



Beyond the crisis: PIRC's manifesto for corporate governance and capital market reform

Introduction

The current financial crisis is unprecedented, and its scale is staggering. Major financial institutions have failed, been taken over cheaply, or survive only because of state intervention, or even public ownership. The value of assets, and the risks attached to them, has been mis-priced by the markets. Those providing investors with assessments of credit-worthiness have failed to provide accurate and timely information. Boards have, in the face of passivity by shareowners, adopted dangerous strategies, and allowed counterproductive remuneration practices to continue. And the precipitous drop in share prices in a number of sectors has put further pressure on the funding of pension schemes.

Many parties and interests have been involved in creating, benefiting from or failing to challenge the types of practice which have helped create the current crisis. And at its heart is the question of governance. This state of affairs poses significant challenges to the future of the public equity markets in the UK, the US and Europe as well as less developed governance markets such as Japan and Asia more generally. In the wake of the credit bubble, attention must now be given to how these markets are to be reformed in order to seek to prevent a recurrence of the failings that have led to this crisis.

The kind of change we have in mind needs to address various challenges: how must corporate governance be reformed to encourage sustainable and socially responsible wealth creation by companies? How can investors, retail and institutional, be encouraged to embrace the proper stewardship of investee businesses that they and their agents have hitherto failed to undertake? And what kind of institutional architecture is required in order for our companies, capital markets and investors to facilitate these kinds of developments?

We are clear that the post-crisis reform agenda must involve both radicalism and pragmatism. At the level of macroeconomic policy, governments have been willing to adopt bold policies to ensure the survival of the banking sector, and to prevent the recession from turning into depression. We believe that corporate governance and capital market reform should be equally fearless. At this early stage it would be

mistaken to be too prescriptive in terms of policy recommendations, but already some obvious reforms do suggest themselves.

We await the Walker Review of bank governance with interest, but believe that market participants also need to make their own views clear. Therefore below we set out PIRC's assessment of the situation, including some of our ideas for reform. Whilst our emphasis is primarily on the UK market, we believe our approach will have resonance in other markets.

The responsibility of boards

Primary responsibility for the failures at financial institutions must lie with the boards of those companies. This was the conclusion, for example, of the House of Commons Treasury select committee's investigation of the Northern Rock collapse in the UK.¹ Yet too much commentary on the banking crisis has overlooked or underplayed the primary responsibility that the boards of banks have for their own failures. It is striking that few directors of failed financial institutions have apologized for what has happened to the businesses under their stewardship, let alone admitted their own responsibility. Whilst it is possible that such contrition results from a fear of legal action if culpability is acknowledged, it nonetheless reinforces the public perception that the financial community believes it is unaccountable to the rest of society.

It is therefore imperative that shareholders and other stakeholders focus attention on the role and responsibility of boards. It was the members of the board of the banks who approved the business strategies and products that have caused such damage. They have failed in their role as stewards of major financial institutions, and as such this must influence investors' views of their directorships of other companies. In particular the need for independent and independently-minded non-executives is greater than ever, since boardroom scrutiny has not been effective in recent history. In addition the necessary skill-sets required need re-stating and monitoring through greater shareholder scrutiny and active oversight. Risks have either not been properly understood, or properly explained. In addition remuneration schemes that may have incentivised inappropriate behaviour have been allowed to be adopted. If there were any lingering misapprehension that a non-executive directorship is a sinecure this must surely have been obliterated over the past twelve months.

Looking ahead, investors and non-executives must work together to prevent such failures occurring again. We agree with the suggestion of UK City minister Lord Myners that institutional investors could, for example, provide training for non-executives and provide guidance on how to properly represent the interests of shareholders.² In future there must also be greater scrutiny of the independence and competence of non-executives and greater accountability to shareholders through annual elections of all directors at listed companies. Also, multiple directorships, particularly for those on the boards of major financial institutions, must be vigorously challenged. PIRC will be looking at the role of the directors of UK banks that have run into serious difficulties, and this will influence our analysis of their directorships at other companies.

