligations should be widened so that directors should have a 'duty of stewardship' to deliver this purpose rather than at present simply 'have regard' to any interest other than their shareholders. Directors should be required to declare what they consider is in the best interests of the business if it is to meet its purpose, and for this to have safe harbour standing in law so that they are protected from being challenged over their judgements.

Recommendation 12:

A stewardship obligation

Investment institutions should have a stewardship obligation alongside their fiduciary obligation. The government should consult with interested parties about the extent to which fiduciary duties are too narrowly defined and offer a redefinition to include stewardship responsibilities. As a starting point all institutional investors should be required to sign, comply with and implement the Stewardship code. In particular investment institutions should provide a guide to what returns they are seeking and how they exercise their stewardship responsibilities. This needs to be promoted with the same vigour as the combined code.

Recommendation 13:

More engaged pension funds

Pension funds and other long-term end assets owners should be encouraged to take more long term control over the terms for the management of their beneficiaries' money. Excessive competition for investment mandates, promising immediate improvements in investment performance, exacerbate the already strong tendencies for short termism. One example of such encouragement is the International Corporate Governance Network's Model Mandate Initiative.

Recommendation 14:

London Listing Rules

London Stock Exchange listing rules should reinforce these measures and be rigorously enforced. In particular the United Kingdom Listing Authority (UKLA) should use the powers that it already has to ensure that companies seeking a listing have at least 50% of shares freely traded so that public shareholders are not in a minority with all the risk that entails.

Recommendation 15:

Stock Lending

All institutional shareholders should declare transparently their policy towards stock lending including how much stock was lent and to whom during the financial year.

Recommendation 16:

Transparency of agents

Advisory firms are necessarily oriented to promoting deals and transactions. Boards will be guided by the advice they receive from such firms. In practice advisors will be appointed by Boards on management recommendations. The Commission believes that advisors must be demonstrably the servants of the Board rather than management, and that the bias to recommend a transaction should be out in the open. In particular the Commission calls for:

- Greater transparency in the fees paid to agents that will enable owners better to judge their value for money.
- Remuneration of agents should be independently approved by Boards.
- Potential conflicts of interest should always be declared to owners.

Recommendation 17:

Takeovers in PLCs

Takeover rules should not give an advantage to firms from countries where firms are less strictly governed than in the UK

- The conduct of offeror boards needs to be as effectively scrutinised as much as offeree boards
- There should be greater transparency in the behaviour of institutional shareholders in an offer period
- All company advisors need to be demonstrably independent
- Boards should be legally able to act with discretion as to the interests of the company, and their judgements and recommendations protected by a safe harbour provision
- Takeovers should be subject to tougher rules to prevent market dominance together with a strategic public interest test for foreign ownership

Engagement

Recommendation 18:

Incentivising Employee Ownership

Employee participation and ownership should be positively encouraged, primarily through increasing understanding of Employee Benefit Trusts, and addressing their current tax inefficiency. A Trust-based model of employee ownership is proven to be the most sustainable, and avoids the downsides of share ownership models, in which employees risk both their capital and their employment in the same business. Tax relief on contributions to Employee Benefit Trusts was abolished in 2003, meaning that profits are taxed twice as they enter and exit Trusts. Tax relief is still available on HMRC-approved Share Incentive Plan Trusts, so long as shares are distributed to employees within 10 years of them being placed in the Trust. We recommend that this 10 year limit is removed, thereby preserving the system of HMRC approval for legitimate Trusts, but enabling businesses to become permanently owned via Trusts on behalf of employees.

Recommendation 19:

Facilitate employee trusts

Awareness and understanding of employee ownership is very limited, beyond the use of employee share ownership schemes. Very few accountants, lawyers, auditors or financiers recognise the model as a basis on which to establish a company or to facilitate the exit of existing owners. We recommend that the department of Business Industry and Skills develops a small number of templates of employee ownership models, and routes to achieving them, which could serve as a starting point for advisors, founders and owners, who are otherwise unaware of options or confused by them. An 'off-the-peg' model of indirect (i.e. Trust-based) ownership, with supporting information on the duties and best practice of Trustees, would further support expansion of this sector. Combined with the restoration of tax relief, we believe that this information could quickly filter into professional advice networks.

Recommendation 20:

A level playing field for employee ownership

A number of further steps can be taken to overcome the disadvantages faced by employee owned firms at critical times in their business lifecycle, including creating taxation and regulatory equivalence with other types of companies, especially at the time of ownership succession.

- Individuals wishing to transfer their shares to an employee trust should be able to benefit from statutory reliefs to take advantage of limiting the tax liability on any gain
- Loans to genuine employee benefit trusts should not be caught by the close company rules that treat such loans as distributions
- A modified form of profit related pay should be introduced, which we call an "Employee Ownership Bonus," targeted towards genuine employee owned companies

Recommendation 21:

A duty to consider employee engagement

There is evidence that greater participation and ownership by employees benefits productivity in business. Companies should systematically disclose their approach to employee involvement, and how they have discharged their obligations to ask employees about such involvement.

Recommendation 22:

Improving trusteeship

Given the current part-time and lay nature of trusteeship, there is a vital need for the greater professionalisation and education of fund trustees. This could include a 'trustee toolkit', which would be of particular interest to member nominated trustees and could be promoted through their networks, or where relevant, the underlying trades unions.

Recommendation 23:

Helping pension funds to exert ownership rights

We recommend that serious consideration is given to the establishment of "aggregation platforms," in particular as not-for-profit mutuals, to aggregate or pool the voting rights of individual and institutional shareholders. Essentially shareholders would give the voting rights accompanying their shareholding to the mutual who would engage on their behalf with the companies and other entities in which they invest to promote their long-term value. The pooling of voting rights would give the new platforms considerable more leverage than any individual investment institution; and by charging each member a small fee would create the resource to pay for the monitoring – a business model to ensure better stewardship. Leadership should be initially provided by long term pension funds who should pioneer the development of the new platforms. Individuals with the right skills and credibility employed by the new aggregation platforms should carry out intervention on behalf of corporate owners at senior management and board director level. Making realistic and realisable demands of companies, informed by significant hands-on experience of business management and strategy setting is critical to the good ownership of our public companies. This proposal has the potential to transform the current situation of "ownerless corporations" and achieve significantly improved communication and effectiveness in engagement. It would address environmental, social, governance and strategic issues that are important to pension fund beneficiaries and promote long-term sustainable value by delivering beneficial change at companies and in public policy.

Recommendation 24:

Communicate better with the ultimate investor

It is becoming technologically possible to canvass the opinions of the pension fund beneficiaries and the other ultimate owners directly. We recommend that pilot schemes are developed and, subject to their success, that such consultation becomes the norm.

Recommendation 25:

Revitalising the PLC AGM

We believe that the combination of recommendations '22-23-24' will lead to better engagement and attendance at the AGM. As these changes go forward, we believe that there may be scope for further reforms including:

- Enlarging the capacity for shareholders to put forward advisory as well as mandatory resolutions for debate
- Enlarging the areas and reducing the voting thresholds at which shareholders can introduce such resolutions
- Utilising technology to link back to underlying beneficiaries for voting input/guidance

Recommendation 26:

Encourage multi-stakeholding in independently provided public services

The participation of the whole range of stakeholders is essential in public service providers that are spun out of the public sector. Government should encourage Foundation Trust style models of multi-stakeholder ownership to be extended across the public sector where independent organisations are being considered.

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