1 <http://www.publications.parliament.uk/pa/cm200708/cmselect/cmtreasy/56/56i.pdf>

2 <http://www.ft.com/cms/s/0/6eef3026-b1b0-11dd-b97a-0000779fd18c.html>

Reforming remuneration

The way that directors and other staff within financial institutions are remunerated is an area where investors and others must make a serious attempt at reform. The initial guidance formulated by the Financial Services Authority (FSA) provided a useful framework for financial institutions to use to configure their bonus policy, even if it is rather a restatement of good practice.³ The regulator's subsequent consultation document puts more flesh on the bones and PIRC is supportive of its general direction.⁴ We concur in particular that at present some short-termism on the part of some shareholders, including but not limited to employees with significant shareholdings themselves, has played a part in the establishment and retention of flawed remuneration systems.

There must be a shift towards remuneration policy that rewards long-term value creation, rather than short-term risk-taking. In addition there is emerging new practice that deserves proper consideration. The bonus-malus system adopted by UBS contains features that could be applied more widely, for example.⁶ Similarly moves to insert clawback provisions in respect of bonuses deserve support.⁷ And PIRC also supports greater linkage between long-term incentives and the effective management of so-called non-financial business performance factors such as health and safety, environmental stewardship and so on.

We should also be clear that standard approaches to remuneration have apparently incentivised inappropriate behaviour. For example, in a special audit demanded by its shareholders, UBS acknowledged that its internal remuneration policy made little adjustment for risk, so staff benefited in the short-term despite the fact that positions made could cause problems at a later stage, and as such did not protect the bank's long-term interests.⁸ Such serious failings have emerged despite the fact that remuneration policy has presumably been designed to encourage effort in the interests of shareholders. Therefore a more fundamental review of how incentive pay affects behaviour might be required. As a starting point shareholders could, for example, finance research into the impact of incentive pay on behaviour.⁹

Clearly remuneration policy at financial institutions poses challenges to shareholders since the effects below board level can be equally as important as at board level, as this is often where decisions on the level of risks to be taken originate. The nature of company reporting on remuneration puts the focus on board members with typically very little or no discussion of pay and incentive structures across the company. Therefore there is a compelling argument that further consideration should be given to the rules covering disclosure of information in companies' remuneration reports. In financial institutions remuneration policy below board level should also be disclosed.

3 http://www.fsa.gov.uk/pubs/ceo/ceo_letter_13oct08.pdf

4 See for example Ariely (19.11.08) *What's the Value of a Big Bonus?*, New York Times

5 http://www.fsa.gov.uk/pubs/cp/cp09_10.pdf

6 http://www.ubs.com/1/e/media_overview/media_americas/releases?newsId=158103

7 <http://www.guardian.co.uk/business/2008/oct/31/executive-salaries-bonus-boss-payout>

8 <http://www.ubs.com/1/ShowMedia/investors/releases?contentId=140331&name=080418ShareholderReport.pdf>

9 See for example Ariely (19.11.08) *What's the Value of a Big Bonus?*, New York Times

We recognize that disclosure alone is not sufficient. One could argue that the type of information discussed above was disclosed at Lehmans for example, but that this didn't prevent failure. Therefore the quality of the disclosure made is key. In addition PIRC believes that the balance between variable and fixed compensation needs to be readjusted in the same way as the balance between long and short term needs adjusting. In the US, for instance, we would question whether much of what is allowed to be explicitly referred to as long-term compensation by SEC disclosure rules is any such thing, as performance is measured over less than three years.

Clearly remuneration will also become a much more politically charged issue during the recession. Though the Combined Code refers to the need to be sensitive to pay and conditions of other employees when setting executive pay, in practice we believe this guidance is widely ignored.¹⁰ Therefore there should also be much better reporting of relative pay and benefits across companies, an area where currently limited boilerplate statements are the norm. In the UK the remuneration reporting regulations were subject to a very minor alteration relatively recently.¹¹ However this did not go far enough, and the issue should be revisited. Companies should be required to disclose information on increases in remuneration for directors versus the workforce as a whole, and median pay for both groups. These should be disclosed as ratios. Both corporate governance codes and remuneration reporting regulations should be strengthened to enact this reform.

We also believe that disclosure in relation to directors' pensions must be enhanced. Companies should be required to disclose accrual rates in DB schemes, contribution rates in DC schemes, normal retirement ages, early retirement provisions and any other enhancements. There should also be clear disclosure of any payments in lieu of pension, expressed as a percentage of salary. Companies should be required to disclose any preferential treatment for directors in any of these areas. In addition the broad heads of terms for executive pension arrangements should also be subject to shareholder approval via the remuneration report. It is no longer acceptable that pension provisions can be left to 'private discussions' between the executives themselves and the non-executives without accountability to shareholders.

Finally, a review should be undertaken into the use of shareholder voting rights by institutional investors in respect of remuneration. The UK now has six years' experience of a shareholder advisory vote on remuneration policy. This is enough time to conduct a comprehensive review of both the impact of the vote on executive remuneration (structure, absolute level and in comparison to pay and benefits within the same company) and how shareholders have used the rights in practice.

Auditors

For PIRC, a key principle of good governance is that the statutory audit should be perceived to be a wholly independent process. This depends on independence being beyond reasonable and informed challenge, as opposed to being simply an arguable case. The independence of the auditor is of paramount importance to shareholders,

¹⁰ Supporting principle to main principle B.1

[http://www.frc.org.uk/documents/pagemanager/frc/Combined_Code_June_2008/Combined%20Code%20Web%20Optimized%20June%202008\(2\).pdf](http://www.frc.org.uk/documents/pagemanager/frc/Combined_Code_June_2008/Combined%20Code%20Web%20Optimized%20June%202008(2).pdf) Times

¹¹ See point 4. http://www.opsi.gov.uk/SI/si2008/draft/ukdsi_9780110806303_en_26#sch8

both in respect of individual companies and in terms of audit's public policy function of ensuring investor confidence in financial reporting. Although the auditing profession has long had ethical guidance on objectivity, this has not been sufficient to prevent significant public and regulatory concerns.

During the financial crisis, there has been some speculation about the independence of the auditors at the banks. The argument has been made, for example, that independence might be compromised by the involvement of auditors in securitisation and other non-audit work. Certainly this is an issue that deserves exploration, and PIRC has carried out some initial analysis of disclosures made by UK-listed banks in respect of auditor fees in relation to securitisation and other non-audit work.

Our own analysis has shown that banks' disclosures do not provide a great deal of detail on non-audit work.¹² However, the reports of two banks – Northern Rock and RBS – specifically highlighted work on securitisation. In addition it is notable that in the majority of cases UK-listed banks have paid considerable fees to their auditor for non-audit work. We share the view expressed in the Treasury select committee's report on the failure of Northern Rock published last year that this creates a conflict of interest.¹³ In fact the level of non-audit work carried out for banks by their auditors often falls foul, in our view, of best practice in this area.

Two reforms that should be considered here are greater prescription in terms of the disclosure of non-audit work carried out by auditors, and the introduction of a shareholder advisory vote on the audit committee's report.

Other corporate governance models

There are broader implications from the financial crisis in terms of the governance model for companies. The recent boom in leveraged buyouts was clearly in large part driven by the availability of cheap debt. However we should not overlook the attractiveness of the private equity governance model to some directors. In this model, directors work with one or two large investors, instead of having to deal with numerous dispersed shareholders and their intermediaries, many of whom have only a basic knowledge of the business and a number who have no long-term interest in its success. This is not to argue that the private equity approach, at least the leveraged buyout model, does not itself have serious potential flaws, but rather that it does have governance features that are worthy of further exploration by investors.

Similarly we might also question whether the UK should seriously consider the idea of employee representation in one form or another within the governance structures of listed companies. We note Lord Myners' recent suggestion that employees or their representatives could feed their views into remuneration policy discussions.¹⁴ Employee representation could provide another form of oversight, and is common in many other developed economies. Given the apparent flaws in a purely investor-focused approach to corporate governance, we believe it is right that all options are considered. As a starting point, BERR should carry out a consultation to seek views on how such employee representation might be structured.

¹² See PIRC submission to Treasury select committee - <http://www.pirc.co.uk/publications/Selectcomm.pdf>

¹³ <http://www.publications.parliament.uk/pa/cm200708/cmselect/cmtreasy/56/56i.pdf>

¹⁴ http://www.hm-treasury.gov.uk/speech_fsst_120309.htm

Regulators and regulatory architecture

As a result of the financial crisis, the role and responsibilities of regulatory authorities also requires proper consideration. Again the select committee's report into the Northern Rock failure provides valuable insight. The larger part of the report was given over to the regulatory oversight of Northern Rock before and during the crisis. The committee identified that the Financial Services Authority (FSA) had "systematically" failed to ensure that Northern Rock did not pose a systemic risk and also failed to engage with the company early enough.

The FSA has already acknowledged that mistakes were made, and has sought to revise its approach.¹⁵ The Turner Review certainly represents a real step forward in financial regulation, and a welcome turn away from the previous 'light touch' regime.¹⁶ However PIRC believes that an important missing piece in the regulatory architecture is a focus on corporate governance within the FSA. The FSA should consider developing a new arm within the regulator that understands and addresses corporate governance and ownership responsibilities. In addition we believe there is a strong case for improving investors' representation in the governance of the Financial Reporting Council (FRC) itself, charged as it is currently to oversee the UK Combined Code on Corporate Governance. Better still the FSA could amalgamate the FRC into a single companies regulator. It could be given wide ranging powers of intervention and market intelligence gathering and much more draconian powers of 'stop and search' amongst market practitioners and company directors.

Whilst it is right that there is scrutiny of the role of regulatory authorities and reform of their structure, PIRC is concerned at the continuing tendency of the financial sector to apportion blame to regulatory authorities as a way of avoiding culpability. In the Madoff case, for example, there has clearly been regulatory failure, but investors ought to be able to expect that institutions to which they pay substantial management fees will undertake effective due diligence on their behalf. The failure of investor oversight is, to us, in many ways a much more fundamental concern. We therefore concur with comments by the FSA's chief executive about the need for shareholders to engage more effectively with investee companies.¹⁷

Shareholders as 'owners'

It is an assumption of market-driven approaches to regulation, corporate governance and company law in the developed capital markets that shareholders will act in their own self-interest to ensure investee companies are properly run, provided they have the tools to do so. Yet the current crisis demonstrates that this assumption has flaws. Some shareholders do take their ownership responsibilities seriously, others, even amongst the largest investors, do not.¹⁸ The principal-agent problem in corporate governance does not solely affect the interaction between a company's management

¹⁵<http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/2787050/FSA-chief-admits-to-Northern-Rock-errors.html>

¹⁶ http://www.fsa.gov.uk/pubs/other/turner_review.pdf

¹⁷ http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2009/0311_hs.shtml

¹⁸ See for example views expressed by fund managers in *Owners, traders and providers of capital: the multiple faces of institutional investors*, CBR Working Paper 296, December 2004

and its shareholders, it also arises in the asset manager-asset owner relationship. Many asset owners, such as pension funds, in theory have a long-term interest in the success of investee companies. However the fund managers they appoint are judged on their ability to deliver returns over a relatively short timeframe, and as such their focus may not be on governance and stewardship.

Therefore one major issue that must be tackled is the nature of share-ownership. Whilst there has been an upsurge in interest in policy circles in the idea of shareholding as a form of ownership, arguably market practice has developed in a rather different direction. Recent work by the business think tank Tomorrow's Company has been useful in seeking to add more detail to the 'shareholder as owner' idea, but there is more to be done.¹⁹ In particular consideration needs to be given to the potential tension between the policy and oversight role large investors play as notional owners, and some of the investment policies adopted by some shareholders.

Stock-lending and shorting

For instance, many long-term shareholders such as pension funds loan their stock out to other market participants who are often only interested in short-term market movements. These same pension funds have also increased their investment in hedge funds, typically paying significant fees in the process, in the search for 'alpha' or out-performance. In many cases hedge funds employ shorting, a tactic which has become increasingly controversial as the financial crisis has developed. Though pension funds may not be directly involved in shorting, they may be linked to the practice through their stock-lending activity. The very act of lending means the long term shareholders share the interests of the short term shareholders. They both derive income from the deal. The Makinson Cowell work for the Shareholder Voting Working Group and the International Securities Lending Association's own report demonstrated that institutions are frequently lending stock to prime brokers who then lend on to funds that short a stock which the original lender may hold or even be overweight in.

These are not straightforward issues to resolve. Pension funds do earn income from stock-lending. On the other hand, some funds argue this is counter-productive if the stock is shorted and returned at a lower value, or having undermined the investee company. Views also diverge on shorting. Some suggest that it allows valuable negative sentiment to be expressed, which can help prevent asset price bubbles.²⁰ Others assert that shorting has failed to prevent bubbles, and claim that it may only exacerbate downward spirals in prices and a loss of confidence in the companies whose shares are being shorted.²¹

These questions deserve proper analysis. A number of years ago, in the wake of the bursting of the dot-com bubble, mathematician Benoit Mandelbrot proposed in a book on financial market volatility that Wall Street firms be required to fund research

¹⁹ <http://www.tomorrowcompany.com/news.aspx>

²⁰ See for example *Bubbles in Experimental Asset Markets: Irrational Exuberance No More*, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=287097

²¹ <http://www.independent.co.uk/news/business/comment/jeremy-warner/jeremy-warner-a-shortselling-ban-that-should-be-extended-1223073.html>

into market behaviour.²² Although not enacted, we consider this a very practical proposal, and one which could be applied more widely. Detailed research should be undertaken into what impact shorting has. This should be a very wide-ranging review, considering not only factors such as liquidity and market efficiency, but also trading costs, the impact on company management, investor sentiment and so on.

PIRC believes that too much of the technical analysis of shorting focuses on admittedly important questions, such as liquidity, but fails to properly address the broader concerns raised. For far too long any attempt at proper discussion of these issue has been restricted by industry interests repeating the mantra that such activity is necessary for liquidity and market efficiency. Yet as the Turner Review argues “regulatory approaches should be based on striking a balance between the benefits of market completion and market liquidity and the potential disadvantages which may arise from inherent instabilities in liquid markets.”²³

Research into these questions could be funded by market participants, perhaps through a small levy on hedge funds which employ the tactic. Turning to regulatory policy, we also strongly support the FSA’s decision to extend the period of the public disclosure of major short positions by market participants.²⁴

In tandem it would be helpful to review the costs and benefits attached to stock-lending by long-term investors such as pension funds. Some have made the point that by making so much stock available to lend, long-term investors like pension funds have made borrowing it very cheap, and the income they can derive from it is therefore limited. Given the mounting policy questions around lending, we welcome Lord Myners’ announcement that he has asked the FSA to look at the issue.²⁵ PIRC believes any review must examine the impact of lending on shareholder rights. Pooled omnibus accounts are there to reduce processing costs for banks but their use obscures the reconciliation of votes cast by investors. The reduced processing costs for banks may or may not be passed on to investor clients but as custodial fees are not itemised investors are not in a position to judge. In addition consideration must be given to the tax treatment of stock lending, which has been tax free up till now. Whether this kind of activity can continue to be called ‘investment’ is a moot point, and tax-exempt investors such as pension funds may face a change in the law.

Pension fund governance

And what of the governance of investors themselves? For pension fund trustees the questions that must be asked are challenging: how far was there an unrealistic pursuit of ‘alpha’? Rightly or wrongly, many fund managers still consider that they are put under pressure by pension fund clients to deliver short-term performance regardless of the long-term consequences. Were trustees also unrealistic about the returns available from less understood asset classes such as hedge funds and private equity, and unaware of the extent to which leverage was driving apparently

22 See Mandelbrot and Hanson (2004) *The (Mis)Behaviour of Markets*, London, Profile

23 http://www.fsa.gov.uk/pubs/other/turner_review.pdf

24 <http://www.fsa.gov.uk/pages/Library/Communication/PR/2009/001.shtml>

25 See Lords Hansard 13th January 2009.

<http://www.publications.parliament.uk/pa/ld200809/ldhansrd/text/90113-0002.htm#09011350000373>

impressive performance? And what kind of scrutiny were their asset managers exercising in terms of the risks inherent in bank business strategies? In short, how much were pension fund trustees and their advisers cognisant of their responsibilities as the debt bubble expanded, and then burst?

Many of these issues require exactly the sort of competence and judgment amongst trustees that the Myners review process has sought to develop. We believe that the review process has been very beneficial in terms of fund governance. However in the wake of the crisis we believe that new work needs to be done. A sub-group of the Investment Governance Group (IGG) should be created to consider how the crisis has hit pension funds, and whether better practice could have mitigated the damage done.²⁶ We would recommend that this include a particular focus on how pension funds have addressed ownership responsibilities, either directly or via their appointed fund managers. It should also consider to what extent funds and their advisers have assessed investments in alternative asset classes, and what kind of scrutiny and due diligence completed when participating in fund-raising.

This begs the question as to how far the Myners process has actually led to a new generation of trustee knowledge and understanding. In our view the time has come for the Government to introduce an investment law to make explicit new responsibilities of stewardship and engagement for institutional investors: this could enshrine and make explicit some of the more implicit recommendations of the original Myners Review. Such a reform could encompass the introduction of a 'do no harm' clause into each pension fund's Statement of Investment Principles, as recently recommended by the TUC and others.²⁷ Enforcement could be carried out by establishing a collective reporting and monitoring body. In the UK the IGG may have a role to play here. Certainly there is a pressing need to make clear, once and for all, that there is a fiduciary duty for institutional shareholders to act like good owners.²⁸

The state as a shareholder

Recent Government policy must also be considered. The fact that the British taxpayer effectively part-owns much of the UK banking system raises significant governance issues. Whilst some investors have not reacted positively to the Government taking an ownership stake in a number of banks, it should be noted that existing shareholders did not themselves play an active role in the governance of those companies whose share collapse led to the Treasury's recapitalization plan. PIRC welcomes the framework document published by UK Financial Investments, which gives taxpayers some idea of how the organisation will address its ownership responsibilities. We also welcome the confirmation that UKFI will publicly disclose its voting record.²⁹ PIRC believes that there is a strong case that voting intentions by fiduciaries are disclosed before the relevant company meeting, as is the case with large responsible investors like CalPERS.

²⁶ <http://www.thepensionsregulator.gov.uk/jgg/index.aspx>

²⁷ <http://www.tuc.org.uk/pensions/tuc-15845-f0.cfm>

²⁸ See John Bogle's recent speech for further exploration of this idea. <http://johnbogle.com/wordpress/wp-content/uploads/2009/03/iacompliance1.pdf>

²⁹ See the statement at www.ukfi.gov.uk

We do not rule out the possibility that businesses with a Government shareholding will benefit from having a large, committed, long-term investor. Some will of course retort that politicians will only meddle, and do damage to the underlying businesses, but in response we have to pose the question whether the laissez-faire, dispersed ownership model is capable of outcomes that are at least as bad. We are where we are, after all, in part as a result of such a hands-off approach. Governance analysis of businesses that include the Government as a shareholder will need to reflect these tensions.

We would also highlight the fact that the Government now finds itself a part-owner of a number of asset management businesses. We believe that the Government should review the extent to which the asset managers it part-owns adhere to best practice as set out in reports and guidelines such as the Myners Review, and ISC guidelines on shareholder responsibilities and disclosure of voting records. These investors also have an influence over remuneration at investee businesses, including financial services companies, so the voting records of these asset managers should be reviewed. We also see no reason why the Government should not compel the disclosure of full shareholder voting records by asset management businesses it part-owns where this is not currently the case.

Disclosure of voting records

Taking this last point further now would be a good time for the Government to re-visit the issue of public disclosure of shareholder voting records more generally. PIRC's own initial analysis of some investors' voting in respect of the banks demonstrates that institutional shareholders appear to have given them a clean bill of health – including in respect of remuneration policies – at AGMs that took place just a few months ago. Yet even today some large asset managers refuse to make their voting decisions available, despite the clear public interest in how shareholders have engaged (if at all) with the banks in the run-up to the crisis. The Institutional Shareholders Committee has apparently not published any analysis of the current voluntary disclosure, despite being requested to do so by Autumn 2008. In practice asset managers which do not disclose voting data ignore the ISC's guidance to provide an explanation for this position. As such we believe that the case is overwhelming for the Government to exercise the reserve power taken in the Companies Act 2006 and make public disclosure mandatory.³⁰

Conclusion

The ideas we have outlined are by no means an exhaustive list of policies. They are informed by our own experience of working with investors, companies, regulators and policymakers over many years, and in recognition of both good and bad practice that currently exists. We issue this manifesto to stimulate debate and spark further ideas, but most importantly to begin the process of pulling together the kind of radical but realistic policy reforms that we believe are necessary. We welcome comments and responses from any interested parties.

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³⁰ http://www.opsi.gov.uk/acts/acts2006/ukpga_20060046_en_77#pt44-pb2-11g1277